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SECTION 1. THE MONETARY AND BUDGETARY SPHERES

1.1. The Monetary and Rate Fixing Policy

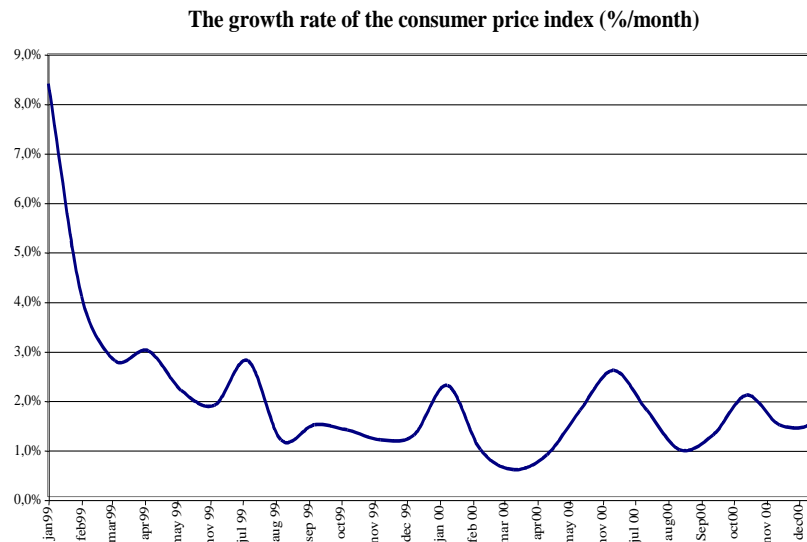
An overview of the monetary policy and the inflationary processes in the Russian economy

The monetary policy of the Central Bank of the RF in the year 2000 was characterized by a considerable restraint despite the fact that during that year there were certain periods of accelerated money supply caused mainly by the necessity to launch additional rouble interventions on the currency market on the part of the Bank of Russia in order to accumulate the currency to be sold to the Ministry of Finance of the RF thus enabling the latter to effect payments on the foreign debt of the RF.

In general, during the year 2000, a certain stabilization of the inflation rate was evident within the range of 1-2% per month (see Figure 1.1). The tendency toward a gradual reduction of the rate of price increase which had first appeared in the second quarter of the year 1999 and continued till March 2000 when the growth of the consumer price index was 0.6% per month. The seasonal price rise in January 2000 (up to 2.3% per month) turned to be relatively small¹; such low price growth rates had been previously recorded only twice: in 1997 (2,3%) and 1998 (1.4%).

¹ The changes in weekly price indices provide some reasons to question the validity of the monthly estimates of the inflation rate.

FIGURE 1.1



Source: the State Statistics Committee of the RF.

Nevertheless, in the following period the fluctuations in the inflation rate intensified, and in June 2000 the highest monthly growth rate of the consumer prices for the whole year was recorded. The consumer price index for this month was 102.6 % (in July 1999 - 102.8 %). The observed acceleration of the inflationary processes could have had the following reasons. Firstly, in April and May were becoming manifest the consequences of active currency issuing that had been going on since January 2000 and was associated with the accumulation of the gold and foreign exchange reserves by the Central Bank of the RF. In the absence of a liquid government securities market, the capabilities of the Bank of Russia to sterilize the growth of the money supply were extremely limited. Secondly, as the real incomes of the population go up and the arrears of wages decrease, the demands limits become weaker, and

the structure of the relative prices changes in the consumer prices toward an acceleration of the price-rise rate in the categories of goods outside the group of the essential commodities. Thirdly, the catching-up increase of the nominal production costs caused by the growing fuel prices and the rates of the services provided by natural monopolies was intensified by the fact that in the year 1999 the growing prices of certain categories of consumer goods, social services and regulated tariffs were significantly lagging behind the growth rate of the general consumer price index, partly for political reasons (the elections to the State Duma and of a number of heads of the RF's subjects). In the year 2000 this gap started to narrow.

It is necessary to point out in this connection that in the absence of financial markets, the lag of the acceleration of price growth behind the start of the increase in money supply becomes shorter. While in the period from 1996 through the first half of 1998 this lag was approximately 9 months², in the years 1999 and 2000 it became smaller. We do not have any precise assessments of the lag in the post-crisis period because the number of observations is not large enough to apply statistical methods. Nevertheless, our estimates suggest that in the years 1999 and 2000 its length was between 2 and 4 months.

In the second half of the year 2000 the rate of inflation went down. By the end of the year the price rise stabilized at the level of 1.5-1.6 % per month. We presume that apart from the seasonal factors some more fundamental reasons came to the fore in late summer and early autumn.

² See the report "The problems of modeling financial indicators: the prices, the exchange rate, the interest rates and the stock exchange index in the Russian economy" written at the first stage of a joint project carried out by the IET and the US Agency for International Development (www.iet.ru).

Firstly, stabilization and even a certain strengthening of the nominal rouble rate has been observed for a long period of time. Simultaneously, there occurs a growth of imports and of the share of foreign goods in the commodity turnover. Lower devaluation expectations produce a stabilizing influence on the consumer prices. Secondly, the sufficiently rapid growth of industrial production and a favourable situation in the fiscal sphere are not directly followed by an increase in the real incomes of the population. This situation leads to stronger limitations imposed on the price rise by the demand level, despite a rather large-scale monetary expansion. Thirdly, the increasing real money balances in the economy are reflected mainly in the growth of the funds kept by commercial banks on their correspondent and deposit accounts with the CBR and do not exert any pressure on the consumer market.

According to the results of the year 2000, the annual inflation rate was 20.2% (or approximately 1.55 % per month). The dynamics of prices in different groups of commodities in 2000 was significantly different from that of the year 1999. While in 1999 the greatest rise was demonstrated by the prices of food and nonfood commodities, in 2000 the highest growth rate was typical of the prices of services which rose by 33.7 %, whereas the rise in the price index of food and nonfood commodities was 17.9 and 18.5 %, respectively. This is the evidence that the real rouble rate has been growing (measured as the ratio of the price level reached by tradeable goods to the price level of nontradeable goods).

When characterizing the inflationary processes in the Russian economy in the year 2000, it is necessary to point out that, firstly, for the second consecutive year one can clearly observe a monetary-inflation cycle depending on Russia's foreign debt repayment schedule (that is, an accelerated price rise in June-July and in September-October - a few months after the Central Bank of the RF

had activated the efforts to accumulate foreign currency). Secondly, the influence of the seasonal factors is smaller than in the years 1996-1998. In particular, the periods of accelerated inflation at the beginning of the year, as well as the corresponding deceleration in late summer-early autumn, have become shorter. The traditional acceleration of inflation at the end of the year has not been registered. Thirdly, producers' prices were rising at priority rates (by 31.7% per year) which created the preconditions for the rate of inflation to remain relatively high on the consumer market also in the year 2001. Thus, as early as January, 2001, the consumer price index rose by 2.8 %, while in February some preliminary estimates were placing it at the level of 2.6-2.8%.

The targets and instruments of the monetary policy

In accordance with the Major Guidelines on the uniform monetary policy of the government for the year 2000 developed by the Central Bank of Russia, the main goal of the monetary policy in 2000 was to decrease the inflation rate and at the same time to keep at the existing level or, if possible, to accelerate the growth of the GDP. The Bank of Russia has confirmed its decision to further pursue its ongoing policy of preserving the floating exchange rate. At the same time, no target values were set for the declining exchange rate of the rouble or its end-of-the-year level. The document specified that the dynamics of the rouble exchange rate would depend on a set of factors, the most important of them being the changing trade balance and the problem of regulating the external debt. According to the forecasts of the Bank of Russia, a rather contradictory influence exerted by these factors was to produce, most likely, a decline in the rouble exchange rate.

The principal aims of the exchange rate policy as defined by the Central Bank of the RF for the year 2000 were, among others, to

level the current considerable fluctuations of the rouble exchange rate and to maintain the gold and foreign exchange reserves at a level that would ensure some confidence in the monetary policy and guarantee the stability of the Russian monetary and financial system. Special emphasis was placed on the necessity to improve the existing mechanism of compulsory reservation and its normative base, as well as on expanding the volume of operations conducted by the Central Bank of the RF on the open market as well as the volume of deposit transactions with commercial banks. The policy of the Bank of Russia in 2000 as regards the interest rates was planned only in an indirect way - through controlling currency issue and the operations on the open market, though because of the slow development of the domestic government securities market these measures could have had only a limited importance.

The virtual absence of a liquid government securities market has significantly narrowed the instrumental capabilities of the Central Bank of the RF, primarily those of short-term liquidity management. The Bank of Russia continued its operations on the open market only in the form of rouble and foreign exchange interventions on the foreign exchange market. Thus, the volume of new government short-term bonds issued in the year 2000 was approximately 13.2 billion roubles (approx. 2% in relation to the wide monetary base in the middle of the year 2000), while the total turnover of all government short-term bonds and federal savings bonds on the secondary market did not exceed 3-5 billion roubles. In these circumstances, deposit operations were the only instrument that the Central Bank of the RF had at its disposal for the money supply sterilization. Another instrument for sterilizing the money supply could be the accumulation of the funds on the Federal budget's accounts owing to the surplus of the Federal budget balance, i.e. money withdrawal from circulation through taxes and nontax reve-

nues of the budget.³ During the first eleven months of the year 2000, the increase in the balances of the Federal budget's accounts rose to more than 64 billion roubles. By early December 2000 the total volume of money withdrawn this way from the economy had reached 103.8 billion roubles. Nevertheless, in December 2000 the balances of the Federal budget's accounts declined by 19 billion roubles.

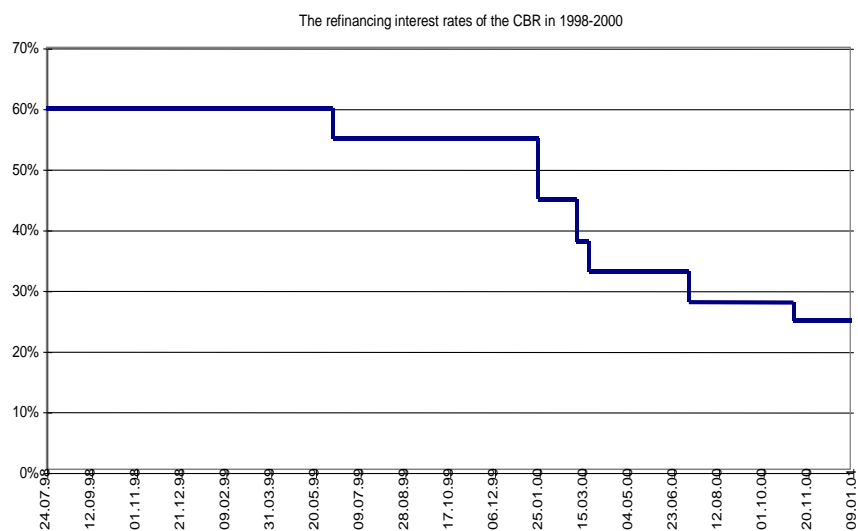
In the year 2000, the Bank of Russia in fact did not pursue the policy of compulsory reservations. The latest change (increase) in reserve requirements, with the purpose of solving the short-term problem of weakening the attack on the rouble took place in the winter of 1999-2000. From January 1, 2000 the norm of the prescribed reserves for the outside funds of legal persons was set at the level of 10%, and for the outside funds of natural persons, at the level of 7 %.

The refinancing interest rate of the Central Bank of the RF in the years 1999 and 2000 became even more symbolic than in the pre-crisis period. The suspension of repo operations and overnight refinancing of primary dealers deprived the refinancing interest rate of any features typical of the payment rate for the use of borrowed resources. Its role as a profitability-restricting measure at the secondary distribution of government securities by tender (the limit

³ It is necessary to point out that the possibility to use the balances on the budget accounts for changing the volume of the monetary base is a peculiarly Russian feature. For example, the USA system of accumulation and use of the budgetary funds is structured in such a way that any increase in the balance of accounts or any spending of the funds does not change the monetary base. In Russia, as both the revenues and the expenditures go from the Federal budget's accounts (not included in the monetary base) to the budget users' accounts with the commercial banks via their correspondent accounts with the Central Bank of the RF and vice versa, the value of the wide monetary base alters in the process of taxpaying and effecting budgetary expenditures.

was equal to the dual refinancing interest rate) had some importance only during the first few months after the restoration of the GKO-FSB (federal savings bonds) market. Subsequently, the level of profitability on the market was much lower than the refinancing interest rate.

FIGURE 1.2



Source: the Central Bank of the RF.

During the years 1999-2000, the Bank of Russia was repeatedly reducing the refinancing interest rate from 60% to 25 % per annum (see Fig. 1.2). Nevertheless, its dynamics generally followed the trend of the growth rate of the consumer price index, both in the level of interbank credit rates and on the government securities market. Thus, on January 24, 2000 the rate was decreased from 55% to 45 % per annum. On November 4, 2000 the Central Bank of the RF fixed it at the level of 25 % per annum. It was the lowest refinancing interest rate in the three recent years (since November, 1997). At the existing rate of inflation, the real refinancing interest

rate is negative, but nevertheless it is higher than the level of profitability on the GKO-FSB market as well as of the rates on the rouble interbank market.

The main aim of the monetary policy for the year 2001 as specified by the CBR is "gradual easing of inflation" to the level announced in the law "On the Federal budget for the year 2001", that is to 12% per annum, while the real GDP will grow by 4-5% per annum (The Major Guidelines on the uniform monetary policy of the government for the year 2001). The Bank of Russia expects that in 2001 the upward tendency in the demand for money will be preserved, while the money velocity will go down. According to the forecasts of the CBR, in 2001 inflation will amount to 12-14 %, while the money supply M2 will increase in the course of this year by 27-34 %.

The main instruments in achieving this aim will be represented by operations on the open market (the Bank of Russia is going to expand their application by issuing its own bonds and by marketing government securities into which are to be converted the GKO and federal savings bonds "frozen" in 1998 and belonging to the CBR), as well as by deposit operations. As far as the exchange rate policy is concerned, the Central Bank of Russia expects to preserve the use of the flexible exchange rate regime.

The money supply

The dynamics and the nature of the money supply in the year 2000 were characterized by a number of specific features to be considered later in the text. They include:

- 1) A strong influence exerted by the situation on the currency market and by the currency supply;
- 2) An increasing backing of the monetary base by the gold and foreign exchange reserves;

- 3) Changes in the structure of the monetary base and accumulation of surplus reserves within the banking system;
- 4) A diminished value of the monetary multiplier;
- 5) Rationing of credit;
- 6) A reduction of lagging of inflationary processes' acceleration behind monetary expansion.

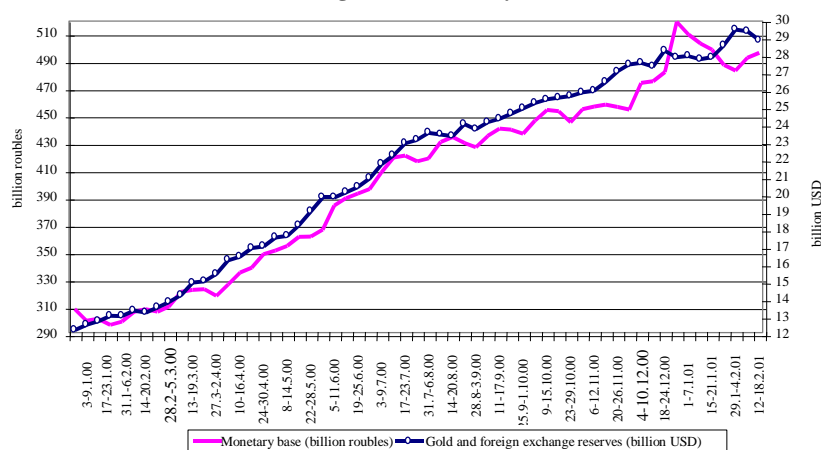
As proceeds from Figure 1.3, in the course of the year 2000 one could discern three periods with a relatively different dynamics of the money supply; January-March - a moderate monetary policy; April-August - a monetary expansion; September-the first half of December - a reduction in the growth rate of money supply. From the second half of December 2000 the fluctuations of money supply became more intensive. Thus, in December 2000, on the threshold of an increase in demand for liquidity to be used in effecting payments and in striking the annual balances, the Central Bank of the RF was forced to activate the emission which resulted in the growth of money supply and in the increase of balances on the correspondent accounts of the commercial banks. Afterwards, the growth rate of money supply decreased, but nevertheless the considerable volume of the rouble funds, firstly, made it possible to preserve the interbank interest rates at a sufficiently low level, and secondly, provoked an attack on the rouble in the last week of the year 2000. Despite the increase in the rate of interest on deposits in the CBR and the growth of the gold and foreign exchange reserves, the Central Bank had to spend more than 500 mn USD in order to stabilize the currency market.

This inconsistency in the monetary policy is explained not only by the political factors dealing with the reshuffles of the Government of the RP but by some fundamental reasons as well. For example, as we have already noted, the rising of the growth rate of the monetary base has a certain seasonal cyclic nature dealing with the

unevenness of repayments on foreign loans from month to month. In spring and autumn, when Russia effects most of her payments on loans, the CBR accumulates currency for crediting or selling it to the Ministry of Finance of the RF, and the growth rate of the monetary base increases. Apart from this, the preservation of the 75 % norm of the compulsory sale of currency receipts at the monetary exchange and the absence of effective instruments of sterilization resulted in a rapid growth of the money supply in the year 2000.

FIGURE 1.3

The dynamics of the monetary base and the gold and foreign exchange reserves in the year 2000



Source: the Central Bank of the RF.

As we have already noted, the main source of the money supply in the Russian economy in the year 2000 was represented by the inflow of export receipts transformed into roubles through the mechanism of compulsory sale of 75% of the receipts at the monetary exchange. As the volume of imports was relatively small (the export surplus for the first three quarters of the year 2000 amounted to approximately 44.5 billion USD), the compulsory sale of currency receipts implied a significant rouble issue which was not com-

compensated by the purchases of currency secured by import contracts.⁴ We estimate that the gross volume of issue for the first three quarters of the year 2000 reached 520 billion roubles (75 % of the currency receipts minus imports, or 18.2 billion USD). It is clear that in order to obtain a correct appraisal of a non-sterilized issue resulting from the CBR's transactions on the currency market, it is also necessary to consider the movement of funds on the accounts dealing with capital transactions and financial instruments. But in order to appraise the volume of issue, much attention must be paid primarily to the volume of currency sold at the exchange in the framework of compulsory sale of export receipts. An indirect evidence of the fact that the supply of currency on the domestic market considerably exceeded the demand for it (all the external operations are also taken into consideration) is the growth of the gold and foreign exchange reserves of the CBR.

In the year 2000 there was an increase in the inflow of foreign currency (primarily because of a substantial export surplus), and in one year the gold and foreign exchange reserves grew more than 2.2 times from 12.5 billion USD to 27.95 billion USD. The latter value exceeds by 3.3 billion USD the previous maximum volume of reserves recorded in June 1997. At present, the reserves can cover 7 - 8 months of import - the highest index since 1992 (in 1992 it did not exceed 3.5-4 months). The share of gold was reduced during the year from 32% to 13 %.

If the price of oil remains at the level of at least 18 USD per barrel, the export surplus of Russia in the year 2001 will amount to

⁴ The purchases of currency by economic agents in order to conduct other current or capital transactions are not taken into account because in such cases the requirement of purchasing currency at the monetary exchanges is not applied, and the CBR formally is not obliged to launch rouble interventions. Therefore we appraise the volume of issue by the results of bidding at the monetary exchange.

at least 30-35 billion USD (according to preliminary estimates, it amounted approximately to 60 billion USD). Therefore, considering the increase in capital outflow (in particular, resulting from the payment of debts to the Paris Club), the increase in the gold and foreign exchange reserves will amount to 5-7 billion USD, and by the end of the year 2001 their volume can reach 33-35 billion USD.

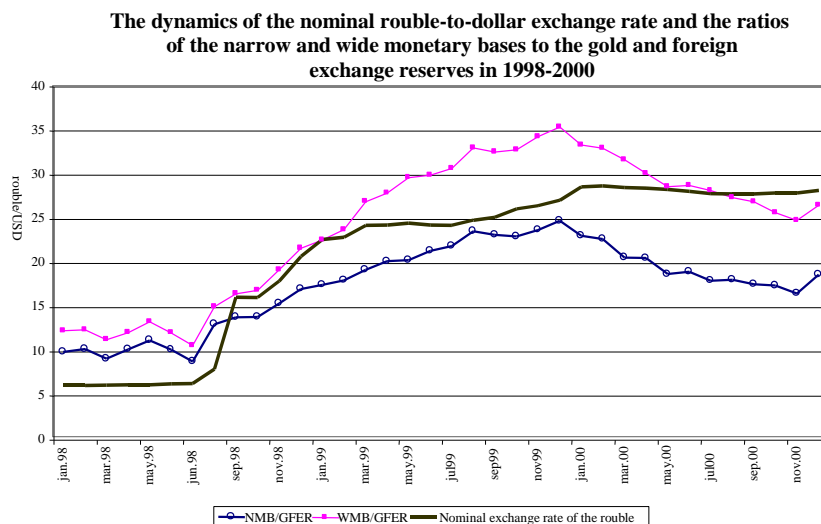
The gold and currency backing of the rouble which characterizes a nominal and potential possibility for the CBR to buy out the total monetary base after selling its currency reserves is shown in Figure 1.4. While in the year 1993, before the crisis, the nominal exchange rate of the rouble calculated as the ratio of the monetary base (narrow or wide) to the gold and foreign exchange reserves significantly exceeded the official exchange rate, from September 1998 onward a different situation emerged. The ratio of the narrow monetary base to the gold and foreign exchange reserves reflected a rouble-to-dollar exchange rate higher than the official exchange rate. Since August 2000, such a ratio has also been observed in the relationship between the wide monetary base and the gold and foreign exchange reserves.

As a whole, in the year 2000 the increase in the narrow monetary base amounted to 69% (from 307.5 to 519.6 billion roubles), and that in the wide monetary base - to 68.1% (from 439.7 to 739 billion roubles). Thus, the real increase in the monetary base during the year amounted to 40.6 % (for the aggregate in its narrow definition) and to 39.9 % for the aggregate in its wide definition,

The sources of the growth of the monetary base, and in particular of a more rapid growth of the given aggregate in the wide definition, can be determined by proceeding from the results of the analysis of the changes in the structure of the wide monetary base (see Figure 1.5). In the years 1999-2000, the share of cash declined from 71.2% to 52-55 %, while the share of the fund of compulsory

reservation rose from 7.4% to 13.6 % (in July 1998 - 16,5 %), the share of the balance on the correspondent accounts - from 10.7% to 14.5% (in July 1998 - 6,5 %), and the share of the deposits and other CBR's liabilities - from 10.7% to 15-20 % (in July 1998 - 10.5 %).

FIGURE 1.4



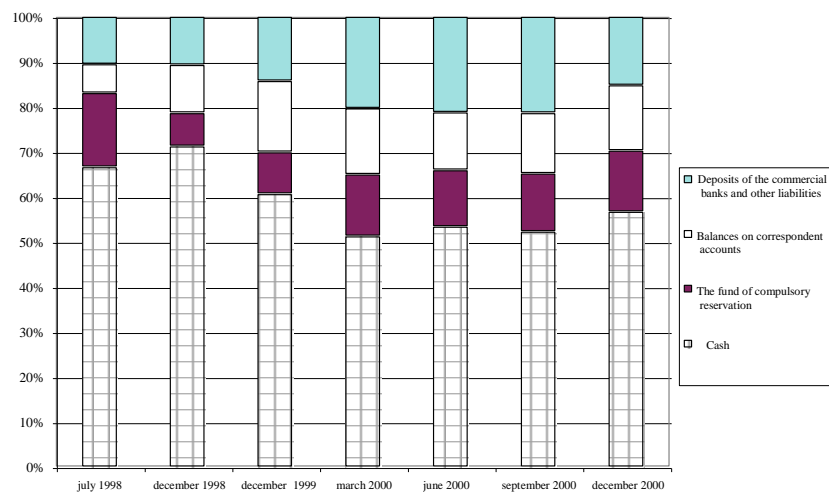
Source: the Central Bank of the FR, estimates of the IET.

The dynamics of the structure of the wide monetary base demonstrates that during the initial period after the crisis, the fund of compulsory reservation underwent a substantial decline (that resulted from a large-scale withdrawal of deposits from the commercial banks and the reduction in the norms of compulsory reservation). At the same time, the share of cash in circulation rose, as well as the balances on the correspondent accounts of the commercial banks with the CBR. Subsequently, the share of cash declined and stabilized at the level slightly higher than 50 %. As the confidence in the banking system was coming back, the share of the fund of

compulsory conservation also began to rise: by the end of the year 2000 it practically reached its pre-crisis level (while the norms of allocation to reserve became lower).

FIGURE 1.5

The structure of the wide monetary base



Sources: the Central Bank of the RF, the IET's calculations.

At the end of the fourth quarter of the year 2000, there occurred a certain decline of the share of deposits and other liabilities (from 20-21% to 15 %) and a simultaneous increase in the share of cash (from 52-53% to 56-57%) which can be apparently explained by the influence of the seasonal factors associated with the increased demand for cash resulting from the growth of retail turnover just before the New Year.

Thus, the main form of growth of the monetary base in the post-crisis period turned to be the balances on the correspondent and deposit accounts of the commercial banks with the Bank of Russia, i.e. the spare liquid funds not used by the banks in their conduct of active profitable operations (including the funds for ser-

ving the current payments of their clients).⁵ The aggregate share of these two components of the monetary base in the years 1999 and 2000 amounted to 30-35%, while in the years 1997 and 1998 it did not exceed 15-20 %.

This tendency has resulted from several processes observed in the monetary sphere. Firstly, a certain segment of the growth of balances on the correspondent accounts can be attributed to the necessity to increase the volume of spare funds servicing the current payments of the clients. With an allowance made for the change in the level of prices in the years 1998-2000 as well as the rise in the share of monetary payments both on the enterprise-to-enterprise basis and in relations with the budgets of all levels, the volume of balances on correspondent accounts of the commercial banks with the CBR just slightly exceeds in real terms the level of the first half of the year 1998.⁶

Secondly, the absence of risk-free financial instruments and the low attractiveness of the existing financial markets have limited the opportunities of the commercial banks to conduct active operations. Under these circumstances, the deposits with the CBR virtually play the role of financial investments despite the low interest they bear. At the same time, the money remains within the banking system thus creating the danger of an attack on the exchange rate of the national currency at the slightest increase in uncertainty and risks (restrained exclusively by the high level of the gold and foreign exchange reserves), but is not used, for example, for crediting the real sector of the economy.

⁵ The deposit operations with the CBR are also placed in the category of non-profit operations because the interest on them is set below the market rate.

⁶ This point of view is reflected in a number of publications including "Obzor rossiiskoi ekonomiki v 1999 godu" (A review of the Russian economy in the year 1999), – M.: BEA, 2000.

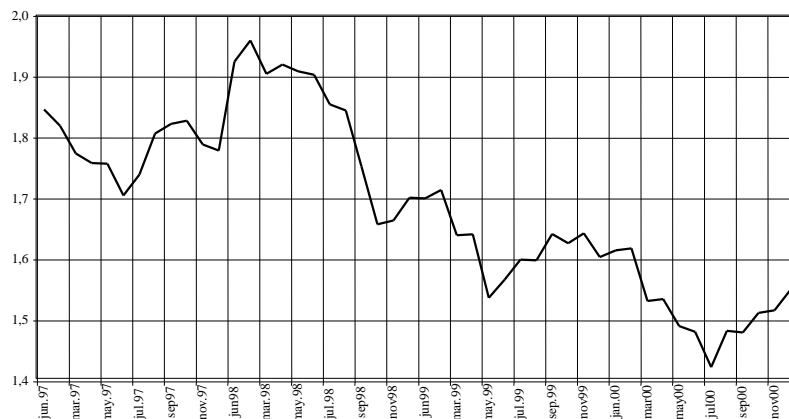
Thirdly, the real sector is still characterized by high credit risks in the sphere of crediting of enterprises. Actually, the Russian commercial banks are still unable to perform the function of creating money in the economy; they ration credit. This process can be illustrated by the dynamics of the money multiplier calculated on the basis of the ratio between M2 and the wide monetary base (the reserve money, see Figure 1.6).

The decrease of the money multiplier started prior to the crisis, in March 1998; and this tendency continued throughout the years 1999 and 2000. Thus, in the year 2000, the multiplier of the reserve money dropped to 1.4-1.5 (from 1.95 in February 1998 and 1.75 in September 1998). This indicates that the attitude of the Russian commercial banks to the real sector has not changed despite the obvious rise in production as well as in the profitability of enterprises. Rigid credit rationing is preserved in the economy, and in the absence of financial markets crediting the state at all the levels of power has become an important sphere of activity of the commercial banks. It should be emphasized that in the second half of the year 2000, a certain growth of the money multiplier was observed (from 1.4 to 1.55), but the observation period has been too short yet for any conclusions to be made on a possible break-through.

Thus, there remains something very "mysterious" in the state of affairs within the Russian economy where in the post-crisis period the money multiplier steadily goes down while the risks in the economy are on the decline, and both inflation and the exchange rate of the national currency are stabilized.

FIGURE 1.6

The money multiplier M2/reserve money in 1997-2000



Sources: the Central Bank of the RF, the IET's calculations.

As noted above, the main reason for the further decline of the money multiplier is the increase in the volume of the surplus reserves (in excess of the fund of compulsory reservation) on the accounts with the CBR. Nevertheless, it would be wrong to suggest an existence of some possibility to reduce the monetary base (in the broad sense) by enabling the banks to invest their funds in certain assets (crediting, securities). The banking system in general cannot change the volume of the wide monetary base by any means other than operations with the Central Bank (in the present situation by launching an attack on the rouble and by buying out a part of the gold and foreign exchange reserves of the Bank of Russia, and vice versa - by selling currency). Widening the scope of active operations can only change the structure of the wide monetary base by transferring some part of the idle reserves (the balances on correspondent and deposit accounts with the CBR) to the fund of compulsory reservation and by converting it into cash.

At present, we cannot offer any unambiguous explanation of this "mystery". Among the possible explanations of the continuing fall of the multiplier one can mention, first, the curtailment of the operations on financial markets (the government securities market, the interbank market); second, the fact that the Bank of Russia does not conduct operations on the open market (on the GKO-FSB market) which precludes any reduction of the aggregate surplus reserves by purchasing securities from the Central Bank; thirdly, the reduction in short-term crediting of the real sector resulting from the falling demand for short credits against current assets, import transactions and trade operations caused by the rise in the volume of internal funds of the enterprises and the decline of imports. At the same time, the ineffective system of enforcement coupled with low financial discipline produce extremely high risks in the sphere of long-term crediting, where no improvements have been made in this respect.

The absence of effective interest rates in the economy and the rationing of credit implied the absence of interest and credit channels of money transmission in the economy.⁷ The situation in the real sector of the economy in fact did not react to the decline of the nominal and real interest rates; the availability of bank credit for the enterprises is low. The only working mechanism of money transmission is the exchange-rate channel dealing with the inflow of money from the abroad into the accounts of export enterprises and its subsequent sale (first of all the compulsory share) at the domestic currency market to the Bank of Russia.

⁷ A similar situation was observed in many countries which had suffered from the "twin crises" - currency and banking (see Garcia-Herrero, A. (1997) "Monetary impact of a banking crisis and the conduct of monetary policy", IMF Working paper, 97/124).

The expansion of the money supply due to currency purchasing by a central bank can exert a rather negative influence on the real sector of any economy. The monetary expansion leads to an acceleration of inflationary processes. In the situation when the nominal exchange rate of the rouble is kept at a stable level by the high volume of the currency supply on the market, the rise in domestic prices results in the increase in the real exchange rate of the rouble, and consequently in the decrease of the volume of the net exports.

The demand for money

One of the most positive results of the devaluation of the rouble in August 1998 which manifested themselves once business recovery had begun was the increase in the volume of internal funds of the enterprises, the downscaling of nonpayments and the decline in the share of transactions serviced by non-monetary forms of payments. The rise in the volume of current assets in the real sector of the economy and the passage of money along the entire production chain guaranteed the demand for products at every stage of production, thus resulting in the growth of the aggregate demand in the economy in general.

The roots of this process must be looked for in the improved economic situation and the rise in the volume of profits of both the export enterprises (caused, among other things, by the situation on the world raw materials markets), and the import substitution industries because of the increased domestic demand for their products. As a result, the share of unprofitable enterprises declined again in comparison with the previous year - to 38.7% in industry (as compared to 39.2% and 49.2% at the end of 1999 and at the end of 1998, respectively). According to the results of our previous re-

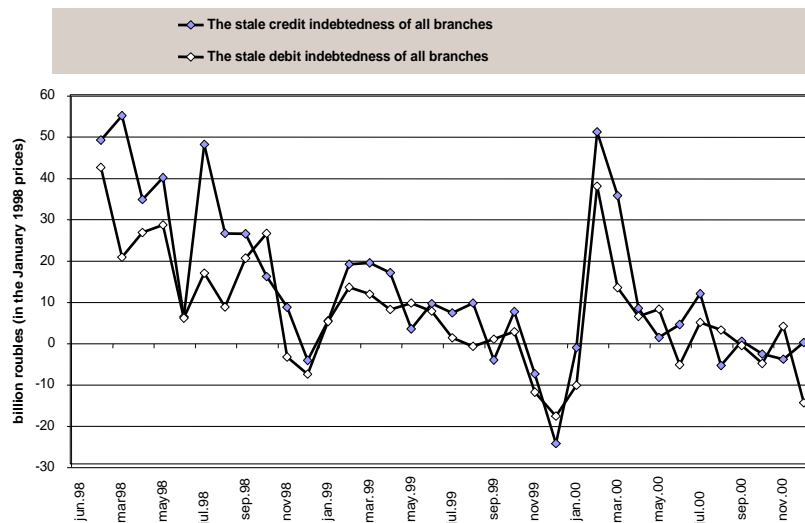
search,⁸ the role of unprofitable enterprises in the emergence of nonpayments is dominant. The reduction of their share served as an important factor in reducing the nominal growth of nonpayments and stabilizing their level. It can be seen in Figure 1.7 that the growth of indebtedness practically stopped, beginning from the second quarter of the year 2000. One could certify a certain stabilization of nominal stale debt at the level of approximately 1600 billion roubles from that period onward. The decline in the volume of stale debt resulted, among other things, from its partial write-off. According to the State Statistics Committee of the RP, the stale credit indebtedness written off into profit and the debit indebtedness written off into losses amounted to 0.4% and 2.4%, respectively, of the total amount of debt (0.4% and 1.5% in the year 1999). The relatively small volume of the written off aggregate indebtedness (especially of credit indebtedness) indicates that the decline resulted either from the reduction of the value of the newly emerging debt or from its direct liquidation. At the same time, during the first quarter of the year 2000 there occurred a rather significant jump-like growth of indebtedness which followed its decrease at the end of the year 1999 - this phenomenon is likely to be attributable to the seasonal factors (the payment of taxes, drawing-up of balances sheets).

Meanwhile, the real volume of credit and debit indebtedness of enterprises continued its steady decline since the end of the year 1998. Thus, the absolute volume of nominal nonpayments grew slower than inflation. For the year 1999, the real growth of stale credit indebtedness amounted to -19.3%, while for the year 2000 it amounted to -3.4%.

⁸ See the report on the subject of "The problem of nonpayments in the Russian economy" written at the second stage of a joint project carried out by the IET and the USAID (www.iet.ru)

FIGURE 1.7

The dynamics of deflated increases of the stale debts of enterprises and organizations

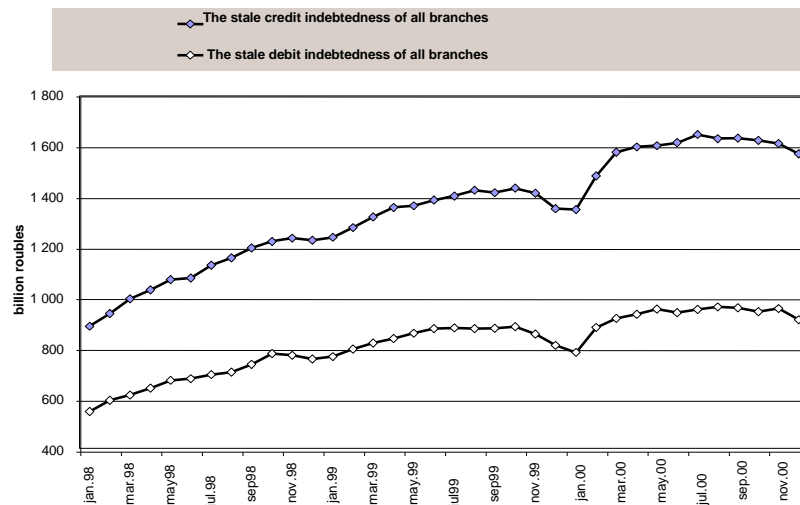


Very important is the fact that the level of tax receipts has guaranteed a greater saturation of the budget and has permitted the implementation of budget expenditures to the extent stipulated by the Budget Law. The absence of growing indebtedness of the budget to economic agents is a serious factor reducing the scale of non-payments in the economy.⁹

⁹ See the report on the subject of “The problem of nonpayments in the Russian economy” written at the second stage of a joint project carried out by the IET and the USAID (www.iet.ru).

FIGURE 1.8

The dynamics of the nominal state indebtedness of enterprises and organizations



The growth of effective demand and the decrease of barter in payments between enterprises are confirmed by the results of enterprise surveys conducted monthly by the IET.¹⁰ The balance of answers concerning the change of volumes of production has become positive since February 1999, while the balance of answers concerning the change of the effective demand - since March 1999; the results of the surveys also reveal that simultaneously there occurred a decrease of demand for barter (the balance of answers has been negative since April 1999). During 1999 and 2000, there was a steady rise in the positive balance of answers to the questions regarding the willingness and readiness on the part of the enterprises to abandon the use of non-monetary forms of payments and barter

¹⁰ See Section 2.2 of the present review.

in their offsets. According to the State Statistics Committee of the RP, the structure of payments for the shipped products (performed work, rendered services) of the monopoly enterprises (the RJ-SC "EES Rossii", the OJ-SC "Gazprom", the Ministry of Railways of Russia, the OJ-SO "Aeroflot", etc.) has changed towards a greater use of monetary means - from 46.6% in 1999 to 71.7% in 2000.

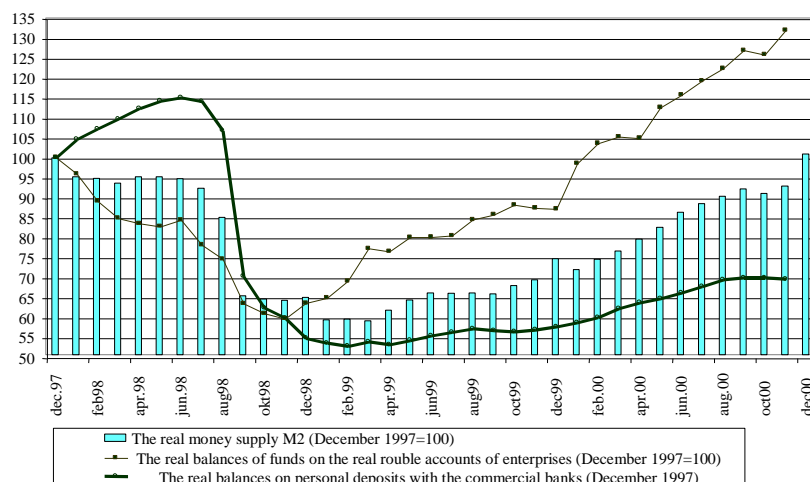
The credits granted to enterprises, organizations, banks and natural persons amounted to 956.3 billion roubles by the end of the year 2000 (596,8 billion roubles in the year 1999). Thus, the real growth of crediting amounted to 33% (2% in the year 1999). The relation between credits and nonpayments is bilateral. On the one hand, an expansion of bank crediting can conduce to normalization of production process (especially in case of the works with a long production cycle), to a decrease of interfirm credit, and if the enterprise is profitable - to a reduction of nonpayments. On the other hand, a reduction of nonpayments and an increase in the number of profitable works can become a signal to intensify the crediting of the real sector and to cut the rationing of credits. In the atmosphere of nonpayments, it becomes more difficult for the financial intermediaries to distinguish between profitable and unprofitable enterprises, and as a result the banks most likely would resort to rationing when making a decision on crediting.

The reduction in nonpayments and non-monetary forms of payments has conducted to a growth of the real cash balances. On the one hand, an expansion of the real money supply implies a growth of liquidity which is beneficial for effecting payments. On the other hand, the growth of monetary payments implies an increase of the demand for real cash balances and, accordingly, an increase of the real money supply. At the same time, a direct influence on the nonpayments is exerted not by the whole volume of the real money supply but only by the real cash balances of enterprises.

As seen from Figure 1.9, the increase of the real balances on the rouble accounts of enterprises between November 1998 and December 1999 amounted to almost 50%, while in January-November 2000 these balances increased again by 51.5%. Apart from this, the practical absence of any income-producing financial instruments throughout the post-crisis period resulted (together with low inflation) in a decrease of the alternative cost of cash keeping which reduced the stimuli for accumulation of nonpayments.

FIGURE 1.9

The dynamics of the money supply (M2) and its component in 1998–2000



Source: The State Statistics Committee of the RF, the Central Bank of the RF, the IET's calculations.

In the year 2000, the money supply M1 increased by 66.9 % (by 38.9 % in real terms), while the money supply M2 -by 62.4 % (by 35.1 % in real terms). The broad money increased by 58.4 % (by 31.8 % in real terms). Thus, with allowance made for the lag of the GDP deflator behind the consumer price index, in the second and

third quarters of the year 2000, the level of monetization of the GDP (as of the M2 aggregate) amounted to 15.75% -15.90% which represents the highest result since the moment of price liberalization¹¹

As can be seen from Figure 1.9, the main component of the increase in the demand for money is the growth of balances on the rouble accounts of enterprises. By the end of November 2000, their volume in real terms amounted to approximately 132% of the December 1997 level, while the growth as related to the trough (November 1998) was more than twofold. At the same time, the real volume of personal assets in the commercial banks remained much below the pre-crisis level. Thus, the balances on the personal rouble deposits in November 2000 amounted to only 70% of the December 1997 level and to approximately 60.5% of the peak value (June 1998).

It should be emphasized that both at the end of 1999 and at the end of 2000, there occurred a decrease of demand for cash; while in the first post-crisis months the share of foreign liabilities in M2 amounted to approximately 44% (in October 1998), in the later half of 2000 it stabilized on the level of 33-35 per cent which corresponded to the situation observed in 1996 and 1997. At the same time, the share of the rouble means of payment in the economy remained on a much lower level than in the post-crisis period. Throughout the period between September 1998 and November 2000, the share of the rouble supply M2 as expressed in the broad

¹¹ The insignificance of the increase of the real money supply in comparison with the data on the achievement of the maximum level of the GDP's monetization can be explained by the difference between the value of the GDP deflator and that of the consumer price index by which the deflation of the real money supply has been performed. Despite the growth of the GDP (by 3.2% in 1999 and by 7-7.5% in 2000), the increase of the CPI accumulated since August 1998 substantially exceeds the accumulated increase of the GDP deflator.

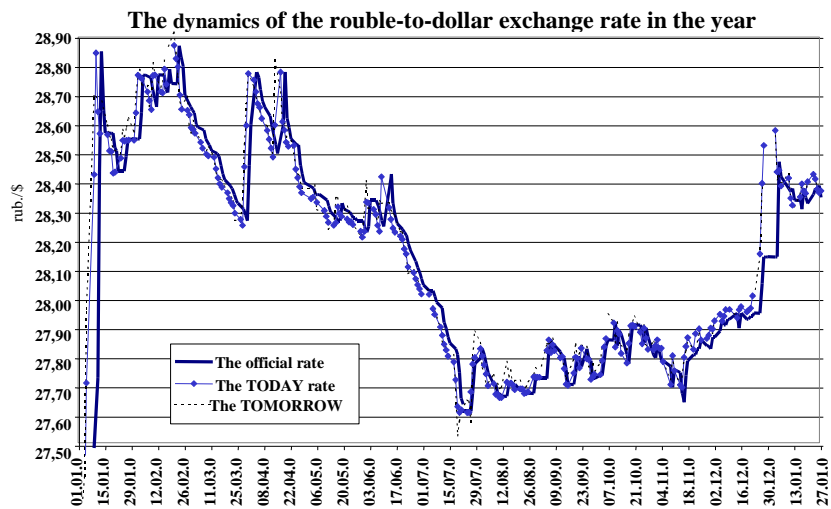
money (M2 plus the balances on currency accounts plus the currency deposits) fluctuated around 70%, while in 1997 and 1998, it exceeded 80%. This phenomenon reflects the preservation of a high extent of dollarization of the economy despite the fact that the effective yield on the currency holdings is negative.

The dynamics of the rouble exchange rate

Figure 1.10 indicates that the dynamics of the exchange rate in the year 2000 can be subdivided into several periods. At the end of 1999, most of the restrictions on participation in the arbitrage between both sessions as well as of those regarding its scope were lifted, and, as early as January 2000, the Russian currency market once again registered a leap in the dollar exchange price in roubles. In early January nothing betokened another drop in the rouble exchange rate. On January 5 the official dollar rate declined, from 27 to 26,9 roubles to the dollar. But from January 10 onward the situation was entirely different. Firstly, the currency supply in the early half of January traditionally is much behind the demand, as far as the sales volume of export receipts declines because of the holidays. Secondly, in the first half of January, there occurred a sharp rise in the balances on the correspondent accounts of the commercial banks with the GBR. Thirdly, the necessity to accumulate the gold and foreign exchange reserves in advance of considerable payments on the Russian foreign debt scheduled for the first quarter of 2000 changed the policy of the CBR which increased the demand for currency. In December, the increased currency supply on the market which was caused by the exporters selling currency to effect tax payments did not permit the rouble rate to drop, despite the rouble interventions on the part of the CBR. The situation in January was absolutely different. In fact, only during the first two

weeks of January, the Central Bank in order to save its reserves permitted the rouble rate to drop by 5.7%.

FIGURE 1.10



Source: The Central Bank of the RF.

In February and March of the year 2000 there occurred a certain stabilization of the situation on the currency market. Despite a considerable volume of payments on the Russian foreign debt effected¹² in January and February, the volume of the gold and foreign exchange reserves of the CBR significantly increased (see Figure 1.3). Meanwhile, the rise in the volume of the currency supply on the part of the exporters created favorable conditions for strengthening the national currency. At the same time, the CBR did not try to compensate the growing sup-

¹² In January 2000 approximately 371 million USD were paid in servicing the debt due to the IMF, while in February the payments amounted to approximately 391 million USD. At the same time, the total amount of payments effected in February 2000 on the Russian external debts was 640 million USD.

ply by a corresponding increase of the demand. As a result, from the end of February to the last days of March, while the gold and foreign exchange reserves rapidly grew, the rouble rate continued to strengthen. Between the 1st and the 29th of March, the "today" average weighted dollar rate as registered in the SELT declined from 28.638 roubles to the dollar to 28.2666 roubles to the dollar which amounted to -3 %. The situation was slightly changed after the OPEC decided to raise the quotas of oil production and marketing. The speculative rise in demand for dollars resulted in the growth of quotations; on 30th March the "today" dollar rate as registered in the SELT rose to 28.46 roubles to the dollar.

The accumulation of the gold and foreign exchange reserves of the CBR which continued throughout April as well as a certain stabilization of oil prices on the world markets played a positive role in restraining the speculative mood of the investors. There was also another factor worth mentioning for its importance to the currency market, that is the suspension by the RP President's decree of the benefits previously granted to a number of Russian companies as regards the return of currency receipts.¹³ From late April to June 2000, the Russian currency market was demonstrating a stable tendency toward strengthening of the rouble resulting from a considerable export surplus. In mid-June the rouble rate rose to 27.65 roubles to the dollar.

The growth of the gold and foreign exchange reserves and the consolidation of the nominal exchange rate of the national currency due to an increase of the export surplus are typical of the countries with the experience of a currency crisis as serious

¹³ See the RF President's Decree No 634 of April 6, 2000.

as the one of August and September of the year 1998.¹⁴ Nevertheless, in Russia in the year 2000, the level of the real exchange rate of the rouble was approximately two times less (in respect to the USD) than the level registered in the first half of the year 1998.

Nevertheless, this course has intensified contradictions between the government and the Central Bank of the RF concerning the course of the currency policy. Thus, Prime Minister Kasyanov repeatedly stated that a premature revaluation of the rouble was unacceptable which corresponded to the interests of the real sector. The Bank of Russia had only limited means to regulate the rouble rate on the market. The absence of any other liquid sectors of the financial market precluded an effective sterilization of the rouble interventions. As noted above, any further issue of money could have resulted only in acceleration of price rise, and its aggregate influence on the real rouble rate could not have been altogether positive. On the other hand, the departure of the GBR from the currency market could have resulted in a sharp rise in the rouble rate as it had already happened in the period between May and July of the year 1995.

In the second half of the year 2000, despite the high volatility of the price of assets on the international financial markets, the situation on the Russian financial market remained sufficiently stable. Among the major causes of the achieved stabili-

¹⁴ See, for example, Eichengreen B., A.Rose, C.Wyplosz (1995) "Exchange market mayhem. The antecedents and aftermath of speculative attacks", *Economic Policy*, October 1995, pp. 249-312. In order to stabilize the market it is necessary either to reduce the currency demand (e.g. by canceling the compulsory selling of currency at the Moscow International Stock Exchange) or to increase the internal demand for currency (e.g. by replacing the external debt from the budget surplus). The problem of the choice of an appropriate policy regarding the real rouble rate still remains an important one.

zation of the rouble rate one should mention the export surplus in many respects resulting from the high price of oil on the world markets, the seasonal factor (the increased demand for roubles in advance of tax payments to be effected at the end of the year), and the policy conducted by the CBR on the open market which resulted in the steady growth of its gold and foreign exchange reserves.

At the same time, by the end of the year 2000, there emerged anticipations of some changes to be expected on the currency market at least in the medium-term outlook. Firstly, the international price of oil can decline already in the middle of 2001 which can open way to a decline in the export surplus and. the supply of dollars on the Russian currency market. It is probable that in the year 2001 the developed countries and the OPEC will come to terms on the creation of a more efficient mechanism for stabilizing the international oil prices which would prevent them from rising to the level typical of the second half of the year 2000.

Secondly, there is a chance that the investors' speculative activity on the currency market will considerably intensify in connection with the growth in the volume of payments on the external Russian debts. Thus, in the year 2003 alone, Russia will have to pay approximately 18 billion dollars which amounts to more than 66 per cent of the present level of the gold and foreign exchange reserves of the CBR.

Thirdly, in November 2000 the Russian President authorized the decree "On signing the Agreement between the Russian Federation and the Republic of Byelorussia on the introduction of a joint monetary unit and the formation of a joint issuing center of the Union State". Although the Russian rouble is planned to be put into circulation in Byelorussia only in the year 2008, it is

possible that Russia will start crediting Byelorussia already in the year 2001 in order to stabilize her balance of payments and the rate of the Byelorussian rouble. No matter what the content of the political and purely technical components of the Agreement was, it should be noted that the fact that it appeared on the eve of the negotiations on the problem of restructuring the Russian debts to the Paris Club and at the time of a certain cooling in the relations between the Russian Government and the IMF exerted a not entirely positive influence on the market.

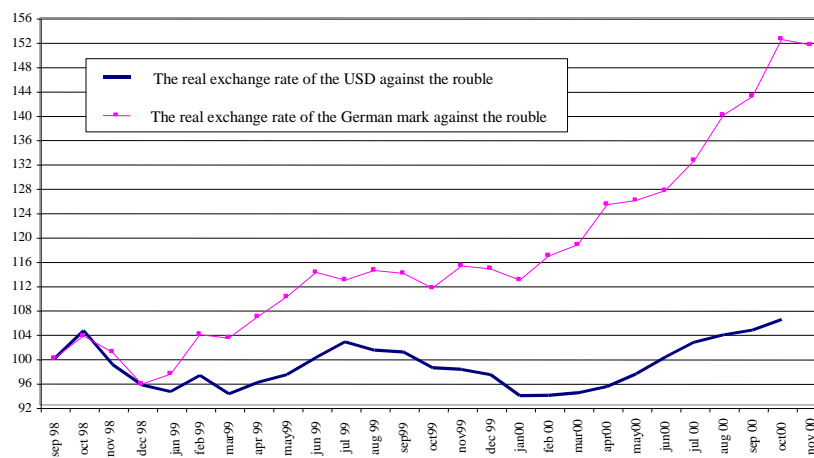
The tendency towards strengthening the rouble became more pronounced in the second half of the year 2000. As seen from Figure 1.11, by the end of October 2000, the real rouble rate against the USD grew by approximately 6,4% (as compared to the September 1998 level), though in comparison with January 2000 (the period of the lowest real rouble rate) the rouble rose by more than 13%. Even more important is the dynamics of the real rouble rate against the Euro because a considerable part of Russian exports (first of all oil and gas) goes to European countries. By the end of November 2000, the real rouble / Euro rate gained 51-52% (Figure 1.11 illustrates the dynamics of the real rate of the rouble against the German mark) which reduces the competitiveness of Russian goods on the European markets (including those outside the Eurozone).

The nominal exchange rate of the rouble against the USD gradually decreased in the second half of the year 2000; the slide accelerated only at the end of December 2000 and at the beginning of January 2001, though already in mid-January 2001 the rate stabilized again at the level of 28.3-28.4 R/USD). On the whole, by the end of the year the nominal exchange rate of the rouble against the USD dropped by 4.3% while gaining 4% against the Euro. Our calculations indicate that the average an-

annual exchange rate of the rouble against the USD in the year 2000 amounted to 28.15 roubles.

FIGURE 1.11

The dynamics of the exchange rate of the rouble



Sources: the Central Bank of the RF, the State Statistics Committee of the RF, International Financial Statistics, the IET's calculations.

At the beginning of 2001, the situation on the Russian currency market aggravated. Among the factors which led to the rise in speculative pressure on the rouble rate one should note the following factors: first, the coming to a final decision regarding the payment of debts to the Paris Club in the year 2001, and the introduction of corresponding amendments to the budget law for the year 2001. Second, the fall in the volume of the gold and foreign exchange reserves from 29.5 to 28.7 billion dollars during the first three weeks of February are most likely to have been caused by the necessity to sell dollars to the RF Ministry of Finance and the concurrent stabilization of the situation on the currency market. Third, the growing rate of inflation. Fourth, the expected cutting of the norm

of compulsory sale of currency receipts on the part of the exporters to 50%. And finally, the latest decline in oil prices on the global markets traditionally viewed by the Russian operators on the currency market as a speculative factor.

The banking system

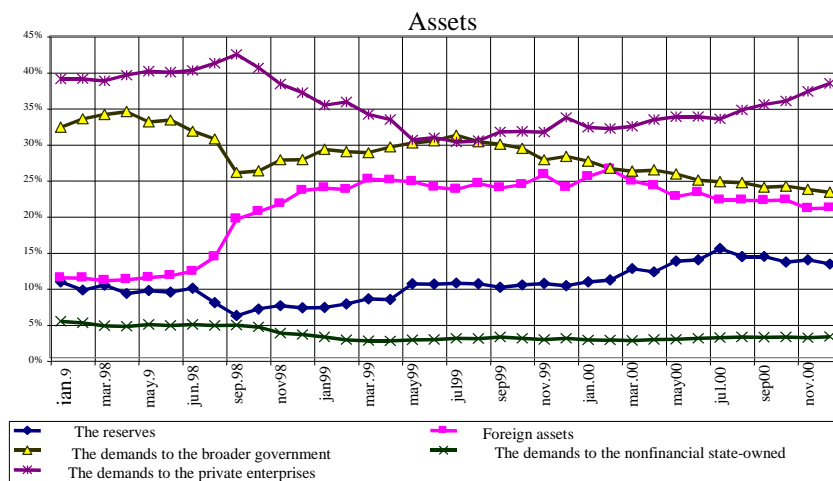
By the end of the year 2000, the Russian banking system did not manage to completely overcome the consequences of the 1998 crisis.¹⁵ Between September 1998 and the end of 2000, the number of operating credit institutions was reduced by 207 banks (from 1556 to 1349).

Assets. Throughout the year 2000, there was a growth in the share of the demands to the private enterprises (from 32% to 39% by the end of 2000), a stabilization of the share of the demands to the nonfinancial state-owned enterprises (on the level of 3.5%-4%) and a stabilization of the share of the foreign assets (25%). The share of the reserves returned to the pre-crisis level (10%). In late 1999 -2000, the share of the demands to the government steadily declined to the level of less than 25%. At the same time, the commercial banks were accumulating the reserves (primarily on the correspondent and deposit accounts with the CBR), and their share rose to 14-15% of the aggregate assets.¹⁶

¹⁵ An analysis of the factors of the 1998 bank crisis can be found in Appendix 3 of the present report.

¹⁶ The Argentinean experience indicates that restructuring of the portfolio of the banking system after a crisis takes approximately six months (see Ramos A. (1998), "Capital structures and portfolio composition during banking crisis: Lessons from Argentina 1995", IMF Working paper, 98/121).

FIGURE 1.12



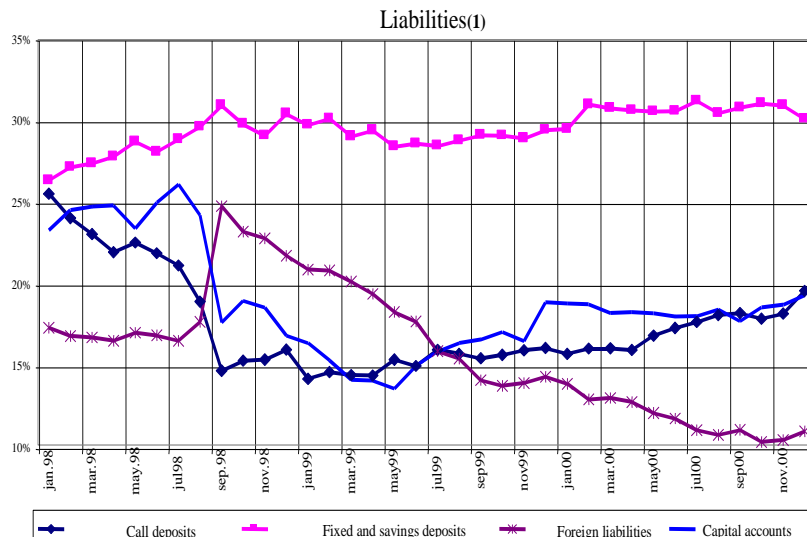
Source: The Central Bank of the RF.

Liabilities. From the end of 1999, the structure of liabilities of the banking system started to evolve gradually restoring the pre-crisis ratios between the types of liabilities. By the end of 2000, the share of the call deposits rose from 15 to 20%, while the share of the money market instruments - from 5% to 8,5%.¹⁷ The share of the fixed and savings deposits remained relatively stable at the level of 30-31%. An important indicator of the banking system's restoration was the increase in the share of the capital accounts from 14% to 19-20%. The share of the foreign liabilities was declining throughout the post-crisis period; at the end of 2000, it dropped to 10-11% of the aggregate liabilities. From the autumn of 1999, the share of the Bank of Russia's

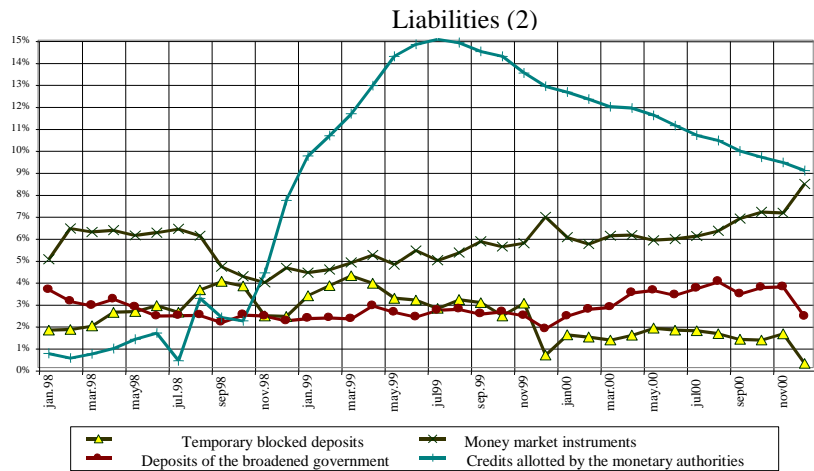
¹⁷ In December 2000, the shares of some types of liabilities were subject to leaps which we are not yet ready to interpret because the data of the summary balance of the banking system are purely evaluative and as such will be corrected by the CBR.

credits dropped by one third, sliding by December 2000 down to 9 per cent. The share of the temporarily blocked deposits¹⁸ declined at the end of 1999, and in 2000 it remained within 1-2% of the aggregate liabilities of the banking system. It is noteworthy that the share of the deposits of the broadened government rose in the year 2000 to 3.5-4% due to an improvement of the situation in the budgetary sphere.

FIGURE 1.13

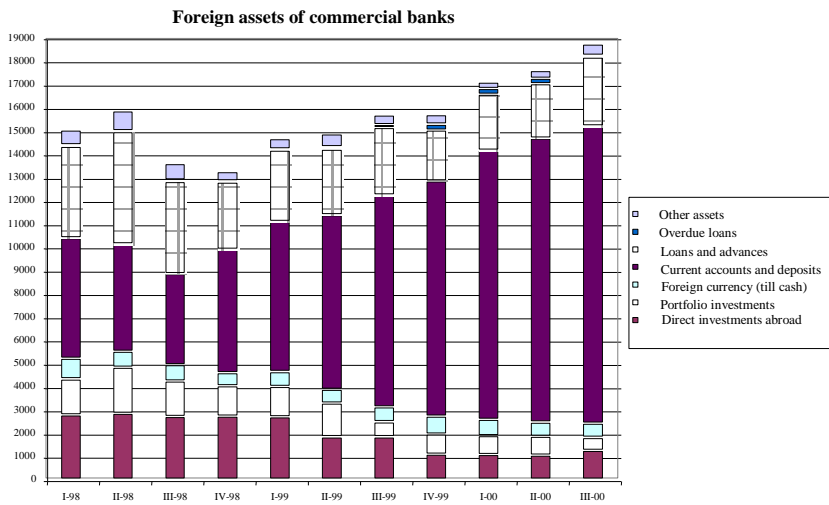


¹⁸ According to the CBR, they include the deposits with the problem banks, and the chances for the bank clients to retrieve this money under the present circumstances are rather negligible.



Source: the Central Bank of the RF.

FIGURE 1.14



Source: the Central Bank of the RF.

The foreign position. The net foreign holdings of the Russian commercial banks became positive as early as the fourth quarter of

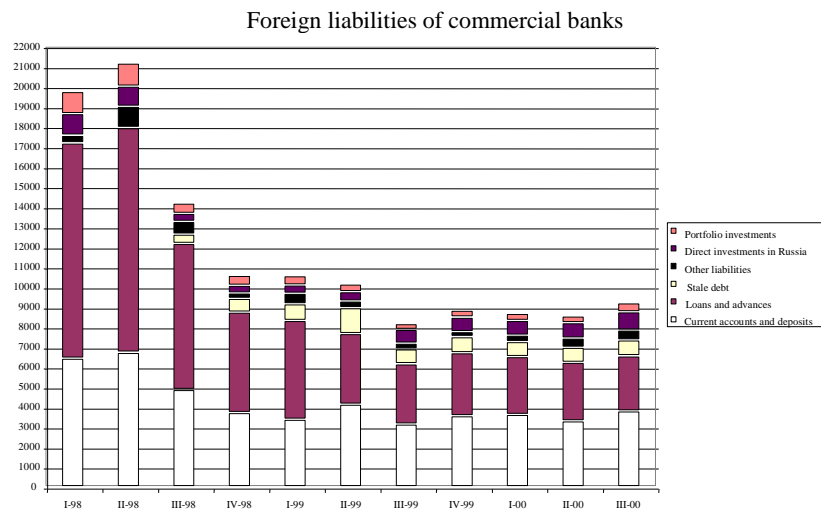
1998. During the years 1999 and 2000, this tendency strengthened, and in the third quarter of 2000 the foreign holdings exceeded the foreign liabilities more than twofold (18,7 against 9.2 billion dollars). It was a result of both the decline in the volume of the foreign liabilities and the rise in the volume of the foreign holdings (see Figures 1.14 and 1.15). In the year 2000 the latter exceeded the maximum pre-crisis level.

The growth of the foreign holdings in the years 1999 and 2000 was furnished mainly by the increase in the volume of the balances on the current accounts and deposits with foreign banks. By the end of the third quarter of 2000, their total volume amounted to almost 12.8 billion dollars (nearly 70% of all foreign holdings). By comparison, in the first quarter of 1999 their volume did not exceed 6.5 billion dollars, while in the fourth quarter of 1999 it amounted to 10.1 billion dollars. At the same time, the volume of direct investments abroad declined from 2.7 to 1,0-1.2 billion US dollars, and the portfolio investments decreased from 1.5 billion USD to 550 million USD. The volume of foreign exchange in till cash remained essentially stable (600-700 million USD).

From July 1998 to September 2000 the foreign liabilities of the Russian commercial banks declined almost by 57% (from 21,1 to 9.2 billion USD). The credits and loans from abroad underwent the largest reduction - from 11.2 to 2.8 billion USD, and the volume of the balances on the current accounts and deposits went down from 6.7 to 3.8 billion USD. It should be emphasized that despite the significant increase in the burden of external debts caused by the fourfold devaluation of the rouble the banks continued to pay on their liabilities to the foreign creditors: the maximum volume of stale indebtedness of the Russian commercial banks (1.3 billion USD in the second quarter of 1999) amounted to just 13% of the

aggregate foreign liabilities; by the end of the third quarter of the year 2000 it declined to 8.7%.

FIGURE 1.15



Source: the Central Bank of the RF.

The present analysis of the activities in the monetary sphere of the Russian economy in the year 2000 suggests a number of conclusions on the nature and specific features of the current monetary policy:

- The system crisis of the banking system has destroyed the mechanism of the money-supply formation. Simultaneously, there occurred an intensification of credit rationing, while the personal savings in the form of bank deposits did not return to their pre-crisis level.
- The favorable situation on the raw materials market and the switch of the consumer's demand to domestic products ensured the instances of high profitability in the real sector of the economy, the increase in the balances on the business accounts and the decline in barter and the nonmonetary forms of intercompany settlements.

- According to the CBR, the main target of the monetary policy was to achieve a slowdown of the inflation and at the same time to satisfy the growing demand for the actual cash balances.
- The monetary policy in 2000 was characterized by a certain inconsistency caused to a large degree by the schedule of payments on the foreign debt.
- Since the Russian financial markets were practically wiped out in August 1998, the Central Bank of the RF could not have used the open market operations as monetary instruments. The main operable instruments were interventions on the currency market, the deposit operations and the change of the norms of compulsory reservation. There existed practically no means of sterilization of the rouble interventions on the currency market (apart from withdrawing the money from the economy through taxation and its consequent accumulation on the federal budget accounts with the CBR and on the regional budget accounts with the Treasury).
- The nominal exchange rate of the rouble stabilized in the year 2000 at the level slightly below 28 roubles against the USD; nowadays it is backed by considerable gold and foreign exchange reserves. In the year 2000, these reserves increased more than twofold in excess of 27 billion USD, their highest value in the history of independent Russia. Under the conditions when inflation continued to grow at a significant rate, the increase in the real rouble rate was brought about by the stabilization of the nominal rate. Most notable was the rise of the rouble against the European currency (caused by the decline of the Euro against the USD), which decreased the competitiveness of Russian goods both on the European and domestic markets.
- The high volume of the rouble issue caused by purchasing of the incoming export receipts on the currency market in the absence of any reliable investment objects resulted in the accumulation of the

idle reserves of the banking system (on the correspondent and deposit accounts with the CBR) while the money multiplier was steadily declining.

- The growth in the demand for money initiated by the transactional motive and the decline in the share of the nonmonetary forms of payment in the real sector made it possible by the end of the year 2000 to practically restore the real volume of the rouble supply at its pre-crisis level, while the monetization of the GDP rose to the peak value (up to 16 per cent). At the same time, the degree of dollarization of the economy remained high exceeding the pre-August level of 1998.

Accordingly, as far as the currency market remains essentially the only channel of money transmission (sale of currency to the Bank of Russia), the Government and the Central Bank of the RF have either to solve the problem of limiting the currency supply on the market or to create some additional (but not related to the speculative behavior of the economic agents) sources of the demand for currency. In particular, it is important to be ready to undertake some curbing of the inflow of short-term foreign capital which does not increase the volume of investments inside the country but goes primarily to the financial markets, and also to be ready to start sterilizing the export receipts. The instruments to be used in carrying out those measures could include the establishment of a stabilization fund¹⁹ and taking steps to control the movement of capital.²⁰

¹⁹ See Appendix 4 of the present review.

²⁰ The Hungarian experience indicates that an attempt at sterilizing the capital inflow by means of the open market operations or other monetary instrument results in excessive tightening of the monetary policy which creates a threat to the prospects of growth in the real sector (see. Siklos, P. (2000) 'Capital flows in a transitional economy and the sterilization dilemma: The Hungarian experience, 1992-1997', *Policy Reform*, 3, pp. 301-326).

TABLE 1.1

The dynamics of the indices of the money and financial

	Narrow monetary base, billion roubles	Growth rate of the narrow monetary base	Net intern. assets, billion roubles	Net intern. res., billion roubles	Wide monetary base, billion roubles	Growth rate of broad monetary base	Foreign liabilities billion roubles	Growth rate of foreign liabilities
Jan. 99	202.5	-2.32%	381.6	-179.1	261.5	-0.84%	178.0	-5.23%
Feb. 99	205.2	1.33%	385.9	-180.7	270.8	3.58%	180.8	1.56%
Mar. 99	205.9	0.34%	392.1	-186.2	289.2	6.77%	174.1	-3.68%
Apr. 99	224.5	9.03%	393.8	-169.3	310.7	7.44%	195.2	12.13%
May 99	241.4	7.53%	387.1	-145.7	353.1	13.66%	205.3	5.14%
Jun. 99	258.4	7.04%	409.9	-151.5	362.7	2.72%	216.4	5.41%
Jul. 99	260.3	0.74%	393.1	-132.8	364.9	0.58%	218.2	0.82%
Aug. 99	264.1	1.46%	395.4	-131.3	369.9	1.39%	216.2	-0.91%
Sep. 99	259.0	-1.93%	383.9	-124.9	364.1	-1.56%	212.8	-1.56%
Oct. 99	269.1	3.90%	372.5	-103.4	384.6	5.61%	222.0	4.30%
Nov. 99	272.0	1.08%	368.8	-96.8	393.8	2.40%	219.3	-1.19%
Dec. 99	307.5	13.05%	372.8	-65.3	439.7	11.67%	266.5	21.53%
Jan. 00	297.8	-3.15%	355.4	-57.6	430.7	-2.06%	232.9	-12.64%
Feb. 00	309.2	3.83%	334.3	-25.1	449.4	4.34%	242.0	3.95%
Mar. 00	318.9	3.14%	284.6	34.3	491.0	9.25%	251.5	3.92%
Apr. 00	349.6	9.63%	259.7	89.9	513.8	4.65%	279.1	10.95%
May 00	365.0	4.41%	207.9	157.1	558.4	8.70%	289.3	3.66%
Jun. 00	397.2	8.82%	194.9	202.3	602.8	7.94%	321.8	11.23%
Jul. 00	417.3	5.06%	141.5	275.8	654.7	8.61%	334.0	3.81%
Aug. 00	427.6	2.47%	122.9	304.7	648.2	-1.00%	341.6	2.27%
Sep. 00	437.6	2.34%	97.8	339.8	671.1	3.53%	350.9	2.72%
Oct. 00	449.0	2.61%	78.9	370.1	662.5	-1.27%	349.7	-0.36%
Nov. 00	455.2	1.38%	48.3	406.9	684.2	3.27%	358.4	2.48%
Dec. 00	519.6	14.15%	-	-	739.2	8.04%	419.3	17.00%

markets from August 1998 through the year 2000

Commercial banks' balances on correspondent accounts with the CBR, billion roubles	Money (M1), billion roubles	Growth rate of M1	Money supply M2, billion roubles	Growth rate of M2	Broad money, billion roubles	Growth rate of broad money	Money multiplier (M2/wide monetary base)	
30.0	330.0	-3.74%	444.2	-0.91%	637.4	1.40%	1.70	Jan. 99
31.3	340.3	3.14%	463.9	4.43%	658.0	3.23%	1.71	Feb. 99
35.1	344.8	1.31%	473.8	2.13%	675.3	2.63%	1.64	Mar. 99
38.7	371.9	7.86%	509.6	7.56%	717.6	6.27%	1.64	Apr. 99
51.0	404.0	8.63%	542.4	6.44%	755.5	5.27%	1.54	May 99
55.0	418.1	3.49%	567.7	4.66%	786.1	4.05%	1.57	Jun. 99
51.8	429.4	2.71%	583.2	2.73%	792.0	0.75%	1.60	Jul. 99
46.9	432.9	0.82%	590.8	1.30%	812.7	2.62%	1.60	Aug. 99
54.0	431.0	-0.44%	597.4	1.12%	823.5	1.33%	1.64	Sep. 99
59.4	454.3	5.42%	625.1	4.64%	866.5	5.22%	1.63	Oct. 99
54.6	471.6	3.79%	646.5	3.42%	909.8	5.00%	1.64	Nov. 99
69.6	526.8	11.71%	704.7	9.00%	984.9	8.25%	1.60	Dec. 99
61.4	508.1	-3.55%	695.0	-1.38%	1000.6	1.60%	1.61	Jan. 00
64.6	529.9	4.29%	726.6	4.55%	1065.0	6.43%	1.62	Feb. 00
72.2	546.4	3.13%	751.4	3.41%	1090.4	2.39%	1.53	Mar. 00
72.2	576.4	5.48%	787.9	4.86%	1123.2	3.01%	1.53	Apr. 00
73.2	611.2	6.04%	831.6	5.55%	1170.3	4.19%	1.49	May 00
77.7	6620.7	8.42%	892.2	7.29%	1242.8	6.20%	1.48	Jun. 00
83.2	692.4	4.48%	931.2	4.37%	1301.7	4.74%	1.42	Jul. 00
81.9	718.0	3.69%	960.1	3.10%	1327.3	1.96%	1.48	Aug. 00
90.0	747.4	4.11%	992.4	3.36%	1388.4	4.61%	1.48	Sep. 00
77.7	750.7	0.43%	1001.2	0.89%	1415.9	1.98%	1.51	Oct. 00
93.9	777.1	3.53%	1036.4	3.52%	1457.3	2.92%	1.51	Nov. 00
107.3	879.3	1.15%	1144.3	1.41%	1560.0	7.04%	1.55	Dec. 00

TABLE 1.1 CONTINUED

	CPI (%/m.)	Official rouble rate (rouble/\$)	Growth of the rouble/ \$ rate	Gold and foreign exchange reserves (\$ billion)	Foreign exchange reserves, \$ million	Gold (\$ million at \$ 300/oz t)
Jan. 99	8.5%	22.60	9.44%	11621	7078	4543
Feb. 99	4.1%	22.86	1.15%	11437	7284	4153
Mar. 99	2.8%	24.18	5.77%	10765	6679	4086
Apr. 99	3.0%	24.23	0.21%	11168	7074	4094
May 99	2.2%	24.44	0.87%	11937	8034	3903
Jun. 99	1.9%	24.22	-0.90%	12152	8188	3964
Jul. 99	2.8%	24.19	-0.12%	11921	7827	4094
Aug. 99	1.2%	24.75	2.32%	11231	6824	4407
Sep. 99	1.5%	25.08	1.33%	11212	6634	4579
Oct. 99	1.4%	26.05	3.87%	11752	7081	4671
Nov. 99	1.2%	26.42	1.42%	11504	7599	3906
Dec. 99	1.3%	27.00	2.20%	12456	8457	3998
Jan. 00	2.3%	28.55	5.74%	12948	8911	4035
Feb. 00	1.0%	28.66	0.39%	13657	9606	4051
Mar. 00	0.6%	28.46	-0.70%	15532	11456	4076
Apr. 00	0.9%	28.40	-0.21%	17091	13410	3682
May 00	1.8%	28.25	-0.53%	19570	15878	3692
Jun. 00	2.6%	28.05	-0.71%	20996	17685	3312
Jul. 00	1.8%	27.80	-0.89%	23302	19955	3347
Aug. 00	1.0%	27.75	-0.18%	23731	20289	3442
Sep. 00	1.3%	27.75	0.00%	25007	21474	3533
Oct. 00	2.1%	27.83	0.29%	25880	22290	3590
Nov. 00	1.5%	27.85	0.07%	27667	24035	3632
Dec. 00	1.6%	28.16	1.11%	27951	24264	3687

Sources: the State Statistics Committee of the RF, the CBR, RTS, Inform. Agency "Fin-market", Russian-European Centre for Economic Policy, International financial statistics.

RTS-1	Growth	Volume of	Average	Turnover of	INSTAR (1	Real ex-
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Index	rate of RTS-1 (%/month)	trans. in RTS (\$ million)	weighted profitability of GKO -federal savings bonds (% per annum)	secondary GKO-FSR market (million roubles)	day) (% per annum)	change rate rouble/\$ (Dec.1997=100)	
55.12	-6.47%	26.8	65.72%	244.8	26.08%	53.50	Jan. 99
70.03	27.05%	102.3	71.53%	991.6	24.99%	51.84	Feb. 99
80.36	14.75%	186.8	63.19%	450.4	22.78%	52.90	Mar. 99
91.83	14.27%	161.2	80.39%	334.6	19.87%	53.60	Apr. 99
97.64	6.33%	197.3	75.90%	4278.4	6.9%	55.11	May 99
125.65	28.69%	272.1	57.45%	8102.2	5.9%	56.56	Jun. 99
116.49	-7.29%	330.2	65.79%	9224.6	9.24%	55.81	Jul. 99
102.50	-12.01%	184.6	69.70%	14069.7	8.69%	55.63	Aug. 99
83.12	-18.91%	172.6	76.26%	14643.0	18.07%	54.21	Sep. 99
97.80	17.66%	151.7	83.56%	25769.0	13.31%	54.06	Oct. 99
112.36	14.89%	264.1	81.10%	9672.6	7.14%	53.59	Nov. 99
177.71	58.16%	289.3	65.81%	12132.4	13.39%	51.69	Dec. 99
172.31	-3.04%	489.51	45.50%	8521.8	9.43%	51.70	Jan. 00
170.93	-0.80%	441.48	33.13%	19457.7	9.94%	51.95	Feb. 00
231.88	35.66%	810.76	30.53%	17914.9	4.65%	52.50	Mar. 00
226.87	-2.16%	499.39	27.71%	14694.9	8.85%	53.66	Apr. 00
190.21	-16.16%	417.20	27.02%	11221.0	7.96%	55.16	May 00
171.40	-9.89%	411.96	20.78%	20411.1	4.57%	56.53	Jun. 00
194.09	13.24%	396.46	22.58%	20628.4	2.59%	57.20	Jul. 00
239.99	23.65%	628.95	19.51%	21304.4	4.50%	57.64	Aug. 00
199.08	-17.05%	443.59	19.76%	16428.7	3.34%	58.58	Sep.00
189.00	-5.06%	414,07	18.76%	16969.2	4.18%		Oct. 00
143.42	-24.12%	353.91	20.85%	13003.5	8.21%		Nov. 00
143.29	-0.09%	247.18	20.94%	10773.6	6.41%		Dec. 00

1.2. The Balance of Payments

The principal figures in the balance of payments for the year 2000 demonstrated further changes in the direction that WAS characteristic of the year 1999: a growing surplus in the balance of payments of the current transactions with corresponding deficit of the account of capital transactions and financial instruments. The positive surplus rate of the current transactions account during the year 2000 was on the average twice as high as a similar rate for quarters I-II of the year 1999, and in January 2000 this figure reached a level unprecedented for the Russian balance of payments, - over \$ 12 billion. At the same time, the principal factor influencing the surplus rate for the current transactions account was the trade balance whose surplus, in its turn, to a decisive degree was defined by the dynamics of the world market prices of oil and other staple goods of Russia's export. The data in Fig. 1 show that the interrelation between the international oil prices and the surplus of Russia's balance of trade which was noted during 1995-1999 could also be seen in the first three quarters of the year 2000.²¹

It should be noted that the growing surplus of the balance of trade was produced mainly by the growing volume of Russia's export, because her import during the year was growing at a negligible rate.

²¹ The estimates for the years 1993-2000 demonstrated a statistically significant dependence of the surplus values of Russia's trade balance (*TB*) on the index of the international oil prices (*P*) with *dummy* = 1 in the third and the fourth quarters of 1998 when other factors were strongly influencing the trade balance of the RF.

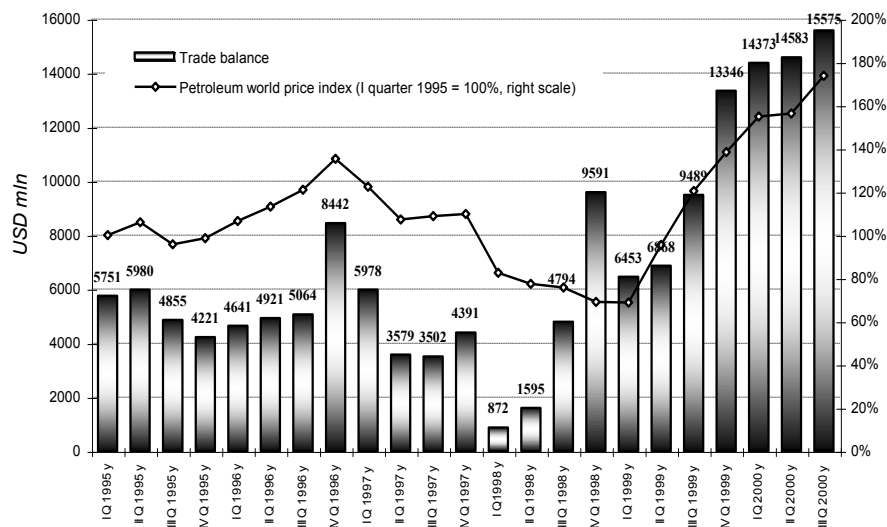
$$TB = -8582 + 135,7 \cdot P + 5943 \cdot \text{Dummy}$$

(-3,6)	(6,7)	(3,0)
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$R^2=0,7$

FIGURE 1.16

The balance of trade of the RF and the index of the international oil prices in 1995 – III quarter of 2000



Source: Central Bank of the RF, International Financial Statistics, the author's calculations.

When taking a look at the tendencies displayed by the individual changes in the surplus values of the balance of payments by each of its different components we can notice that the large positive surplus of the trade balance provided the source for financing those changes that were occurring in all its other RF components - the negative balance of the services rendered by labor and capital (the wages paid to non-residents and debt servicing), payments of capital transfers to non-residents, portfolio investments abroad, the increasing foreign assets of Russian residents and the payments effected to reduce the liabilities of Russian residents to non-residents. Besides, the inflow of capital transfers from non-residents to Russia in the third quarter of the year 2000 should be taken into consideration: in contrast to the pre-

ceding years when they amounted to \$ 200 to 600 million per quarter, the total sum of such transfers in July-September 2000 was over \$ 11 billion. According to the Bank of Russia, this surplus value of the capital transfers in the third quarter of 2000 resulted from entering in the balance of payments the operations of writing-off, on a gratis basis, a part of Russia's foreign indebtedness within the framework of the restructuring of Russia's debt to the London Club²² (earlier, in 1997, the results of a similar operation of the restructuring of Russia's debt to the member countries of the London Club were entered as "Portfolio Investments")

If we consider the aggregate indices of Russia's balance of payments in January-September 2000, the situation with the balance of Russia's assets and liabilities can be described as follows: due to trade operations with non-residents, the Russian foreign exchange assets increased by \$ 44.5 billion (the trade balance of January-September 2000). Besides, the sources of replenishments for Russia's foreign assets were direct investments into Russia (the balance of the account "Direct Investments" amounted to \$ 600 million), attraction of credit resources by the government bodies and against their guarantee (\$ 960 million), as well as transfer of the indebtedness of the government bodies (\$ 3,4 billion).

This increment in the growth of foreign assets was balanced by the changing surplus of the following items: import of factoring and non-factor services (\$ 10.9 billion); portfolio investments abroad (\$ 9.9 billion), other investments in the foreign assets totaling about \$ 11 billion (the growth of the balance of foreign accounts and deposits, credits and advances granted, increased stale debts of non-residents and non-residents' debts resulting from delayed receipt of export proceeds and outstanding import advances). This external surplus also the source for paying Russian non-residents' debts and re-

²²See "Vestnik Banka Rossii", No 13-14, 2001, p. 5

paying stale debts - the balance of attracted credits and reduced stale debts of residents was \$ 8.6 billion (without taking into account the credits received and the postponed repayment of the debts of the government bodies).

So the year 2000 saw the same trends as regards the changes in the balance of payments that were characteristic also of the preceding year: the growth of foreign assets due to a large trade balance surplus in the absence of any significant borrowings was the sole source for repaying those debts due to non-residents that had accumulated during the preceding years. Thus, the negative balance of portfolio investments in January-September 2000 (– \$ 9.9 billion.) resulted mainly from a considerable reduction of residents' liabilities to non-residents (repayment of debt). A similar situation was noted in the area of the public sector debts - in almost total absence of new borrowings the negative balance of the financial operations carried out by the government bodies resulted from repayments of both deferred and stale debts (despite the large volume of stale and deferred debts of –\$ 4.8 billion). On the other hand, considering that some transactions in the public sector (i.e. writing-off the debt due to the London Club) were entered under the item "Capital Transfers", it can be said that the total balance of transactions in the public sector was positive.

At the same time, among the operations financed from the export surplus, we should note not only the reduction in the liabilities to non-residents but also the increase in the foreign assets of Russian residents which for several years has been a significant outlet (though every year progressively smaller) for utilizing the residents' funds resulting from the positive balance of current transactions - the negative balance of assets in the Section "Other Investments" as of the end of the period of January-September 2000 was \$ 10.7 billion (\$ 15.4 billion as of the end of the year 1999). The main types of the Russian foreign assets that demonstrated the most significant growth

in 2000, as in the preceding year, were current accounts and deposits (the increment being \$ 26 billion), allocation of commercial credits and advances (\$ 1.6 billion), as well as the increment of the internal debt and the debt caused by delayed receipt of export proceeds and outstanding advances (total \$ 9.1 billion).

In connection with the growth of the Russian foreign assets we should also mention the problem of capital outflow from Russia which we already touched upon in last year's review. As it is known, a part of residents' funds placed abroad in the form of such assets, for example the internal debt and delayed receipt of export proceeds and outstanding import advances, as well as a part of resources entered into the balance of payments under the item "Net Errors and Omissions", can represent a non-registered capital outflow. In this connection it can be supposed that if the balance of the abovesaid items stays negative for a long period of time, its changes may reflect the dynamics of non-registered capital outflow from Russia. In the year 2000, judging by the cited variables, capital outflow became more active: while in 1999 the total balance under the item "Net Errors and Omissions" was – \$ 6,9 billion, the figure that emerged during the first three quarters of the year 2000 was already – \$ 7,4 billion. A similar picture appears when we analyze the total balance of net errors and omissions, stale debt and delayed receipt of export proceeds: this figure in the first three quarters of the year 2000 was equal to that of the annual balance of the preceding year. In connection with these estimates it should be stressed that, firstly, the variables analyzed can be regarded only as indirect indicators of the dynamics and not of the absolute volumes of illegal capital outflow, and secondly, the growth of both stale debt and net errors and omissions could be the result of a dramatic increase in export value which could, quite naturally, have led to a proportional growth of the debt caused by delayed receipt of

export proceeds and an increase in the statistical deviation of the main estimates in the balance of payments.

When analyzing the state of the balance of payments in the year 2000, one should pay attention to the fact that the positive trade balance was so large that despite the considerable payments of Russia's debt due to non-residents and the growth of the Russian foreign assets, there was a simultaneous growth of the reserve assets - in the first three quarters of 2000 they increased by \$ 13.3 billion, and approximately a half of this increase occurred in the second quarter of 2000 when the reserve assets of the Russian Federation increased by \$ 6.2 billion.

By the time this review was being written the Central Bank of the RF had not yet released the figures of the balance of payments of the RF for the year 2000, however it can be presumed that the trade balance, despite a small fall in the international oil prices in the fourth quarter, will not slide below the level of the third quarter due to the typical end-of-the-year increase in foreign trade turnover. This is supported by the data released by the State Statistics Committee of the RF demonstrating that the trade balance of the RF in the year 2000 amounted to \$ 61 billion.²³

Nevertheless, there are reasons to believe that Russia's balance of payments for the year 2001 would be somewhat different from that of the year 2000 in the negative sense – firstly, proceeding from the already mentioned dependence of the trade balance on the international oil prices, it can be assumed that the growth of residents' foreign assets associated with this article of export will be proportionally reduced; secondly, one should take into consideration the demands of foreign creditors to settle Russia's debts. On the other hand, until oil prices reach critical levels (which is not so at the present moment,

²³ See "Sotsial'no-ekonomicheskoe polozhenie Rossii" (Socioeconomic situation in Russia) (January-February 2001). M., Goskomstat Rossii, March 2001

partly because of the OPEK's decision to reduce the volume of oil production, also supported by other large-scale exporters of oil who do not belong to this organization), Russia's balance of payments in 2001 still has a certain "margin of safety" which will allow her to follow the model of behavior developed in 1999-2000, i.e. to finance the settlement of indebtedness by means of a positive trade balance and partial restructuring of debt.

TABLE 1.2

**The balance of payments of the Russian Federation in 1996 –
3rd quarter of year 2000 (\$ millions)**

	1998 год				1999 год				2000 год		
	I	II	III	IV	I	II	III	IV	I	II	III
Current Operations	-1569	-3673	777	6110	4424	4209	5650	10765	12015	10991	10614
Goods and non-factor services	-174	296	4130	9407	5558	5930	8362	12133	12873	12583	13446
<i>Goods (trade balance)</i>	872	1595	4794	9591	6453	6868	9489	13346	14373	14583	15575
Export of goods	18558	18835	18093	19314	15564	16976	18973	24179	24249	24934	26446
Import of goods	-17686	-17240	-13299	-9723	-9111	-10108	-9484	-10833	-9876	-10351	-10871
<i>Non-factor services</i>	-1046	-1299	-664	-184	-895	-938	-1127	-1213	-1500	-2000	-2129
Export	2904	3329	3691	3012	1771	2283	2618	2382	1804	2343	2918
Import	-3950	-4628	-4355	-3196	-2666	-3221	-3745	-3595	-3304	-4343	-5047
Balance of services of labor and capital (balance of incomes)	-1243	-3807	-3311	-3239	-1085	-1798	-2918	-1673	-907	-1673	-2783
<i>Export of services</i>	2477	835	585	404	2277	721	421	463	2510	718	713
rendered by labor	51	74	82	94	102	111	111	102	103	116	129
rendered by capital	2426	761	503	310	2175	610	310	361	2407	602	584
<i>Import of services</i>	-3720	-4642	-3896	-3643	-3362	-2519	-3339	-2136	-3417	-2391	-3496
rendered by labor	-141	-145	-114	-65	-45	-53	-62	-45	-50	-73	-91
rendered by capital	-3579	-4497	-3782	-3578	-3317	-2466	-3277	-2091	-3367	-2318	-3405
Current transfers	-152	-162	-42	-58	-49	77	206	305	49	81	-49
Received	69	71	54	76	52	220	330	426	165	193	82
Paid	-221	-233	-96	-134	-101	-143	-124	-121	-116	-112	-131
Operations with capital and financial instruments	4515	6728	2876	-5991	-3825	-3221	-4507	-6586	-9346	-9152	-7702
<i>Operations with capital</i>	-92	-189	15	-117	-30	-96	-124	-78	22	-39	10968
Capital transfers	-92	-189	15	-117	-30	-96	-124	-78	22	-39	10968

TABLE 1.2 CONTINUED

	1998 год				1999 год				2000 год		
	I	II	III	IV	I	II	III	IV	I	II	III
received	341	537	475	351	220	188	225	252	211	182	11216
paid	-433	-726	-460	-468	-250	-284	-349	-330	-189	-221	-249
Financial account	4607	6917	2861	-5874	-3795	-3125	-4383	-6508	-9368	-9113	-18669
Direct investments	369	109	313	944	286	303	202	808	173	301	119
Abroad	-254	-341	-98	-334	-356	-448	-457	-449	-396	-217	-575
In Russia	623	450	411	1278	642	751	659	1257	569	518	694
Portfolio investments	3560	4404	118	105	67	-620	-44	-440	616	-1521	-9037
Assets	-97	-506	350	-3	-23	-202	306	172	37	9	-292
Liabilities	3657	4910	-232	108	90	-418	-350	-612	579	-1530	-8745
Other investments	-232	1637	-173	-7899	-5221	-1090	-5618	-4491	-7147	-1622	-5614
Assets	-3339	-2392	-3950	-6500	-6224	-550	-4977	-3619	-6517	-1372	-2789
Currency in cash	608	1273	-1712	773	178	1020	-393	116	-33	430	272
Current accounts and deposits	1617	596	-102	-1155	-1095	-1535	-473	-786	-1476	-597	-603
Commercials credits and advances	-90	-1157	-1186	-4385	-1892	675	-2588	-1928	-906	211	-936
Loans and credits granted (not outstanding)	1843	1606	1278	618	1800	2186	139	730	1622	977	324
Outstanding debt	-3712	-2791	-488	-436	-4073	-1311	-231	-193	-3812	-694	-879
Debts due on goods supplied according to intergovernmental agreements					-185	158	113	-281	-580	-45	307
Changed debt due on delayed receipt of export proceeds (in foreign currency and roubles) and outstanding import advances	-3395	-1650	-1507	-2111	-960	-1504	-1342	-1245	-1231	-1438	-1051
Other assets	-210	-269	-233	196	3	-239	-202	-32	-101	-216	-223
Liabilities	3107	4029	3777	-1399	1003	-540	-641	-872	-630	-250	-2825
National currency in cash	-3	69	17	-17	-2	1	-7	11	23	42	35
Current accounts and deposits	-961	349	-1376	-844	-258	644	-378	153	148	-326	494
Commercial credits and advances	-58	119	86	175	123	91	41	-225	0	0	0
Balance of credits attracted	4360	2799	5294	202	1107	-1102	-283	-765	-857	-48	-3350
Other liabilities	-231	693	-244	-915	33	-174	-14	-46	56	82	-4
Reserve assets	892	768	2596	1050	969	-1611	1091	-2227	-3102	-6219	-3979
Monetary gold	0	0	0	0	0	0	0	0	0	0	0
Special borrowing rights	117	-250	252	0	-1	0	0	0	0	-1	1
Reserve position in the IMF	0	0	0	0	0	0	0	0	0	0	0
Other foreign exchange assets	775	1018	2344	1050	970	-1611	1091	-2227	-3101	-6218	-3981
Reserve assets adjustment	18	-1	7	-74	104	-107	-14	-158	92	-52	-158
Net errors and omissions	-2946	-3055	-3653	-119	-599	-988	-1143	-4179	-2669	-1839	-2913
Total balance	0	0	0	0	0	0	0	0	0	0	0

Source: Central Bank of the RF

1.3. Public Finances

Major factors of the budgetary policy in year 2000

In year 2000, there formed an exceptionally favorable situation of the budgetary sphere. For the first time since 1992 the level of tax revenues of the federal budget has exceeded 15 per cent of GDP, while total revenues have topped 16 per cent. At the same time, the budgetary expenditures have been at the lowest level during the last decade.

TABLE 1.3

Administration of Revenues and Expenditures of the Federal and Territorial Budgets (% of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Federal Budget									
Tax revenues	16,6	12,4	11,5	11,6	9,9	10,9	9,6	12,6	15,2
Revenues*	16,8	14,0	13,1	14,3	12,7	12,5	11,2	13,7	16,2
Expenditures	44,8	23,2	25,2	19,2	20,1	18,5	14,4	14,8	13,7
Deficit	-28,0	-9,2	-12,1	-4,9	-7,4	-6,0	-3,2	-1,1	2,5
Territorial Budgets									
Tax revenues	12,0	13,5	13,5	12,2	11,6	12,9	12,1	12,0	12,6
Revenues*	12,3	16,9	18,2	14,8	14,7	16,0	14,8	14,5	15,2
Expenditures	12,0	13,1	17,9	15,2	15,6	17,3	15,1	14,5	14,7
Deficit	0,3	3,8	0,3	-0,4	-0,9	-1,3	-0,3	0,0	0,5

* including revenues of target budgetary funds.

Source: RF Finance Ministry, authors' calculations.

There were several factors behind such a positive situation of the federal budgetary revenues.

First, the key factor was the price situation favorable for traditional Russian staple exports – oil, natural gas, non-ferrous metals, and timber²⁴.

Second, the general growth in the economy led to a broader tax base, what resulted in increasing tax revenues both in nominal and real terms. Thus, real profits of enterprises grew by 50 per cent as compared to 1999 figures, while the real increase of tax revenues made 82 per cent. In year 2000 the growth of real household incomes made 9.1 per cent, while wages and salaries increased by 22.5 per cent, the aggregate personal income tax revenues of the federal budget were up by 14 per cent. Aggregate indirect tax revenues of the federal budget increased by 36 per cent as compared with 1999 figures (VAT revenues grew by 40 per cent).

Fourth, tax administration improved, what, according to the Revenue Ministry data, resulted in a growth in tax revenues by one fourth. This growth was mostly generated by large taxpayers (262 enterprises). For instance, “Gazprom” increased its cash payments by 50 per cent, while “UES” nearly tripled cash payments.

Fifth, the growth rate of arrears of taxes²⁵ due to the federal budget decelerated considerably. In year 2000 the annual increase in tax arrears made only 0.1 per cent of GDP, while the real increment of the balanced tax arrears for year 2000 made only 2 per cent.

²⁴ According to our estimates, in 1998 through 2000 the fluctuations of federal budgetary revenues related to changes in oil prices exceeded 4 per cent of GDP (i.e. 40 per cent of the total amount of revenues of the federal budget). For instance, in 1998 (oil prices were below US \$ 12 per barrel) the value of the cyclic (caused by oil price fluctuations) deficit of the federal budget reached 2.2 per cent of GDP. On the other hand, according to preliminary estimates in year 2000 the amount of extra revenues received by the federal budget due to high oil prices made about 2 per cent of GDP. It is necessary to note that over last 10 years the oil price levels were above the long-time average (15 years) only in 1996 and 1997, and in 2000, when the industry generated extra revenues for the budget.

²⁵ Prior to year 2000 the Revenue Ministry balanced tax arrears against excess tax revenues. In order to ensure comparability, the data are adjusted according to the 1999 methodology.

Sixth, the level of non-monetary budget administration lowered. For instance, the amount of target financing made Rub. 16.6 billion (0.2 per cent of GDP) in year 2000.

The diminishing federal budgetary expenditure in terms of its GDP share may be explained by the fact that GDP grew in real terms by 7.5 per cent over the year, and by 12.5 per cent exceeded the amount of nominal GDP (Rub. 5,350 billion) set by the budget.

TABLE 1.4

Annual Increase in Tax Arrears (% of GDP)					
	1996	1997	1998	1999	2000
Federal budget	1,1%	1,3%	2,1%	0,8%	0,1%
Consolidated budget	3,0%	2,4%	2,9%	0,7%	0,5%

Source: RF Revenue Ministry, authors' calculations.

TABLE 1.5

Rate of Increase in Arrears in Real Terms (Real Annual Increase in Arrears in % of the Amount of Arrears in the Previous Year)					
	1996	1997	1998	1999	2000
Federal budget	41%	42%	30%	18%	2%
Consolidated budget	100%	46%	24%	9%	10%

Source: RF Revenue Ministry, authors' calculations.

Analyzing the administration of 2000 budget law

On August 25, 1999, the RF government submitted to the State Duma draft Federal law "On the Federal Budget for Year 2000," however, the first draft was voted down and returned for further elaboration. After the conciliation commission had redesigned the draft, the State Duma passed it at the first reading on October 26 of

1999. The draft budget was passed at the second reading on November 5, the third reading took place on November 29, 1999. On December 3, 1999, the draft was approved upon the whole and submitted to the Council of Federation. The Council approved the draft on December 22. On December 31, 1999, the President signed the draft into law “On the Federal Budget for Year 2000.”

The expenditure was planned at 16 per cent of the amount of GDP set by the budget, after the expenditure items were adjusted for extra revenues, they made 19 per cent of GDP.

The expenditure items related to law enforcement agencies were considerably increased (by 43 per cent), while expenditure for the social sphere grew by one third, and the financing of the state support of branches of the national economy was increased 1.5 times.

Administration of the original budget for year 2000 across items of budgetary classification was very uneven. Although financing of such items as “Industry, power engineering, and construction” exceeded targets by 74 per cent, “Target budgetary funds” – by 61 per cent, National defense” – by 35 per cent, the expenditure for “Education” increased only by 19 per cent, “Health care” – by 6 per cent, and “Social policy” – by 5 per cent. At the same time “Government debt servicing” and “International activities” were under-financed (by 22 and 59 per cent respectively).

Several factors were behind this unevenness. The under-financing of the “International activities” item was chiefly caused by the absence of tied credit facilities from international financial organizations in amounts envisaged by the budget. The cut in expenditure for the government debt servicing chiefly concerned the domestic debt.

The excessive spending for law enforcement agencies once more demonstrated the power and purposefulness of their lobby.

TABLE 1.6

	Law "On the Federal Budget for Year 2000" (Rub. mil.)	Law on amendments and additions to law "On the Federal Budget for Year 2000" introduced in connection with extra revenues (Rub. mil.)	Administration of the 2000 federal budget (Rub. mil.)	% of the target	% of the adjusted target
Profit tax	63449	171009	178603	281%	104%
Personal income tax	23928	27543	27321	114%	99%
Value Added Tax	277488	366751	371812	134%	101%
Excises	119938	131534	131039	109%	100%
Fees for use of natural resources	11112	17841	18635	168%	104%
Taxes on foreign trade and foreign economic operations	175476	226842	229256	131%	101%
Other taxes, fees and duties	3648	2271	8817	242%	388%
Tax revenues	675039	949913	965482	143%	102%
Revenue from government property or activity	25155	24732	28552	114%	115%
Revenue from foreign economic operations	34560	34387	36403	105%	106%
Other non-tax revenues	2192	4671	4952	226%	106%
Non-tax revenues	61907	63789	69906	113%	110%
Revenues of target budgetary funds	60255	89800	92182	153%	103%
Revenues	797201	1109517	1127571	141%	102%
Government administration	25892	26843	25019	97%	93%
National defense	140852	209445	190790	135%	91%
International activities	56119	39487	23042	41%	58%
Law enforcement, security, and judiciary	87924	111547	113668	129%	102%
Basic research and promotion of scientific and technological progress	15927	17095	17534	110%	103%
Industry, power engineering and construction	20071	38126	35023	174%	92%
Agriculture and fisheries	11505	15440	13352	116%	86%

TABLE 1.6 CONTINUED

	Law "On the Federal Budget for Year 2000" (Rub. mil.)	Law on amendments and additions to law "On the Federal Budget for Year 2000" introduced in connection with extra revenues (Rub. mil.)	Administration of the 2000 federal budget (Rub. mil.)	% of the target	% of the adjusted target
Protection of the environment and natural resources, hydro-meteorology, mapping and geodetic surveying	3738	4074	4112	110%	101%
Transportation, road maintenance, communications and information technology	1639	1901	1852	113%	97%
Preventing and/or eliminating the effects of emergencies and natural disasters	9027	9599	9450	105%	98%
Education	32099	37644	38117	119%	101%
Culture and arts	4679	5399	5193	111%	96%
Mass media	5725	6140	6096	106%	99%
Health and physical fitness	15993	16998	16880	106%	99%
Social policy	62997	66758	66330	105%	99%
Expenditures of target budgetary funds	60585	97261	97271	161%	100%
Government debt servicing, including:	220069	188722	172211	78%	91%
Domestic debt	63269	63269	54949	87%	87%
External debt	156800	125452	124791	80%	99%
Financial aid to other levels of government	69149	97274	101381	147%	104%
Other expenditure	135392	121719	193900	143%	159%
Expenditure	855073	1014196	954105	112%	94%
Proficit	-57872	95321	173466	-300%	182%

Administration of consolidated and federal budgets: the Dynamics

For monthly dynamics of the federal and consolidated budgetary indicators see Table 5. The federal budgetary reve-

nues peaked in the middle of the year (May and June), at that time tax revenues (revenues of target budgetary funds excluded) were above 15 per cent of GDP, and the total revenues made over 17 per cent of GDP. By end-year the indicators of tax revenues and total revenues were back to values registered in the beginning of the year and made 13.5 to 14 per cent of GDP and 15.5 to 16 per cent of GDP respectively.

The mid-year surge in revenues was caused by growing profit tax revenues, which stabilized later in the year at 2.6 per cent. At the same time, indirect taxes (first of all VAT) decreased by 1 percentage point to 7.3 per cent of GDP from August to the end of the year. The decrease in VAT revenues may be explained by a considerable growth in VAT reimbursements in the second half of year 2000.

Profit tax. Profit tax revenues of the federal budget increased from 1.8 per cent of GDP to 2.6 per cent of GDP (by 83 per cent in comparable prices) over year 2000. They exceeded the original budgetary target by 180 per cent and were by 4 per cent higher than it was stipulated by the budget adjusted for extra revenues. The most important factor behind the increase in profit tax revenues (occurring without substantial changes in the legislation regulating this tax) was a growth in profits of enterprises and improved payment performance.

Profit tax revenues of the consolidated budget increased from 3.3 per cent of GDP in January to 5.8 per cent of GDP in December (by 51 per cent in comparable prices). The revenues peaked to 5.9 per cent of GDP in June.

Income tax. Income tax revenues of the federal budget were at 0.3 to 0.4 per cent of GDP, while revenues of the consolidated budget generated by this tax stabilized at the level of 2.2 to 2.4 per cent of GDP (after a traditionally low level of

income tax revenues registered in the first quarter). In year 2000 the income tax revenues of the consolidated budget increased by one fourth as compared with the previous year figures, thus slightly outpacing the increase in the federal budgetary income tax revenues. This fact may be explained by some redistribution of tax revenues between the federal and territorial budgets (territorial budgets disposed of 100 per cent of income tax revenues until April 1, 1999; after this date 3 per cent of the tax were entered to the federal budget, and in year 2000 the rate of income tax revenues due to the federal budget was set at 16 per cent.

Value added tax. The growth in VAT revenues of the federal budget calculated as the percentage of GDP was less impressive than that in profit tax revenues (from 4.9 per cent of GDP to 5.4 per cent of GDP). In comparable prices VAT revenues by 40 per cent exceeded respective figures registered in 1999. Over the year several factors differently affected the level of VAT revenues. For instance, the federal budget accumulated extra VAT revenues (about Rub. 7,5 billion, or 0.1 per cent of GDP) due to the redistribution of VAT among the levels of the budgetary system. At the same time, there was registered some increase in the amount of VAT reimbursement to exporters (from 0.8 per cent of GDP to 1.5 per cent of GDP, or more than twofold in comparable prices). Besides, some new items were included in the list of goods subject to lower VAT rates, what resulted in less revenues (by about Rub. 5.6 billion, or 0.1 per cent of GDP).

Tax revenues of the consolidated budget diminished from 7.2 per cent of GDP to 6.6 per cent of GDP over the year, while growing by 32 per cent as measured in comparable prices. As in case of the income tax, VAT revenues of territorial

budgets grew less because the share of VAT revenues due to them was diminished from 25 per cent in 1999 to 15 per cent in year 2000.

Excises. No increase in excises as measured in percentage of GDP was registered in year 2000 (excises on domestic products were at 1.8 per cent of GDP and excises on imported products were at 0.04 per cent of GDP as compared with 1.8 per cent of GDP and 0.08 per cent of GDP respectively registered in 1999). In comparable prices excises grew by 29 per cent (excises on domestic products increased by 32 per cent, while excises on imported products fell by 37 per cent).

The increase in excises on natural gas made 34 per cent as measured in comparable prices. This increase may be attributed to a growth in natural gas prices occurring in the situation of *ad valorem* taxation. The increase in oil excises (by 43 per cent) resulted from growing oil extraction and exports. A general contraction of imports was responsible for a decrease in import excises. Excise-generated revenues of the consolidated budget were stable as measured in the percentage of GDP (2.4 per cent of GDP). In comparable prices excises grew by 27 per cent.

Foreign trade taxation. Customs duties and charges increased from 1.9 per cent of GDP in 1999 to 3.3 per cent of GDP in year 2000. This growth occurred at the background of contraction of imports and stable revenues from import duties (1 per cent of GDP in 1999 and 0.9 per cent of GDP in year 2000), what may be explained by a twofold increase in the revenues generated by export duties as measured in the percentage of GDP (from 0.9 per cent of GDP to 2.4 per cent of GDP) and their growth by 3.5 times in comparable prices.

The expenditures of the federal budget practically followed the revenue dynamics. The only difference was that large amounts were expended in the last month of the year, thus bringing the total amount of expenditures up to 13.8 per cent of GDP. The key factor behind the dynamics of the total expenditures were changes in the financing of the state support of branches of the national economy.

TABLE 1.7

Administration of the 2000 Federal Budget (% of GDP)

	January	February	March	April	May	June	July	August	September	October	November	December
Profit tax	1,6%	1,6%	2,0%	2,3%	2,6%	2,6%	2,4%	2,6%	2,5%	2,4%	2,5%	2,6%
Personal income tax	0,3%	0,3%	0,3%	0,3%	0,3%	0,4%	0,4%	0,4%	0,4%	0,4%	0,4%	0,4%
Taxes on goods and services. License and registration fees	8,2%	8,3%	8,0%	8,1%	8,3%	8,1%	8,0%	7,6%	7,3%	7,2%	7,2%	7,3%
Taxes on foreign trade and foreign economic operations	3,1%	3,4%	3,5%	3,5%	3,5%	3,5%	3,4%	3,4%	3,3%	3,3%	3,3%	3,3%
Other taxes	0,3%	0,3%	0,3%	0,3%	0,3%	0,3%	0,3%	0,3%	0,3%	0,3%	0,3%	0,4%
Tax revenues	13,6%	14,0%	14,1%	14,6%	15,1%	14,9%	14,6%	14,2%	13,8%	13,6%	13,7%	13,9%
Non-tax revenues	1,9%	1,8%	1,8%	2,0%	2,1%	2,2%	2,1%	2,2%	2,1%	2,1%	2,2%	2,3%
Total revenues	15,5%	15,8%	16,0%	16,6%	17,2%	17,0%	16,7%	16,4%	16,0%	15,7%	15,9%	16,2%
Government	0,1%	0,2%	0,3%	0,3%	0,3%	0,4%	0,3%	0,3%	0,3%	0,3%	0,3%	0,4%
National defense	0,0%	2,5%	3,0%	3,0%	2,9%	2,8%	2,6%	2,6%	2,5%	2,6%	2,6%	2,7%
International activities	0,7%	0,9%	0,8%	0,8%	0,6%	0,0%	0,2%	0,2%	0,2%	0,3%	0,3%	0,3%
Judiciary	0,0%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%
Law enforcement, security	0,8%	1,2%	1,3%	1,3%	1,4%	1,4%	1,4%	1,4%	1,3%	1,3%	1,3%	1,5%
Basic research and promotion of scientific and technological progress	0,0%	0,1%	0,1%	0,2%	0,2%	0,2%	0,2%	0,2%	0,2%	0,2%	0,2%	0,3%
Government services to the national economy, of which:	0,3%	0,4%	0,5%	0,6%	0,7%	0,7%	0,6%	0,7%	0,7%	0,6%	0,7%	0,9%
Social services	1,3%	1,5%	1,8%	1,9%	1,9%	1,9%	1,9%	1,8%	1,8%	1,7%	1,8%	1,9%

TABLE 1.7 CONTINUED

	January	February	March	April	May	June	July	August	September	October	November	December
Government debt servicing	3,8%	3,1%	2,9%	2,8%	2,9%	3,1%	3,0%	3,0%	3,0%	2,7%	2,6%	2,5%
Other expenditure	5,6%	2,4%	2,5%	2,5%	2,9%	2,9%	2,9%	2,9%	2,8%	2,8%	2,9%	3,2%
Total expenditure	12,6%	12,4%	13,3%	13,4%	13,8%	13,6%	13,3%	13,2%	12,9%	12,7%	12,8%	13,8%
Credit less repayment	0,1%	0,3%	0,5%	0,4%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	-0,1%
Total expenditure and credit less repayment	12,6%	12,7%	13,8%	13,8%	13,8%	13,6%	13,3%	13,2%	12,9%	12,7%	12,8%	13,7%
Deficit	2,9%	3,1%	2,2%	2,8%	3,4%	3,4%	3,4%	3,2%	3,1%	3,0%	3,1%	2,5%
Domestic financing	-0,5%	-1,5%	-0,3%	-0,3%	-1,1%	-0,6%	-0,6%	-0,6%	-0,7%	-0,4%	-0,5%	0,0%
External financing	-2,4%	-1,6%	-1,9%	-2,5%	-2,3%	-3,2%	-2,9%	-2,7%	-2,4%	-2,7%	-2,5%	-2,5%
Total financing	-2,9%	-3,1%	-2,2%	-2,8%	-3,4%	-3,7%	-3,4%	-3,2%	-3,1%	-3,0%	-3,1%	-2,5%

TABLE 1.8

Administration of the 2000 Consolidated Budget (% of GDP)

	January	February	March	April	May	June	July	August	September	October	November	December
Profit tax	3,3%	3,3%	4,3%	5,2%	5,9%	5,9%	5,6%	5,8%	5,6%	5,4%	5,6%	5,8%
Personal income tax	1,9%	2,0%	2,2%	2,2%	2,3%	2,4%	2,4%	2,4%	2,4%	2,4%	2,4%	2,5%
Taxes on goods and services. License and registration fees	10,3%	10,4%	10,1%	10,2%	10,4%	10,2%	10,2%	9,7%	9,4%	9,4%	9,3%	9,5%
Taxes on foreign trade and foreign economic operations	3,1%	3,4%	3,5%	3,5%	3,5%	3,5%	3,4%	3,4%	3,3%	3,3%	3,3%	3,3%
Other taxes	2,2%	2,2%	2,5%	3,0%	3,4%	3,4%	3,3%	3,5%	3,4%	3,3%	3,4%	3,5%
Tax revenues	20,8%	21,4%	22,6%	24,2%	25,5%	25,4%	24,9%	24,8%	24,1%	23,7%	24,0%	24,6%
Non-tax revenues	3,6%	3,4%	3,8%	4,0%	4,2%	4,4%	4,4%	4,5%	4,4%	4,3%	4,6%	5,4%
Total revenues	24,4%	24,8%	26,4%	28,2%	29,7%	29,7%	29,3%	29,2%	28,4%	28,0%	28,6%	30,0%
Government	0,5%	0,8%	0,9%	1,0%	1,0%	1,0%	1,0%	1,0%	1,0%	1,0%	1,0%	1,1%
National defense	0,0%	2,5%	3,0%	3,0%	2,9%	2,8%	2,6%	2,6%	2,5%	2,6%	2,6%	2,7%
International activities	0,7%	0,9%	0,8%	0,8%	0,6%	0,0%	0,2%	0,2%	0,2%	0,3%	0,3%	0,3%
Judiciary	2,8%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%
Law enforcement, security	1,1%	1,5%	1,6%	1,7%	1,8%	1,8%	1,8%	1,7%	1,7%	1,7%	1,7%	1,9%

TABLE 1.8 CONTINUED

	January	February	March	April	May	June	July	August	September	October	November	December
Basic research and promotion of scientific and technological progress	0,0%	0,1%	0,1%	0,2%	0,2%	0,2%	0,2%	0,2%	0,2%	0,2%	0,2%	0,3%
Government services to the national economy, of which:	2,5%	2,9%	3,5%	4,0%	4,4%	4,5%	4,5%	4,7%	4,6%	4,6%	4,7%	5,4%
Social services	4,7%	5,7%	6,6%	7,0%	7,2%	7,7%	7,5%	7,4%	7,2%	7,1%	7,2%	7,7%
Government debt servicing	4,0%	3,8%	3,7%	3,7%	3,8%	3,9%	3,7%	3,7%	3,4%	3,1%	3,0%	2,8%
Other expenditure	3,4%	2,6%	2,8%	3,0%	3,1%	3,2%	0,5%	3,3%	3,3%	3,4%	3,5%	4,5%
Total expenditure	19,8%	20,9%	23,3%	24,3%	25,0%	25,3%	22,1%	24,8%	24,3%	24,0%	24,4%	26,8%
Credit less repayment	-0,1%	0,2%	0,5%	0,5%	0,2%	0,2%	0,2%	0,3%	0,3%	0,2%	0,2%	0,2%
Total expenditure and credit less repayment	19,6%	21,1%	23,8%	24,8%	25,2%	25,5%	22,3%	25,1%	24,5%	24,2%	24,6%	27,0%
Deficit	4,7%	3,7%	2,6%	3,4%	4,5%	4,3%	7,0%	4,1%	3,9%	3,8%	4,0%	3,0%
Domestic financing	-2,7%	-2,1%	-0,7%	-0,9%	-2,1%	-1,3%	-1,3%	-1,4%	-1,4%	-1,0%	-1,2%	-0,1%
External financing	-1,9%	-1,6%	-2,3%	-2,8%	-2,6%	-3,1%	-3,1%	-3,2%	-2,9%	-3,1%	-3,1%	-3,2%
Total financing	-4,6%	-3,7%	-3,0%	-3,7%	-4,7%	-4,4%	-4,4%	-4,6%	-4,3%	-4,2%	-4,3%	-3,3%

Enlarged government budget

An analysis of administration of the enlarged government budget permits to draw the following conclusions:

First, in year 2000 the federal budget accounted for almost all increase in the revenues of the enlarged government. Thus, in year 2000 tax revenues of the enlarged government made 37.9 per cent of GDP (34.4 per cent of GDP in 1999), while the total revenues were at 40.4 per cent of GDP (36.9 per cent of GDP in 1999). At the same time, the increase in the revenues of the federal budget made 2.6 percentage points (up to 15.2 per cent of GDP), while territorial budgets accounted only for the growth by 0.6 percentage points (up to 12.6 per cent of GDP), and revenues of extra-budgetary funds increased by 0.3 percentage points (up to 10.1 per

cent of GDP). This unevenness may be chiefly attributed to the fact that the favorable oil and natural gas price situation did not directly affect the revenue base of territorial budgets and extra-budgetary funds.

Second, the uneven growth of revenues resulted in some structural changes: the share of federal budgetary revenues in the revenues of the enlarged government increased from 37 per cent to 40 per cent, while the revenues of territorial budgets decreased from 39 to 37.5 per cent, and those of extra-budgetary funds diminished from 29.3 per cent to 27.7 per cent.

Third, the 2.8 percentage points decrease in the expenditures of the enlarged government (down to 35.4 per cent of GDP) accompanied by a growth in revenues resulted in the increase in the primary profit by 6.3 percentage points. The expenditures diminished unevenly: while expenditures of the federal budget and of extra-budgetary funds decreased by 1.1 percentage points and 1.5 percentage points respectively, the expenditures of territorial budgets increased by 0.2 percentage points. Social funds accounted for the decrease in the expenditures of extra-budgetary funds, while the expenditures of road funds remained at 2 per cent of GDP.

TABLE 1.9

Enlarged Government Budget Balance in 1999

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		% of revenues, expenditure
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	
REVENUE									
1.Income, profit, and capital gain taxes	101129,2	2,3%	236016,9	5,3%			337146,1	7,5%	20,4%
1.1.Profit tax	81201,1	1,8%	139005,4	3,1%			220206,6	4,9%	13,3%
1.2.Personal income tax	19928,1	0,4%	97011,5	2,2%			116939,6	2,6%	7,1%

TABLE 1.9 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		% of revenues, expenditure
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	
2. Taxes on goods and services. License and registration fees	307383,5	6,9%	111307,3	2,5%			418690,8	9,4%	25,3%
2.1. Value added tax	221031,3	4,9%	65852,4	1,5%			286883,7	6,4%	17,4%
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%	6,3%
Including: 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%
2.4. License and registration fees	689,1	0,0%	931,2	0,0%			1620,2	0,0%	0,1%
2.5. Tax on purchase of foreign currency notes and payment documents denominated in foreign exchange	1451,4	0,0%	1016,5	0,0%			2467,9	0,1%	0,1%
2.6. Sales tax	0,0	0,0%	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%	3,2%
5. Fees for use of natural resources	10496,0	0,2%	34079,5	0,8%			44575,5	1,0%	2,7%
5.1. Fees for use of mineral wealth	7190,5	0,2%	22886,3	0,5%			30076,7	0,7%	1,8%
5.2. Fees for use of continental shelf	0,3	0,0%	25,2	0,0%			25,5	0,0%	0,0%
5.3. Fees for use of forest fund	446,9	0,0%	1280,1	0,0%			1727,0	0,0%	0,1%
5.4. Fees for use of water objects	198,4	0,0%	836,4	0,0%			1034,8	0,0%	0,1%
5.5. Fees for normative and extra-normative emissions of harmful substances	460,5	0,0%					460,5	0,0%	0,0%
5.6. Land tax	2189,3	0,0%	8749,7	0,2%			10939,0	0,2%	0,7%
5.7. Other fees for use of natural resources	10,2	0,0%	301,8	0,0%			312,0	0,0%	0,0%
6. Taxes on foreign trade and foreign economic operations	86261,8	1,9%	0,1	0,0%			86261,9	1,9%	5,2%
6.1. Customs duties	86168,4	1,9%					86168,4	1,9%	5,2%

TABLE 1.9 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		% of revenues, expenditure
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	
6.2. Other taxes and duties related to external economic operations	93,5	0,0%	0,1	0,0%			93,5	0,0%	0,0%
7. Other taxes, fees and duties	2228,2	0,0%	54157,5	1,2%			56385,7	1,3%	3,4%
7.1. State duty	797,5	0,0%	1149,8	0,0%			1947,3	0,0%	0,1%
7.2. Other federal taxes	1094,6	0,0%					1094,6	0,0%	0,1%
7.3. Taxes imposed by RF subjects			2736,5	0,1%			2736,5	0,1%	0,2%
7.4. Local taxes and charges			49031,0	1,1%			49031,0	1,1%	3,0%
7.5. Other tax payments and charges	336,1	0,0%	1240,2	0,0%			1576,3	0,0%	0,1%
8. Отчисления во внебюджетные фонды					438966,3	9,8%	438966,3	9,8%	26,6%
8.1. Extra-budgetary social insurance fund receipts					344344,6	7,7%	344344,6	7,7%	20,8%
Pension Fund					250435,6	5,6%	250435,6	5,6%	15,2%
Social Insurance Fund					48268,0	1,1%	48268,0	1,1%	2,9%
Employment Fund					12494,1	0,3%	12494,1	0,3%	0,8%
Compulsory Medical Insurance Fund (CMIF) and territorial CMIFs					33146,9	0,7%	33146,9	0,7%	2,0%
8.2. Contributions to territorial road funds					89309,5	2,0%	89309,5	2,0%	5,4%
8.3. Contributions to other extra-budgetary funds					5312,2	0,1%	5312,2	0,1%	0,3%
9. Other extra-budgetary funds	55183,4	1,2%	42030,4	0,9%			97213,8	2,2%	5,9%
TOTAL TAXES AND PAYMENTS	564690,6	12,6%	535119,3	12,0%	438966,3	9,8%	1538776,1	34,4%	93,1%
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 land and intangible assets	20,2	0,0%	609,7	0,0%			629,9	0,0%	0,0%
3. Administrative charges	456,9	0,0%	1392,4	0,0%			1849,2	0,0%	0,1%
4. Penalties and indemnity	4219,2	0,1%	1518,9	0,0%	5524,5	0,1%	11262,6	0,3%	0,7%
5. Revenue from foreign economic operations	34722,4	0,8%	17,1	0,0%			34739,5	0,8%	2,1%

TABLE 1.9 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	% of revenues, expenditure
6. Other non-tax revenue	817,9	0,0%	16105,3	0,4%	11061,3	0,2%	27984,5	0,6%	1,7%
7. Transfers from other levels of government	9,2	0,0%	62135,3	1,4%			x	x	x
8. Other grants			2193,2	0,0%			2193,2	0,0%	0,1%
9. Receipts from government extra-budgetary funds			10702,6	0,2%			10702,6	0,2%	0,6%
10. Receipts from government organizations	0,1	0,0%	2155,2	0,0%			2155,3	0,0%	0,1%
11. Funds transferred to extra-budgetary funds					29650,5	0,7%	x	x	x
11.1. Federal budget funds					18623	0,4%	x	x	x
11.2. Local budget funds					11027,5	0,2%	x	x	x
TOTAL NON-TAX REVENUE	47018,8	1,1%	112769,3	2,5%	46236,2	1,0%	114229,3	2,6%	6,9%
TOTAL REVENUE	611709,4	13,7%	647888,5	14,5%	485202,5	10,8%	1653005,4	36,9%	100,0%
EXPENDITURES									
1. Government administration	14832,4	0,3%	31688,9	0,7%			46521,3	1,0%	2,7%
2. National defense	116127,5	2,6%					116127,5	2,6%	6,8%
3. International activities	58080,3	1,3%					58080,3	1,3%	3,4%
3. Judiciary	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%	4,4%
5. Basic research and promotion of scientific and technological progress	11196,8	0,3%	706,0	0,0%	1823	0,0%	13725,4	0,3%	0,8%
6. Government services to the national economy, of which:	37199,9	0,8%	206687,2	4,6%	91061,8	2,0%	334886,9	7,5%	19,6%
6.1. Industry, power engineering and construction	16921,3	0,4%	14081,9	0,3%	832,3	0,0%	31835,5	0,7%	1,9%
6.2. Agriculture and fisheries	9068,0	0,2%	26700,9	0,6%			35768,9	0,8%	2,1%
6.3. Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	2894,9	0,1%	2369,1	0,1%	2113,1	0,0%	7377,1	0,2%	0,4%
6.4. Transportation, road maintenance, communications and information technology	941,6	0,0%	25126,5	0,6%			26006,1	0,6%	1,5%
Funds transferred to territorial road funds (TRF)			62,0	0,0%			x	x	x

TABLE 1.9 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		% of revenues, expenditure
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	
6.5. Market infrastructure development	0,0	0,0%	12332,6	0,3%			12332,6	0,3%	0,7%
6.6. Housing and utilities	0,0	0,0%	124580,2	2,8%			124580,2	2,8%	7,3%
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					88116,3	2,0%	88116,3	2,0%	5,2%
7. Social services	85059,4	1,9%	280397,5	6,3%	347007,4	7,8%	682874,9	15,3%	40,0%
7.1. Education	20945,4	0,5%	126071,5	2,8%	665,9	0,0%	147682,7	3,3%	8,6%
7.2. Culture and arts	2876,6	0,1%	15012,6	0,3%			17889,2	0,4%	1,0%
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%	43407,7	1,0%	135552,3	3,0%	7,9%
Funds transferred to Compulsory Medical Insurance Fund (CMIF) and territorial CMIFs			10940,4	0,2%			x	x	x
7.5. Social policy, including:	49096,0	1,1%	43088,8	1,0%	302933,8	6,8%	376469,6	8,4%	22,0%
Funds transferred to Pension, Employment, and Social Insurance Funds	18623,0	0,4%	26,1	0,0%			x	x	x
8. Target budgetary funds	55275,3	1,2%	37529,9	0,8%			92805,3	2,1%	5,4%
9. Government debt service	162582,7	3,6%					162582,7	3,6%	9,5%
10. Other expenditure	76460,3	1,7%	64576,8	1,4%			113979,2	2,5%	6,7%
10.1. Financial aid to other levels of government	62135,3	1,4%	9,2	0,0%			x	x	x
10.2. Other expenditure not attributed to other sub-items	14325,0	0,3%	64567,6	1,4%	35086,6	0,8%	113979,2	2,5%	6,7%
TOTAL EXPENDITURE	677247,5	15,1%	640591,5	14,3%	474978,3	10,6%	1701021,5	38,0%	99,6%
CREDIT LESS 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%
Loans to budgets	7914,0	0,2%	2010,0	0,0%			x	x	x
Repayment of loans by budgets	20487,8	0,5%	643,3	0,0%			x	x	x
Budgetary loans granted to ministries, agencies, enterprises, and organizations	0,0	0,0%	20165,7	0,5%			20165,7	0,5%	1,2%

TABLE 1.9 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	% of revenues, expenditure
Repayment of loans by ministries, agencies, enterprises, and organizations	0,0	0,0%	13207,4	0,3%			13207,4	0,3%	0,8%
TOTAL EXPENDITURE AND CREDIT LESS REPAYMENT	664673,8	14,8%	648916,5	14,5%	474978,3	10,6%	1707979,8	38,2%	100,0%
SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	-52964,4	-1,2%	-1028,0	0,0%	10224,1	0,2%	-54974,4	-1,2%	
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%	10445,9	0,2%	-46130,4	-1,0%	
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	0,0	0,0%	-2211,3	0,0%			-2211,3	0,0%	
1.7. Other government securities	15,1	0,0%	0,0	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 extra-budgetary funds					-221,8	0,0%	-221,8	0,0%	
TOTAL DOMESTIC FINANCING	5544,5	0,1%	1028,0	0,0%	10224,1	0,2%	7554,7	0,2%	
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%	10224,1	0,2%	54974,4	1,2%	

TABLE 1.10

Enlarged Government Budget Balance in 2000

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		% of revenues, expenditure
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	
REVENUE									
1. Income, profit, and capital gain taxes	205923,3	3,0%	368668,5	5,3%			574591,8	8,3%	20,9%
1.1. Profit tax	178602,8	2,6%	221311,5	3,2%			399914,3	5,8%	14,6%
1.2. Personal income tax	27320,5	0,4%	147357,0	2,1%			174677,5	2,5%	6,4%
2. Taxes on goods and services. License and registration fees	505141,5	7,3%	156800,8	2,3%			661942,3	9,5%	24,1%
2.1. Value added tax	371811,8	5,4%	85095,3	1,2%			456907,1	6,6%	16,6%
2.2. Excises on excisable goods and selected mineral raw materials produced on RF territory	128376,4	1,8%	35171,8	0,5%			163548,3	2,4%	6,0%
Including: Excises on oil, including gas condensate	7053,5	0,1%	0,0	0,0%			7053,5	0,1%	0,3%
2.2. Excises on excisable goods and selected mineral raw materials imported to RF territory	2662,5	0,0%	0,0	0,0%			2662,5	0,0%	0,1%
2.4. License and registration fees	707,0	0,0%	800,3	0,0%			1507,3	0,0%	0,1%
2.5. Tax on purchase of foreign currency notes and payment documents denominated in foreign exchange	1583,1	0,0%	1063,6	0,0%			2646,7	0,0%	0,1%
2.6. Sales tax	0,0	0,0%	34638,2	0,5%			34638,2	0,5%	1,3%
2.7. Other taxes and charges imposed on goods and services	0,7	0,0%	31,6	0,0%			32,3	0,0%	0,0%
3. Aggregate income tax	2589,1	0,0%	12143,2	0,2%			14732,4	0,2%	0,5%
4. Property tax	1289,7	0,0%	63439,2	0,9%			64728,9	0,9%	2,4%
5. Fees for use of natural resources	18635,1	0,3%	59089,8	0,9%			77724,9	1,1%	2,8%
5.1. Fees for use of mineral wealth	13154,6	0,2%	45781,8	0,7%			58936,3	0,8%	2,1%
5.2. Fees for use of continental shelf	2,6	0,0%	22,1	0,0%			24,7	0,0%	0,0%
5.3. Fees for use of forest fund	780,7	0,0%	1392,8	0,0%			2173,6	0,0%	0,1%

TABLE 1.10 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		% of revenues, expenditure
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	
5.4. Fees for use of water objects	677,2	0,0%	943,3	0,0%			1620,4	0,0%	0,1%
5.5. Fees for normative and extra-normative emissions of harmful substances	615,0	0,0%	0,0	0,0%			615,0	0,0%	0,0%
5.6. Land tax	3365,5	0,0%	10677,3	0,2%			14042,7	0,2%	0,5%
5.7. Fees for the right to use objects of animal world and water biological resources	13,4	0,0%	20,0	0,0%			33,4	0,0%	0,0%
5.8. Other fees for use of natural resources	26,2	0,0%	252,5	0,0%			278,7	0,0%	0,0%
6. Taxes on foreign trade and foreign economic operations	229255,5	3,3%	0,0	0,0%			229255,5	3,3%	8,4%
6.1. Customs duties	228698,5	3,3%	0,0	0,0%			228698,5	3,3%	8,3%
6.2. Customs charges	0,0	0,0%	0,0	0,0%			0,0	0,0%	0,0%
6.1. Other taxes and duties related to external economic operations	557,1	0,0%	0,0	0,0%			557,1	0,0%	0,0%
7. Other taxes, fees and duties	2647,7	0,0%	82038,1	1,2%			84685,9	1,2%	3,1%
7.1. State duty	1186,2	0,0%	1351,4	0,0%			2537,6	0,0%	0,1%
7.2. Other federal taxes	1108,7	0,0%	0,0	0,0%			1108,7	0,0%	0,0%
7.3. Taxes imposed by RF subjects			2008,8	0,0%			2008,8	0,0%	0,1%
7.4. Local taxes and charges			78027,3	1,1%			78027,3	1,1%	2,8%
7.5. Other tax payments and charges	352,8	0,0%	650,7	0,0%			1003,4	0,0%	0,0%
8. Contributions to extra-budgetary funds					699088,5	10,1%	699088,5	10,1%	25,0%
8.1. Extra-budgetary social insurance fund receipts					551542,2	7,9%	551542,2	7,9%	19,7%
Pension Fund					391931,6	5,6%	391931,6	5,6%	14,0%
Social Insurance Fund					90852,7	1,3%	90852,7	1,3%	3,2%
Employment Fund					20742,0	0,3%	20742,0	0,3%	0,7%
Compulsory Medical Insurance Fund (CMIF) and territorial CMIFs					48015,9	0,7%	48015,9	0,7%	1,7%
8.2. Contributions to					140119,7	2,0%	140119,7	2,0%	5,1%

territorial road funds

TABLE 1.10 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		% of revenues, expenditure
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	
8.3. Contributions to other extra-budgetary funds					7426,5	0,1%	7426,5	0,1%	0,3%
9. Other extra-budgetary funds	92182,1	1,3%	132059,5	1,9%			224241,6	3,2%	8,2%
TOTAL TAXES AND PAYMENTS	1057664,2	15,2%	874239,1	12,6%	699088,5	10,1%	2630991,7	37,9%	93,9%
NONTAX REVENUES									
1. Revenue from government property or activity	28552,1	0,4%	39579,3	0,6%			68131,4	1,0%	2,5%
2. Proceeds from the sale of land and intangible assets	20,3	0,0%	860,7	0,0%			881,0	0,0%	0,0%
3. Administrative charges	739,6	0,0%	2083,8	0,0%			2823,4	0,0%	0,1%
4. Penalties and indemnity	1955,1	0,0%	2757,1	0,0%	6065,3	0,1%	10777,5	0,2%	0,4%
5. Revenue from foreign economic operations	36402,6	0,5%	1,8	0,0%			36404,4	0,5%	1,3%
6. Other non-tax revenue	2236,2	0,0%	16706,1	0,2%	17383,8	0,3%	36326,1	0,5%	1,3%
7. Transfers from other levels of government			101198,2	1,5%			x	x	x
8. Other grants	0,5	0,0%	3510,2	0,1%			3510,7	0,1%	0,1%
9. Receipts from government extra-budgetary funds			7819,8	0,1%			7819,8	0,1%	0,3%
10. Receipts from government organizations	0,1	0,0%	3892,4	0,1%			3892,5	0,1%	0,1%
11. Funds transferred to extra-budgetary funds					51348,3	0,7%	x	x	x
11.1. Federal budget funds					34781	0,5%	x	x	x
11.2. Local budget funds					16567,5	0,2%	x	x	x
14.2. Means of other extra-budgetary funds					2311,9	0,0%	x	x	x
TOTAL NON-TAX REVENUE	69906,5	1,0%	178409,4	2,6%	74797,5	1,1%	170566,8	2,5%	6,2%
TOTAL REVENUE	1127570,6	16,2%	1052648,5	15,2%	773886,0	11,2%	2801558,5	40,4%	100,0%
EXPENDITURES									
1. Government administration	25019,0	0,4%	48031,9	0,7%			73050,9	1,1%	3,0%

2. National defense	190789,9	2,7%	0,0	0,0%			190789,9	2,7%	7,9%
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TABLE I.10 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	% of revenues, expenditure
3. International activities	23042,1	0,3%	0,0	0,0%			23042,1	0,3%	0,9%
3. Judiciary	8277,9	0,1%	202,4	0,0%			8480,3	0,1%	0,3%
4. Law enforcement and security	105390,0	1,5%	26951,0	0,4%			132341,0	1,9%	5,5%
5. Basic research and promotion of scientific and technological progress	17534,1	0,3%	1031,6	0,0%	2339	0,0%	20904,6	0,3%	0,9%
6. Government services to the national economy, of which:	63838,3	0,9%	312798,8	4,5%	134405,6	1,9%	511004,3	7,4%	21,1%
6.1. Industry, power engineering and construction	35022,9	0,5%	23425,5	0,3%	1509,4	0,0%	59957,8	0,9%	2,5%
6.2. Agriculture and fisheries	13352,3	0,2%	40833,5	0,6%			54185,8	0,8%	2,2%
6.3. Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	4111,7	0,1%	4074,0	0,1%	2357,7	0,0%	10519,4	0,2%	0,4%
Funds transferred to TEFs			24,0	0,0%			x	x	x
6.4. Transportation, road maintenance, communications and information technology	1851,8	0,0%	36555,3	0,5%	130538,6	1,9%	168931,2	2,4%	7,0%
Funds transferred to territorial road funds (TRF)			14,4	0,0%			x	x	x
6.5. Market infrastructure development	50,0	0,0%	6988,7	0,1%			7038,7	0,1%	0,3%
6.6. Housing and utilities			198929,7	2,9%			198929,7	2,9%	8,2%
6.7. Preventing and/or eliminating the effects of emergencies and natural disasters	9449,6	0,1%	1992,1	0,0%			11441,7	0,2%	0,5%
7. Social services	132617,2	1,9%	401414,3	5,8%	471456,3	6,8%	961833,3	13,9%	39,1%
7.1. Education	38117,3	0,5%	176166,5	2,5%	914,3	0,0%	215198,1	3,1%	8,8%
7.2. Culture and arts	5193,5	0,1%	23221,6	0,3%			28415,1	0,4%	1,2%
7.3. Mass media	6096,5	0,1%	5951,9	0,1%			12048,4	0,2%	0,5%
7.4. Health and physical fitness	16879,5	0,2%	135613,5	2,0%	56268,8	0,8%	192250,3	2,8%	7,8%
Funds transferred to territorial CMIFs from budgets			16511,5	0,2%			x	x	x

TABLE I.10 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	% of revenues, expenditure
Funds transferred to territorial CMIFs from CMIF					2036,3	0,0%	x	x	x
7.5. Social policy, including:	66330,4	1,0%	60460,7	0,9%	414273,2	6,0%	513921,4	7,4%	20,9%
Funds transferred to Pension, Employment, and Social Insurance Funds	27125,4	0,4%	17,6	0,0%	274,3	0,0%	x	x	x
8. Target budgetary funds	97270,9	1,4%	125200,2	1,8%			214814,4	3,1%	8,9%
10. Government debt service	172211,2	2,5%	18890,9	0,3%			191102,1	2,8%	7,9%
11. Other expenditure	122410,5	1,8%	65652,8	0,9%			188063,4	2,7%	7,8%
11.1. Financial aid to other levels of government	101198,2	1,5%	0,0	0,0%			x	x	x
11.2. Other expenditure not attributed to other sub-items	21212,3	0,3%	65652,8	0,9%	26065,7	0,4%	112930,9	1,6%	4,7%
TOTAL EXPENDITURE	958401,1	13,8%	1000173,9	14,4%	634266,6	9,1%	2440293,8	35,2%	99,2%
CREDIT LESS REPAYMENT	-4296,6	-0,1%	18538,2	0,3%			18538,2	0,3%	0,8%
Budgetary loans	-4296,6	-0,1%	18538,2	0,3%			18538,2	0,3%	0,8%
Loans to budgets	12250,9	0,2%					x	x	x
Repayment of loans by budgets	16547,5	0,2%					x	x	x
Budgetary loans granted to ministries, agencies, enterprises, and organizations			50483,0	0,7%			50483,0	0,7%	2,1%
Repayment of loans by ministries, agencies, enterprises, and organizations			31944,8	0,5%			31944,8	0,5%	1,3%
TOTAL EXPENDITURE AND CREDIT LESS REPAYMENT SURPLUS OF REVENUE OVER EXPENDITURE AND CREDIT LESS REPAYMENT	173466,1	2,5%	33936,4	0,5%	139619,4	2,0%	342726,6	4,9%	
TOTAL FINANCING									
1.Domestic financing									
1.1. Change in bank account balances of budget funds, in Rubles	-42248,9	-0,6%	-20607,4	-0,3%	-138686,3	-2,0%	-201542,5	-2,9%	
1.3. Short-term government debt	-3616,3	-0,1%	0,0	0,0%			64230,7	0,9%	

TABLE 1.10 CONTINUED

	Federal budget		Territorial budgets		Extra-budgetary funds		Enlarged government budget		% of revenues, expenditure
	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP	
1.4. Federal floating rate bonds	24072,0	0,3%	0,0	0,0%			127087,0	1,8%	
1.5. Non-marketable government bonds	16807,9	0,2%	0,0	0,0%			16807,9	0,2%	
1.6. Government (municipal) securities	0,0	0,0%	-1877,3	0,0%			-1877,3	0,0%	
1.7. Other government securities	34,4	0,0%	0,0	0,0%			34,4	0,0%	
1.8. Federal flat rate bonds	-39070,1	-0,6%					-39070,1	-0,6%	
1.9. Federal fixed rate bonds	10337,2	0,1%					10337,2	0,1%	
1.10. Budgetary loans from other-level budgets			-2374,5	0,0%			-2374,5	x	
1.11. Government savings bonds	-1707,7	0,0%	0,0	0,0%			-1707,7	0,0%	
1.12. Receipts from sale of state or municipally owned property	27168,9	0,4%	7555,4	0,1%			34724,3	0,5%	
1.13. National stockpile of precious metals and gems	39874,3	0,6%	-22,2	0,0%			39852,1	0,6%	
1.14. Other domestic borrowing	-34099,0	-0,5%	12030,1	0,2%			-22068,9	-0,3%	
1.15. Credits and loans to extra-budgetary funds	0,0	0,0%			-933,1	0,0%	-933,1	0,0%	
TOTAL DOMESTIC FINANCING	-2447,2	0,0%	-5295,8	-0,1%	-139619,4	-2,0%	-143067,1	-2,1%	
2. External financing									
2.1. Loans from international financial institutions	-74396,5	-1,1%	-1570,4	0,0%			-75966,9	-1,1%	
2.2. Foreign government loans to RF	-38381,4	-0,6%	0,0	0,0%			-38381,4	-0,6%	
2.3. Loans from foreign commercial banks and companies to RF	-9045,9	-0,1%	-2981,7	0,0%			-12027,6	-0,2%	
2.4. Other foreign financing	-31847,3	-0,5%	-23015,0	-0,3%			-54862,2	-0,8%	
2.5. Change in bank account balances of budget funds, in foreign exchange	-18238,0	-0,3%	-351,3	0,0%			-18589,3	-0,3%	
Difference in exchange rates	890,2	0,0%	-722,1	0,0%			168,1	0,0%	
TOTAL FOREIGN FINANCING	-171018,9	-2,5%	-28640,6	-0,4%	0,0	0,0%	-199659,5	-2,9%	
TOTAL FINANCING	-173466,1	-2,5%	-33936,4	-0,5%	-139619,4	-2,0%	-342726,6	-4,9%	

Budgetary process in year 2001

Federal law “On the Federal Budget for Year 2001” was approved at the fourth reading on December 14, on December 20 it was approved by the Council of Federation, and signed by the President on December 27, 2000.

Budgetary revenues are balanced against expenditures and set at Rub. 1193 billion (15.4 per cent of GDP). The share of tax revenues in the total revenues is at 93 per cent.

The 2001 federal budget envisages an increase in expenditures (by 1.7 percentage points of GDP) and a decrease in revenues (by 0.8 percentage points) as compared to the budget for year 2000.

The budget for year 2001 sets the level of tax revenues at 3 per cent over and the level of total revenues at 5 per cent below the actual administration of the 2000 federal budget as measured in comparable prices. The expenditures shall by 12 per cent exceed the administration of the budget for year 2000.

An increase in indirect taxes (excises and VAT shall by 30 per cent exceed the administration of the budget for year 2000 as measured in comparable prices) and a sharp decrease in income tax account for the noticeable changes in the structure of tax revenues. The changes in VAT are explained by the fact that in year 2001 all VAT-generated revenues shall be entered to the federal budget, the increase in excises is attributed to the imposition of excise taxes on diesel fuels and higher taxation rates for alcohol beverages and gasoline, and the decrease in income tax revenues resulted from the redistribution of these revenues in favor of territorial budgets.

TABLE 1.11

	Law "On the Federal Budget for Year 2000" (Rub. mil.)		Law on amendments and additions to law "On the Federal Budget for Year 2000" introduced in connection with extra revenues (Rub. mil.)		Administration of the 2000 federal budget (Rub. mil.)	
	Rub. mil.	% GDP	Rub. mil.	% GDP	Rub. mil.	% GDP
Profit tax	172647	2,2%	171009	2,5%	178603	2,6%
Personal income tax	1903	0,0%	27543	0,4%	27321	0,4%
Value Added Tax	516436	6,7%	366751	5,3%	371812	5,4%
Excises	188040	2,4%	131534	1,9%	131039	1,9%
Fees for use of natural resources	37184	0,5%	17841	0,3%	18635	0,3%
Taxes on foreign trade and foreign economic operations	192315	2,5%	226842	3,3%	229256	3,3%
Other taxes, fees and duties	6802	0,1%	2271	0,0%	8817	0,1%
Tax revenues	1115328	14,4%	949913	13,7%	965482	13,9%
Revenue from government property or activity	26833	0,3%	24732	0,4%	28552	0,4%
Revenue from foreign economic operations	31498,8	0,4%	34387	0,5%	36403	0,5%
Other non-tax revenues	5929,5	0,1%	4671	0,1%	4952	0,1%
Non-tax revenues	64261,3	0,8%	63789	0,9%	69906	1,0%
Revenues of target budgetary funds	13893,9	0,2%	89800	1,3%	92182	1,3%
Revenues	1193483	15,4%	1109517	16,0%	1127571	16,2%
Government administration	40699	0,5%	26843	0,4%	25019	0,4%
National defense	214688	2,8%	209445	3,0%	190790	2,7%
International activities	22183	0,3%	39487	0,6%	23042	0,3%
Law enforcement, security, and judiciary	142955	1,8%	111547	1,6%	113668	1,6%
Basic research and promotion of scientific and technological progress	22094	0,3%	17095	0,2%	17534	0,3%
Industry, power engineering and construction	23250	0,3%	38126	0,5%	35023	0,5%
Agriculture and fisheries	20801	0,3%	15440	0,2%	13352	0,2%
Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	4774	0,1%	4074	0,1%	4112	0,1%
Transportation, road maintenance, communications and information technology	30602	0,4%	1901	0,0%	1852	0,0%
Preventing and/or eliminating the effects of emergencies and natural disasters	6334	0,1%	9599	0,1%	9450	0,1%
Education	48803	0,6%	37644	0,5%	38117	0,5%
Culture and arts	6385	0,1%	5399	0,1%	5193	0,1%
Mass media	6231	0,1%	6140	0,1%	6096	0,1%
Health and physical fitness	22207	0,3%	16998	0,2%	16880	0,2%
Social policy	107781	1,4%	66758	1,0%	66330	1,0%
Expenditures of target budgetary funds	13894	0,2%	97261	1,4%	97271	1,4%
Government debt servicing, including:	239794	3,1%	188722	2,7%	172211	2,5%
Domestic debt	56640	0,7%	63269	0,9%	54949	0,8%
External debt	183153	2,4%	125452	1,8%	124791	1,8%
Financial aid to other levels of government	186628	2,4%	97274	1,4%	101381	1,5%
Other expenditure	33380	0,4%	121719	1,8%	193900	2,8%
Expenditure	1193483	15,4%	1014196	14,6%	954105	13,7%
Profit	0	0	95321	1,4%	173466	2,5%

In February of 2000, having repeatedly failed to restructure the debt to the Paris Club, the government had to amend law “On the Federal Budget for year 2001” in its part concerning the distribution of extra revenues across expenditure items. The original schedule (first Rub. 70 billion of extra revenues to be divided between interest and non-interest expenditures at the 50:50 ratio with consequent transition to the 30:70 ratio in favor of interest expenditures) was changed as follows: first Rub. 41 billion of extra revenues were earmarked for the repayment and servicing of the foreign debt, other extra revenues should be divided between interest and non-interest expenditures at the 50:50 ratio. Besides, the ceiling amount of the public debt as on 1.01.2002 was increased by Rub. 30 billion. The deputies refused to lift the restrictions on privatization of state-owned enterprises promoted by the government.

Budgetary Situation in Early 2001

In January, the administration of the federal budget was characterized by a record for this month inflow of tax revenues. In spite of traditionally low profit tax revenues and a decrease in the share of income tax revenues entered to the federal budget, the total inflow of tax revenues was considerably above respective figures registered in previous years (15 per cent of GDP). Tax revenues grew due to an increase in VAT revenues (by 0.5 percentage points), excises (by 0.2 percentage points), and taxes on foreign trade (by 0.5 percentage points).

A sharp contraction of expenditures (by 2.5 percentage points as compared with January of 2000) may be attributed to a decrease in expenditures for the judiciary (by 2.8 percentage points), servicing of the public debt (by 0.5 percentage points), international activities (by 0.4 percentage points), other expenses (by 0.9 percent-

age points), and the absence of expenditures of target budgetary funds.

The preliminary estimates of the administration of the federal budget in January and February demonstrate that budgetary revenues continue to grow. Over two months budgetary revenues were at slightly over 18 per cent of GDP. The primary profit of the federal budget made about 4.5 per cent of GDP. Expenditures were at about 19.5 per cent of GDP. The budgetary deficit was financed mainly at the expense of internal funds accumulated on accounts (about Rub. 31 billion, i.e. 2.7 per cent of GDP), borrowings on the domestic market (Rub. 7 billion, i.e. 0.6 per cent of GDP), and sales of precious metals and gems from the national stockpile (over Rub. 3 billion, i.e. 0.3 per cent of GDP).

In early 2001, the level of income tax revenues inflow was considerably over the respective figures registered in the previous year. For instance, in January the amount of consolidated budget income tax revenues was over Rub. 14 billion, in February it made Rub. 16 billion. Therefore, the inflow of income tax revenues to the consolidated budget was at 2.4 per cent of GDP in January, and at 2.8 per cent of GDP in January and February as compared to 1.9 per cent of GDP and 2.0 per cent of GDP over respective period of the previous year. Taking into account the fact that in early 2001 there was registered neither a substantial rise in wages (according to Goskomstat, in December of 2000 the average nominal wage was at Rub. 3,025.00, in January of 2001 – at Rub. 2,733.00, in February – at Rub. 2,766.00), nor a considerable contraction of unemployment (according to Goskomstat, the number of officially registered unemployed remained at the 7 million level), it may be assumed that

the tax collection improved considerably²⁶, and that a substantial cut in tax rates resulted in the legalization of incomes.

An increase in budgetary profit tax revenues was also substantial – in January of 2001 the profit tax revenue inflow in the consolidated budget made 3.5 per cent of GDP, in January through February of 2001 it made 4 per cent of GDP as compared to 3.3 per cent of GDP over respective two period of year 2000. VAT-generated revenues of the consolidated budget diminished from 7.2 per cent of GDP in January of 2000 to 6.7 per cent of GDP in January of 2001. In January of 2001, excises-generated revenues increased by 0.2 percentage points in comparison with the level registered in January of 2000 (2.4 per cent of GDP). The single social tax revenues made over Rub. 6.5 billion (1.1 per cent of GDP) in January of 2001, while in January through February of 2001 they made over Rub. 37 billion (4.0 per cent of GDP).

²⁶ Unfortunately, since 2001 Goskomstat has discontinued to register arrears of personal income tax, therefore it is impossible to evaluate the ratio between the collected taxes and taxes due.

1.4. Inter-Budgetary Relations and Regional Finances

The reform process in the sphere of inter-budgetary relations and regional finances started in 1998 – 1999 continued in year 2000²⁷. Moreover, the gradual reform in the area of fiscal federalism implemented since 1998, when the Concept of the reform of the inter-budgetary relations in the Russian Federation in years 1999 through 2001 was approved, was given a new impetus as the government embarked on elaboration of a program of measures for a mid-term perspective, and by the start of implementation of tax and administrative reforms. The Budgetary Code, enacted on January 1, 2000, sets a number of restrictions and limitations on budgets and budgetary policies of RF subjects. For the first time since the start of reforms in the sphere of relations between budgets of different levels transformations have transgressed the measures chiefly aimed to reform the mechanism of distribution of federal financial aid from the Fund of Financial Aid to Regions (FFAR). Key measures aimed to improve inter-budgetary relations and regional finances, approved in year 2000 (most of them shall be implemented after January 1, 2000) may be broken down by several blocks:

1. *Amendments to tax legislation and changes in prorating of tax revenues among budgets of different levels.* Among the key measures in the sphere of fiscal policies and the distribution of tax revenues among the levels the budgetary system approved in year 2000, there shall be first of all mentioned decisions to enter total VAT revenues to the federal budget and transfer 99 per cent of personal income tax revenues to the budgets of RF subjects (simultaneously with the introduction of a flat 13 per cent rate of this tax),

²⁷ For details of the developments in inter-budgetary relations in Russia and the progress of the reform of inter-budgetary relations in 1998 through 1999 see respective annual IET surveys “Russian Economy: Trends and Perspectives.”

abolish the tax designed to finance the maintenance of residential housing and objects pertaining to the social and cultural sphere and replace it with a 5 per cent municipal profit tax on enterprises and organizations, collect 50 per cent of excises on alcohol beverages at the stage of its wholesale realization.

2. *Amendments to budgetary legislation and norms regulating federal financial aid to regions.* The law on the federal budget for year 2001 stipulates to introduce an additional type of federal aid to regional budgets – targeted transfers from the Compensatory Fund. This fund was created within the federal budget at the expense of the centralization of VAT revenues; federal aid from this fund is distributed among all RF subjects and is targeted to finance expenditures for implementation of federal laws “On State Allowances for Citizens with Children” and “On State-Sponsored Assistance to Disabled Persons in the Russian Federation.” In the process of elaboration of the 2001 federal budget law there was continued the improvement of methods applied to evaluate tax potential and expenditure requirements of RF subjects in the course of calculating the amounts of transfers from the Fund of Financial Aid to Regions.

3. *Other decisions affecting relations between the federal budget and the budgets of the subjects of the Russian Federation.* Alongside with amendments to the tax and budgetary legislation in year 2000 there was taken a number decisions on other issues, which may substantially affect the situation in the budgetary sphere. Among these decisions shall be mentioned the legislative amendments vesting the Federal Center with the right to dismiss executive heads of RF subjects tolerating violations of federal laws committed on their territories and the toughening of attitude to the special budgetary status of such Federation subjects, as the Republics of Bashkortostan and Tatarstan²⁸.

²⁸ For details see the Introduction to this Survey.

Inter-Budgetary Relations in Russia in Year 2000

In the course of an analysis of the regional public finances it shall be first of all mentioned that in year 2000 the share of tax revenues generated by regional budgets decreased in comparison with the similar indicator of the RF consolidated budget (see Table 1.12).

TABLE 1.12

Share of Some Budgetary Indicators of RF Subjects in the Consolidated Budget of the Russian Federation in 1992 through 2000 (%)

		1993	1994	1995	1996	1997	1998	1999	2000
Tax revenues	44,20%	53,10%	53,40%	47,60%	49,50%	53,10%	54,00%	48,90%	43,46%
Revenues	44,00%	58,00%	53,90%	52,60%	53,80%	57,50%	56,60%	49,20%	50,63%
Expenditures	34,00%	40,30%	37,70%	43,40%	45,40%	48,10%	48,40%	46,90%	54,43%

Source: RF Finance Ministry, authors' calculations

Table 1.12 demonstrates the decrease in the share of tax revenues of regional budgets in the total amount of tax revenues of the RF consolidated budget (in year 2000 this indicator was at its lowest level since 1992 – 43.5 per cent), while the registered share of regional budgets in the total amount of revenues of the consolidated budget made 51 per cent (practically no change in comparison with 1999 figures, slightly below indicators registered in 1993 through 1998). At the same time, there was observed a growth in the share of regional budgetary expenditures in the total amount of expenditures of the RF consolidated budget: for the first time since 1992 this indicator exceeded 50 per cent (54 per cent).

It is apparent that several groups of factors affected the balance between the federal and regional budgets. In year 2000 the centralization of tax revenues in the federal budget progressed (the norm that 85 per cent share of VAT revenues shall be entered into the federal budget and the norm stipulating the change in the distribu-

tion of income tax between the federal and regional budgets were in effect over the whole year²⁹), and revenues from taxes collected by the federal budget grew at a faster rate than revenues generated by regional and local taxes (first of all, it concerns export duties and other taxes on foreign trade and external economic operations). These developments resulted in a shift in the balance of tax revenues of the RF consolidated budget in favor of the federal budget (at the same time, tax revenues of regional budgets grew from 9.5 per cent of GDP in 1999 to 10.7 per cent of GDP in year 2000, while the increase in federal tax revenues made 2.7 per cent of GDP – from 11.2 per cent of GDP to 13.9 per cent of GDP - over the same period).

Since the substantial growth in tax revenues of the federal budget occurring in year 2000 was expended both to increase the profit of the federal budget and to provide financial aid to lower-level budgets and due to a substantial growth in amounts of non-tax revenues and revenues of target budgetary funds the total amount of revenues of the consolidated budget was shared between the federal budget and budgets of RF subjects almost equally.

It is worthy of note that the balance of expenditures of the RF consolidated budget shifted in favor of RF subjects. The observed increase in the share of expenditures of regional budgets in the aggregate expenditures resulted from the structure of expenditures at the federal and regional levels: in year 2000 the budgetary profit made 18.2 per cent of federal expenditures (2.5 per cent of GDP), while regional budgets registered the excess of revenues over expenditures at 3.3 per cent (0.5 per cent of GDP). In other words, in year 2000 the federal government assigned a considerably larger share of revenues for the repayment of indebtedness and accumulation of financial resources on Treasury accounts than authorities of

²⁹ These norms were effected on April 1, 1999

RF subjects, what resulted in a decrease in the share of federal budgetary expenditures in the expenditures of the RF consolidated budget.

An analysis of the amounts and structure of federal financial aid to RF subjects' budgets reveals that in year 2000 the quantitative characteristics of federal aid remained at the level formed over two previous years (see Table 2). Transfers from the Fund of Financial Aid to Regions amounted to 1 per cent of GDP thus making about 70 per cent of the total federal aid to the subjects of the Russian Federation. The balance of budgetary loans was in the red by end-year. The total amount of federal financial resources transferred to regional budgets made 1.4 per cent of GDP (10 per cent of the expenditures of the federal budget. At the same time, the share of budgetary revenues of RF subjects financed at the expense of federal financial aid somewhat decreased in comparison with the figures registered in the previous year: while in 1999 federal financial aid (excluding budgetary loans) made 10.3 per cent of regional budgetary revenues, in year 2000 this indicator was at 9.6 per cent.

Besides, the share of federal financial aid to regions allocated on formalized principles somewhat decreased in comparison with the figures registered in the previous year: first, there was observed an insignificant decrease in the share of FFAR transfers proper in the total amount of federal aid (from 71 per cent in 1999 to 67 per cent in 2000). Second, the share of financial resources transferred in the framework of mutual payments increased from 10 per cent to 20 per cent of transferred funds. Third, the share of financial resources granted to budgets of close administrative territorial entities grew considerably (from 4 per cent to 11 per cent), while the share of subventions decreased.

This change in policy pursued by the federal authorities with regard to financial aid to regions may be caused by several factors,

among them the following shall be singled out: extra revenues of the federal budget considerably exceeding budgetary targets permitted to transfer additional financial resources to regions (as a rule, in the framework of mutual payments). An increase in subsidies allotted to close administrative territorial entities (CATEs) resulted from restrictions on CATEs right to grant federal tax privileges introduced in 1999. A decrease in the share of subventions may be explained by transfer of financial resources earmarked for financing of seasonal deliveries to the North from budgetary item “Subventions” into FFAR transfers. No extra financial aid (in supplement of FFAR transfers) was earmarked to finance seasonal deliveries to the North in year 2000 (as is revealed by an analysis of the volumes of financial aid provided in 1999 and 2000). While in 1999 the amount of FFAR transfers and subventions (mostly comprised of financial resources earmarked for financing of deliveries to the North) made about 1.2 per cent of GDP (including FFAR transfers at 1 per cent of GDP), by end-2000 FFAR transfers (including financial resources earmarked for financing of deliveries to the North) made about 1 per cent of GDP similarly to the previous year. Therefore, in spite of the fact that financial resources necessary to finance the deliveries to the North were set as a separate item within FFAR transfer, in reality this type of financial aid was fully integrated into the composition of transfers from the Fund of Financial Aid to Regions both in terms of calculation methods and its amounts³⁰.

An analysis of federal financial aid provision across regions reveals that no substantial changes in the regional structure of federal

³⁰ A year ago we already stressed that it is unnecessary to set the financing of seasonal deliveries to districts with limited duration of delivery of goods as a separate type of financial aid (see: “Russian Economy in 1999: Trends and Perspectives.”)

financial aid were registered in year 2000 (Figure 1). Among noticeable changes it is worthwhile to note a considerable increase in financial aid to the Republic of Bashkortostan (the share of this region in the total amount of granted financial resources increased to make 3 per cent), and to several other traditionally well-provided from the budget regions: the Perm, Samara, and Tver Regions. However, an analysis of factors behind these developments reveals that in the above mentioned cases (except Samara) the increases were caused by a considerable growth in subsidies from the federal budget transferred directly to the budgets of closed administrative territorial entities in bypass of regional budgets.

On the other hand, it is necessary to pay attention to continuing shift in the structure of federal financial aid in favor of heavily subsidized regions: in year 2000 shares of the majority of regions characterized by high levels of budgetary security in the aggregate amount of federal financial aid decreased. First of all, it concerns the Tumen, Vologda, Moscow, Lipetsk, Volgograd, Leningrad, Yaroslavl, and Sverdlovsk Regions, the Republics of Komi and Sakha (Yakutiya), city of St. Petersburg. At the same time the majority of Federation subjects traditionally defined as heavily subsidized regions experienced increases in receipts of federal financial resources (for instance, the Republics of Dagestan, Altai, the Bryansk Region, some North Caucasus regions, etc.).

As it was mentioned above, in year 2000 the work aimed to reform the system of federal financial aid to regions continued. The present mechanism for discussing the methods applied to distribute resources of the Fund of Financial Aid to Regions and other issues pertaining to inter-budgetary relations in the framework of a trilateral working group may be characterized as an appropriate procedure to elaborate key budgetary decisions in the sphere of inter-budgetary relations, which allows to transgress the framework of

annual parliamentary debates on budget laws and thus broaden the discussion about forms and methods of financial support of regions. It renders the discussion more constructive and leads to the objectivity of the process of financial aid redistribution. In the course of debates on the federal budget law for year 2001 the State Duma for the third time has approved the calculations of transfers from FFAR and the Compensatory Fund presented by the Finance Ministry without making any amendments. It shall be noted that FFAR transfers for year 2001 were calculated in accordance with improved methods similar to the key principles applied to distribute transfers from the Fund of Financial Aid to Regions in year 2000.

TABLE 1.13

Amount and Structure of Federal Financial Aid to RF Subjects in 1992 through 2000.

	1997		1998		1999		2000	
	% GDP	% fin. aid	% GDP	% fin. aid	% GDP	% fin. aid	% GDP	% fin. aid
Subsidies	0,13%	5%	0,10%	6%	0,06%	4%	0,16%	11%
Subventions	0,09%	4%	0,02%	1%	0,20%	14%	0,03%	2%
Total transfers from FFAR	1,22%	49%	1,12%	70%	0,99%	71%	0,98%	67%
Including:								
Transfers	0,86%	35%	1,00%	63%	0,99%	71%	0,98%	67%
VAT transfers	0,36%	14%	0,12%	8%	0,00%	0%	0,00%	0%
Funds transferred in the course of mutual payments	0,43%	17%	0,36%	23%	0,14%	10%	0,29%	20%
(balance)								
Loans less repayment to other levels of government	0,64%	25%	-0,03%		-0,28%		-0,06%	
Arrears of RF subjects' contributions to target budget funds	0,00%	0%	0,00%		0,00%		0,00%	
Total: funds transferred to budgets of other level of government (including repayment of loans)	2,50%	100%	1,57%		1,11%		1,40%	
Expenditures of the federal budget less repayments	15,3%		14,5%		14,8%		13,8%	

Source: RF Finance Ministry, authors' calculations

TABLE 1.14

Shares of RF Subjects in the Total Amount of Federal Financial Aid in 1999 through 2000 (%)

Region	1999	2000
City of Moscow	0,0	0,0
Vologda Region	0,298	0,033
Lipetsk Region	0,127	0,047
Samara Region	0,044	0,103
City of St. Petersburg	0,262	0,148
Yaroslavl Region	0,295	0,165
Krasnoyarsk Area	1,428	0,291
Republic of Khakasia	0,467	0,315
Perm Region	0,068	0,345
Taimyr (Dolgano Nenets) AD	0,513	0,383
Nizhni Novgorod Region	0,464	0,403
Republic of Kalmykia	0,461	0,449
Komi Permyak AD	0,342	0,519
Kaliningrad Region	0,424	0,535
Ust Ordynsk Buryat AD	0,400	0,573
Evenk AD	0,526	0,594
Republic of Altai	0,351	0,608
Kursk Region	0,622	0,623
Astrakhan Region	0,812	0,650
Kostroma Region	0,758	0,682
Kirov Region	0,970	0,691
Tomsk Region	0,542	0,706
Kurgan Region	0,825	0,778
Irkutsk Region	1,458	0,946
Novgorod Region	0,519	0,973
Tula Region	0,660	1,030
Tambov Region	0,832	1,058
Republic of North Osetia	1,390	1,130
Republic of Mordovia	1,443	1,171
Voronezh Region	1,257	1,201
Novosibirsk Region	0,942	1,262
Omsk Region	1,006	1,309

TABLE I.14 CONTINUED

Region	1999	2000
Chukotka AD	1,755	1,391
Pskov Region	0,978	1,467
Ivanovo Region	1,248	1,650
Tver Region	0,797	1,768
Chita Region	1,908	1,807
Bryansk Region Krasnodar Area	1,036	1,924
Stavropol Area	1,359	2,042
Khabarovsk Area	2,820	2,136
Rostov Region	2,224	2,598
Primorski Area	3,897	3,113
Republic of Sakha (Yakutia)		3,513
Republic of Dagestan	4,984	7,412

Source: RF Finance Ministry, authors' calculations

As it was mentioned above, in year 2000 the work aimed to reform the system of federal financial aid to regions continued. The present mechanism for discussing the methods applied to distribute resources of the Fund of Financial Aid to Regions and other issues pertaining to inter-budgetary relations in the framework of a trilateral working group may be characterized as an appropriate procedure to elaborate key budgetary decisions in the sphere of inter-budgetary relations, which allows to transgress the framework of annual parliamentary debates on budget laws and thus broaden the discussion about forms and methods of financial support of regions. It renders the discussion more constructive and lends to the objectivity of the process of financial aid redistribution. In the course of debates on the federal budget law for year 2001 the State Duma for the third time has approved the calculations of transfers from FFAR and the Compensatory Fund presented by the Finance Ministry without making any amendments. It shall be noted that FFAR transfers for year 2001 were calculated in accordance with improved

methods similar to the key principles applied to distribute transfers from the Fund of Financial Aid to Regions in year 2000.

Similarly to previous years, the financial resources of FFAR were in part distributed aiming to equalize the adjusted regional gross tax resources (GTR) at the level determined by the amount of FFAR (20 per cent of FFAR resources were expended for this purpose), and in part in proportion to the deviation of per capita gross tax resources from the all-Russian average (80 per cent of FFAR)³¹.

The principles of evaluation of regional tax potential (gross tax resources) and expenditure requirements (index of budgetary expenditures) for year 2001 underwent some changes as compared with the methods applied in year 2000. While in the previous year gross tax resources of RF subjects were estimated proceeding from the national average share of tax withholding in the added value generated by major sectors of the economy, for the estimation of transfers to be made in year 2001 GTR was calculated on the basis of a larger number of the sectors of the economy, and there were introduced coefficients adjusting evaluations for the sectoral structure of regional economies.

The calculation methods applied to estimate indices of budgetary expenditures also underwent some minor changes in comparison with the previous year. First, evaluation of expenditures earmarked by regional budgets to finance allowances for citizens with children and the enforcement of the law on state-sponsored assistance to disabled persons were excluded from the methods because of the formation of the Compensatory Fund. Second, evaluation of some types of expenditure was improved by introduction of supplementary data characterizing the need for financing of various

³¹ For a detailed description of basic equalization principles applied to the allocation of FFAR in 2000 and 2001, see survey "Russian Economy in 1999: Trends and Perspectives."

state-provided services. Similarly to the previous year, federal standards for the maximal cost of housing and public utilities services effected in 1999 were used to determine the normative expenditures of regional budgets for their respective HPU sectors. Among the changes in the calculation methods expected to result in shifts in amounts of transferred financial resources there shall be mentioned introduction of reporting data for 1999 as the basis of calculations.

Transfers from the Compensatory Fund formed within the federal budget for year 2001 are targeted to finance a number of federal expenditure mandates. The Compensatory Fund shall be distributed among all regions with no exceptions according to the methods taking into account the number of consumers of budgetary services subsidized at the expense of the Fund and recipients of social transfers, as well as the average per capita cost of such services and the amount of benefits per recipient. The calculation of transfers from the Compensatory Fund is complicated due to the fact that budgets of RF subjects did not keep a separate record of expenditures pertaining to implementation of the federal law on the state-sponsored assistance to disabled persons prior to January 1, 2001. Therefore, the amounts of regional transfers from the Fund were calculated basing on the national average of the expenditures differentiated by regions. Since 2001 the expenditures for implementation of federal law "On State-Sponsored Assistance to Disabled Persons in the Russian Federation" were recorded separately as stipulated by amendments to the budgetary classification.

As mentioned above, the Compensatory Fund was formed at the expense of surplus resources of the federal budget generated as a result of the total centralization of VAT revenues in the federal budget. Our estimates demonstrate that on the national level this principle is complied with: the amount of the Compensatory Fund

earmarked for 2001 (Rub. 41.7 billion) is only slightly below VAT-generated revenues of regional budgets estimated on the basis of VAT sharing rates effective for subjects of the Russian Federation in year 2000 (Rub. 43.3 billion)³². As VAT-generated revenues of RF subjects are compared with subsidies from the Compensatory Fund (in terms of 2000), it shall be noted that the introduction of the new mechanism of financing of some regional expenditures results in substantial inter-regional redistribution of resources. For instance, the regions with traditionally high levels of budgetary security (Cities of Moscow and St. Petersburg, the Samara, Sverdlovsk, and Perm Regions, Republics of Tatarstan and Bashkortostan, Khanty Mansi and Yamal Nenets Autonomous Districts) were most affected by the replacement of the 15 per cent share in VAT revenues with subsidies from the federal budget. At the same time, the amount of resources transferred to heavily subsidized RF subjects increased substantially: the highest values of per capita funds withdrawn from regional budgets due to VAT centralization and resources received as subsidies from the Compensatory Fund were registered in such regions as the Republics of Dagestan, Tyva, Sakha, North Osetia, the Chukotka, Komi Permyak, Ust Ordynsk and Aginski Buryat Autonomous Districts, the Altai Area, the Amur, Magadan, and Bryansk Regions.

The distribution of transfers from the Fund of Financial Aid to Regions for year 2001 in accordance with improved methods resulted in the following. First, the number of RF subjects not receiving transfers slightly increased: in 2001 there were 19 such regions as compared with 18 in the previous year (Nenets AD, Orenburg and Belgorod Regions replaced Moscow and Chelyabinsk Regions). A cross-regional analysis of the structure of FFAR resources

³² Estimated amount of federal VAT revenues less planned tax reimbursement to exporters.

reveals substantial redistribution in comparison with targets set in the previous year. For instance, among the most suffered “losers” (their share in FFAR diminished more than by one third) were the Murmansk, Irkutsk, Tomsk, Astrakhan, Novgorod, Kemerovo, Sakhalin, Smolensk, Orel Regions, the Republics of Udmurtia and Karelia. The most lucky “winners” (their share in FFAR increased more than by one third as a result of the improvement in the calculation methods) were such regions as the Vodgograd, Omsk, Kurgan, Leningrad and Kirov Regions, the Taimyr AD, the Republics of Altai, Sakha and Kalmykia, the Primorski Area, the Chuvash and Chechen Republics. At the same time, the Chechen Republic and the Leningrad Region increased their shares in FFAR more than twofold. However, the composition of largest recipients of FFAR transfers did not change: in year 2001 about 28 per cent of transfers (24 per cent in year 2000) were granted to five regions – the Rostov Region, the Primorski and Altai Areas, the Republics of Sakha and Dagestan.

In spite of the fact that it is impossible to single out any apparent trend in the occurring redistribution of resources among the recipients of transfers, it shall be noted that on the face of it traditionally “poor” regions were more numerous among “winners” than among “losers,” what is an evidence of the enhanced effectiveness of redistribution of funds resulting from the improvement in FFAR transfers calculation methods.

As concerns the Compensatory Fund’s subsidies, their distribution also demonstrates a high degree of inter-regional differentiation: the estimated amount of the subsidy to the largest per capita recipient (the Republic of Ingushetia) by more than 4.5 times exceeds the smallest subsidy (the Kaliningrad Region). An analysis of the structure of distribution of the Fund’s resources reveals that Moscow is the largest recipient of subsidies from the Fund (6.1 per

cent of Compensatory Fund), while the smallest subsidy was granted to the Evenk AD (0.03 per cent). At the same time, 20 most populated regions (52 per cent of the national populace) concentrate about 50 per cent of the Compensatory Fund that being an evidence that resources of the Fund were distributed in proportion to regional populations.

In the course of analysis of transfers from the Compensatory Fund a special attention shall be paid to federal budget expenditure item “subsidies to RF subjects earmarked to compensate for the loss related to changes in the amount and formation of the Compensatory Fund,” which makes about 25 per cent of the total Compensatory Fund³³. The distribution of these supplementary subsidies among RF subjects is region-specific: some regions are excluded from the number of its recipients, while amounts of supplementary subsidies to certain subjects of the Russian Federation exceed amounts of “bulk” transfers from the Compensatory Fund (the Ivanovo and Voronezh Regions and the Komi Permyak AD). Taking into account the fact that the Compensatory Fund was first formed within the federal budget for year 2001, it may be assumed that supplementary transfers were introduced in order to remunerate regional authorities for their support of new methods applied to calculate amounts of transfers from the Compensatory Fund basing on objective expenditure requirements, and that these supplementary transfers were calculated basing on actual regional budgetary expenditures for implementation of stipulations of federal laws requiring subsidizing.

In the course of analysis of the total amount of federal financial aid to RF subjects granted from the Fund of Financial Aid to Regions and the Compensatory Fund it shall be noted that on the

³³ See Article 46 of law No 150-FZ of 27.12.2000 “On the Federal Budget for year 2001”

whole its distribution structure coincides with the structure of distribution of FFAR transfers (that especially concerns largest and smallest recipients). On the other hand, in per capita terms the largest amounts of financial aid are transferred to sparsely populated underdeveloped regions of the country: the Republics of Tyva and Altai, the Taimyr, Koryak, Chukotka and Evenk Autonomous Districts, while among smallest per capita recipients of financial aid are mainly industrially developed regions characterized by high budgetary security.

As it was mentioned above, year 2000 saw the start of the process of accommodation of budgetary relations between the federal center and such Federation subjects enjoying a special status in the national budgetary system as the Republics of Tatarstan and Bashkortostan. The budgetary agreements concluded in the early 1990s in accordance with treaties on delimitation of powers and authorities between the federal center and aforesaid regions, which stipulated that greater part of tax revenues and payments due to the federal center should be entered in their budgets, expired in year 2000. Since end-1999 the federal authorities insisted on equalization of the budgetary status of these Republics with the status enjoyed by other subjects of the Russian Federation and refused to prolong the aforesaid agreements. However, later the federal center conceded permitting these Republics to expend federal tax and fee revenues derived on their territories for financing of federal programs, provision of federal financial aid, and maintenance of federal agencies and organizations located on their territories³⁴ (earlier the Republican authorities assumed the responsibility to finance some of the federal expenditures borne on their territories in return for permission to retain a portion of tax revenues due to the federal budget).

³⁴ See Article 43 of law No 150-FZ of 27.12.2000 "On the Federal Budget for year 2001"

Among the novations contained in law on the federal budget for year 2001, there shall be mentioned the imposition of restrictions on the maximal amount of resources transferred to regional budgets in the framework of mutual payments and financing of federal mandates related to benefits stipulated by federal law “On Veterans.”³⁵ Initially it was planned that transfers from the newly created Compensatory Fund should be also allocated for financing of veteran benefits stipulated by the federal legislation. However, at the stage of discussion of the draft law on the federal budget for year 2001 the financing of these mandates was rejected. As a result, the law on the federal budget for the first time contains a stipulation constraining the throughput of such a channel of non-formalized financial aid to regions as funds transferred in the framework of mutual payments. The total amount of the restriction made Rub. 4 billion, within this amount there were stipulated individual restrictions on such expenditure items as reimbursement of fare, installation of telephones, etc.

In accordance with the Concept of the reform of the inter-budgetary relations in the Russian Federation in years 1999 through 2001 within the federal budget there were formed the Regional Development Fund (accumulates funds transferred to regions for investment purposes) and the Fund for Development of Regional Finances (its resources are allocated for financial aid to regional authorities aimed to improve administration of state finances in regions). However, the distribution of the resources of the said funds remains extremely non-formalized, since the mandate to determine the procedure for allocation and expenditure of these funds is vested with the RF government³⁶.

³⁵ See Article 47 of law “On the Federal Budget for year 2001”

³⁶ See Article 44 of law “On the Federal Budget for year 2001”

Law “On the Federal Budget for Year 2001” has further tightened the tax regime applicable to close administrative territorial entities (CATEs). Although similarly to the 2000 budget law the law on the federal budget for year 2001 suspends the Budgetary Code stipulations that CATE authorities have the right to adjust tax rates and introduce tax privileges pertaining to regional and local taxes only in compliance with the legislation of the Federation subjects having jurisdiction over them, the freedom of CATE authorities to change rates of taxes and introduce tax privileges is rather strictly limited. The law on the federal budget for year 2001 specifically stipulates that amounts of tax and fee revenues due to the federal budget from CATE territories shall be entered in the federal budget according to procedure in effect to all RF subjects, while revenues generated by regional and local taxes and the tax on motor road users shall be entered in CATE budgets³⁷. In fact, these stipulations of the federal legislation put CATEs on the same level as RF subjects in terms of their budgetary and tax status. It shall be specifically noted that the new budgetary law makes no exceptions (law “On the Federal Budget for Year 2000” stipulated similar measures concerning all CATEs, however, it made an exception for those, where federal nuclear centers were located – in year 2000 these two CATEs retained all revenues generated by taxes and fees collected within their respective territories). An important novation of the law on the federal budget for year 2000 imposes restrictions on the CATE authorities to grant tax privileges: Article 52 of the law specifies that CATE authorities are vested with the right to grant additional tax privileges only in regard to profit tax rates and in amounts entered to their budgets.

In the course of the discussion of law “On Amendments to the Second Section of the Budgetary Code and law ‘On Enactment of

³⁷ See Article 52 of law “On the Federal Budget for year 2001”

to the Second Section of the RF Budgetary Code” in the State Duma and the Federation Council the deputies approved a stipulation granting the authorities of RF subjects to introduce unrestricted privileges pertaining to regional taxes and fees (it seems that representatives of regional authorities in the federal legislature succeeded to insist on such an original “compensation” for a number of novations in the area of tax and budgetary policies). At the time this survey was completed we had no information either in what degree regional authorities have exercised their right to introduce tax privileges, or the financial outcome of such decisions; however, it appears that such an extremely ambiguous norm approved irrespectively to certain tax laws can not be reviewed as a measure capable to positively affect public finances.

Thus, summarizing the developments in the sphere of inter-budgetary relations in Russia in year 2000, it is necessary to note the continuing formalization of the process of distribution of federal financial aid, as well as the aspiration to eliminate manifestations of asymmetry pertaining to budgetary statuses of different subjects of inter-budgetary relations at different levels. It is also necessary to stress the fact that measures in the sphere of tax and budgetary policies approved in year 2000 were aimed to further smooth the inter-regional differences in budgetary security and to redistribute budgetary revenues in favor of heavily subsidized regions. At the same time, the pace of the reform of relations between budgets of different levels and regional finances was slower than required. In spite of the fact that a larger number of goals set by the Concept of the reform of the inter-budgetary relations in the Russian Federation were achieved, the federal government failed to impose on authorities of RF subjects tight enough budgetary constraints, to take control over the effectiveness of expenditures at the regional level, and to achieve the required formalization of inter-budgetary relations.

Now the RF government shall settle all these problems in the course of implementation of the program of mid-term measures.

Evaluation of the impact of changes in tax and budgetary legislation on regional finances

As it was noted above, a number of decisions in the sphere of tax and budgetary policy approved in year 2000 may considerably affect regional finances. These changes shall be realized in the framework of law “On the Federal Budget for Year 2001” and approved first fourth articles of the Second (Special) Section of the RF Budgetary Code. Both these two documents were enacted on January 1, 2001. An attempt to evaluate the impact of changes in the legislative base on the balance of budgetary revenues and expenditures will be made in this section of survey.

The state of consolidated budgets of RF subjects in year 2001 was estimated taking into account the following changes (as compared to the situation in 2000) directly affecting budgets of RF subjects:

1. Empowerment of local governments to impose special rates of the tax on profits of enterprises and organizations (up to 5 per cent), the generated revenues shall be entered in budgets of municipal entities. In case this right is exercised to the full extent, this change will result in an increase in the aggregate profit tax rate from 30 to 35 per cent, of which 24 per cent rate represent the share of the regional consolidated budget (69 per cent of the total profit tax revenues) in case the tax rates are set at the maximum (19 per cent and 5 per cent respectively at the regional and municipal levels).
2. Changes in prorating of the personal income tax between the federal budget and budgets of RF subjects. While in year 2000 84 per cent of the total personal income tax revenues were entered in

regional budgets, in year 2001 99 per cent of personal income tax revenues derived from the territory of a Federation subject are due to its budget. Besides, a flat personal income tax rate set at 13 per cent has been in effect since January 1, 2001.

3. Changes in prorating of VAT-generated revenues between the federal and regional budgets. Since January 1, 2001, the total VAT revenues have been entered to the federal budget (in year 2000 15 per cent of the total VAT revenues collected within the territory of a Federation subject were due to its budget).

4. Abolition of the tax designed to finance the maintenance of residential housing and objects pertaining to the social and cultural sphere on January 1, 2001.

5. Introduction of a 1 per cent rate of tax on motor road users on January 1, 2001. Prior to this date its maximal aggregate rate was set at 3.75 per cent (including the regional component).

6. An increase in excise rates stipulated by the enacted Second Section of the Budgetary Code. Regional budgets will be chiefly affected by an increase in excises on alcohol beverages, since 50 per cent of this tax generated revenues are due to the budgets of RF subjects.

7. Formation of the Compensatory fund within the federal budget. The transfers (subsidies) from this Fund shall finance expenditures of RF subjects' budgets for implementation of federal laws "On State Allowances for Citizens with Children" and "On State-Sponsored Assistance to Disabled Persons in the Russian Federation."

It is necessary to mention that only changes appreciable in quantitative terms on the basis of available statistical data were taken into account. For instance, such measures as the abolition of the tax designed to finance the maintenance of residential housing and objects pertaining to the social and cultural sphere and the decrease

in the rate of the tax on motor road users shall result in an increase in the profit tax base, what was not taken into account in the course of computation.

The state of regional budgets was estimated without taking into account possible shifts in tax revenues resulting from changes in tax rates. No evaluation of changes in inter-regional distribution of revenues generated by the tax on alcohol beverages resulting from the transfer of a portion of excise liabilities to the stage of wholesale realization was conducted. In all cases authorities of RF subjects were granted the right to impose special tax rates (not above legislatively set maximal tax rates), it was assumed that tax is charged at the maximal rate.

In order to evaluate the state of consolidated regional budgets in prices of year 2001, regional budgetary revenues in year 2000 were adjusted for inflation (annual inflation rate estimate used to calculate the key indicators set in the law on the budget for year 2001). Further, tax and non-tax revenues were adjusted for the new conditions. Shifts in non-tax revenues were evaluated by substituting new values representing the amounts of transfers from the Fund of Financial Aid to Regions and amounts of principal and supplementary subsidies from the Compensatory Fund set by the law on the budget for year 2000 for amounts of federal financial aid.

Since municipalities were granted the special right to impose the tax at a 5 per cent rate, the amounts of profit tax revenues flowing into regional budgets were evaluated as follows³⁸:

³⁸ The calculations are based on estimated profit tax revenues of the consolidated budget of the Russian Federation presented by the RF Finance Ministry in the framework of documentation supplemented to the draft federal budget for year 2001. Evaluations were carried out proceeding from the assumption that the estimates of changes in tax revenues of the consolidated budget in relation to GDP are also true for regional profit tax revenues (in relation to estimated amounts of gross regional product).

$$RT_i^{2001} = \left(RT_{i,BC}^{2000} \cdot \frac{RT^{2001}}{RT^{2000}} \cdot \frac{BBII^{2001}}{BBII^{2000}} \cdot \frac{BPPI_i^{2001}}{BPPI_i^{2000}} \right) \times \frac{24\%}{35\%},$$

where $RT_{i,BC}^{2000}$ represents actual profit tax revenues flowing into the Russian budgetary system from the i -th region in year 2000;

RT_i^{2001} represents prognosticated value of profit tax revenues flowing into the budget of the i -th region in year 2001;

RT^{2000} and RT^{2001} represent the inflow of profit tax revenues into the consolidated budget of the Russian Federation in years 2000 and 2001 (calculated basing on the estimation of tax revenues the RF Finance Ministry carried out in the process of elaboration of 2001 federal budget indicators);

24% is the maximal regional and municipal profit tax rate, 35% is the maximal aggregate profit tax rate;

$BBII^{2000}$ and $BBII^{2001}$ represent Russia's GDP in current prices in year 2000 and estimated GDP in 2001;

$BPPI_i^{2000}$ and $BPPI_i^{2001}$ represent the GRP of the i -th region in year 2000 and the estimated GDP of the i -th region in year 2001 (based on GRP estimates by the RF Ministry of Economy).

Since income tax-generated revenues were prorated in favor of regional budgets and because of the introduction of a flat 13 per cent rate of this tax, the amounts of personal income tax revenues flowing into regional budgets were evaluated according to a formula similar to that applied to estimate profit tax and proceeding from similar presumptions:

$$IT_i^{2001} = \left(IT_{i,BC}^{2000} \cdot \frac{IT^{2001}}{IT^{2000}} \cdot \frac{BPII_i^{2001}}{BPII_i^{2000}} \cdot \frac{BPII^{2001}}{BPII^{2000}} \right) \times 99\%,$$

where $IT_{i,BC}^{2000}$ represents actual income tax revenues flowing into the Russian budgetary system from the i -th region in year 2000;

IT_i^{2001} represents prognosticated value of personal income tax revenues flowing into the budget of the i -th region in year 2001;

99% is the share of budgets of RF subjects in personal income tax revenues collected within their territories;

IT^{2000} and IT^{2001} represent personal income tax revenues flowing into the consolidated budget in year 2001 (calculated basing on the estimation of tax revenues the RF Finance Ministry carried out in the process of elaboration of 2001 federal budget indicators).

The evaluation of changes in regional budgetary revenues resulted from the change in rates of excises on alcohol beverages across regions presents difficulties, since the changes were region-specific. Therefore, the amounts of revenues generated by increases in excises on alcohol beverages flowing into regional budgets were evaluated taking into account the changes in ratio between total revenues pertaining to this tax and GDP and GRP of respective region, i.e. as follows:

$$A_i^{2001} = A_i^{2000} \cdot \frac{A^{2001}}{A^{2000}} \cdot \frac{BPII^{2001}}{BPII^{2000}} \cdot \frac{BPII_i^{2001}}{BPII_i^{2000}},$$

where A^{2001} and A^{2000} represent alcohol beverage excise revenues flowing into the federal budget in years 2001 and 2000 (calculated basing on the estimation of tax revenues the RF Finance Ministry carried out in the process of elaboration of 2001 federal budget indicators);

A_i^{2001} and A_i^{2000} represent actual and prognosticated inflow of revenues generated by excises on alcohol beverages into the budget of the i -th RF subject.

The lowering of the rate of the tax on motor road users down to 1 per cent was taken into account with regard to information about specific tax rates imposed by respective Federation subjects while estimating revenues of territorial road funds of RF subjects for year 2001.

The evaluation of changes in the ratio between revenues and expenditures of regional budgets resulting from financing of regional expenditures for implementation of federal laws “On State-Sponsored Assistance to Disabled Persons in the Russian Federation” and “On State Allowances for Citizens with Children” from the federal budget was conducted by adding amounts of transfers from the Compensatory Fund formed for these purposes to budgetary revenues of RF subjects.

It was assumed that the share of other budgetary revenues of Federation subjects in GRP in 2001 will remain at the level registered in 2000.

The results of the evaluation are as follows: in absolute terms revenues of regional budgets increased from Rub.1,031 billion in year 2000 (14.9 per cent of GDP) to Rub. 1,121 billion in year 2001 (14.5 per cent of GDP), expenditures grew from Rub. 996.7 billion (14.4 per cent of GDP) to Rub. 1,122 billion (14.4 per cent of GDP). The estimated deficit of the aggregate budget of RF subjects is Rub. 0.6 billion (0.07 per cent of GDP) that being the equivalent

of 0.05 per cent of consolidated regional expenditures. Therefore, allowing for an error in estimate, it may be stated that under the assumed conditions the changes in the tax and budget legislation will not substantially affect the balance of regional revenues and expenditures on the whole.

The estimated effect of changes in the tax and budget legislation on revenues of RF subjects in year 2001 may be divided into the following components:

- Change in the rate of tax on profits of enterprises and organizations resulted in an increase in regional budgetary revenues by 1.72 per cent of GDP;
- Change in the rate and inter-budgetary prorating of the personal income tax resulted in an increase in regional budgetary revenues by 0.31 per cent of GDP;
- Centralization of VAT-generated revenues in the federal budget resulted in a decrease in regional budgetary revenues by 1.18 per cent of GDP;
- Abolition of the tax designed to finance the maintenance of residential housing and objects pertaining to the social and cultural sphere resulted in a decrease in regional budgetary revenues by 1.07 per cent of GDP;
- Lowering of the upper rate of tax on motor road users resulted in a decrease in regional budgetary revenues by 1.18 per cent of GDP;
- Changes in amounts of transfers from the Fund of Financial Aid to Regions, and the introduction of a new type of financial aid (subsidies from the Compensatory Fund) resulted in an increase in regional budgetary revenues by 0.83 per cent of GDP;
- Change in the rate of excise tax on alcohol beverages resulted in an increase of regional budgetary revenues by 0.08 per cent of GDP.

An analysis of individual budgets of the subjects of the Russian Federation reveals that the impact of changes initiated in year 2000 on the ratio between budgetary revenues and expenditures varied across regions. The number of regions estimated to have positive and negative values of revenues to expenditures differential in year 2001 is almost equal. Thus, regions estimated to have largest negative balances in year 2001 (see Fig. 2) are: the Republic of Tatarstan (Rub. 11.39 billion, or 17.80 per cent of expenditures), the Republic of Sakha (Yakutia) (Rub. 4.71 billion, or 17.85 per cent of expenditures), the Orenburg Region (Rub. 4.78 billion, or 29.93 per cent of expenditures), the Republic of Bashkortostan (Rub. 4.64 billion, or 9.97 per cent of expenditures), the Samara Region (Rub. 3.97 billion, or 19.66 per cent of expenditures).

Among leaders (in terms of budgetary surplus) are: the City of Moscow (Rub. 18.42 billion, or 9.74 per cent of expenditures), the Republic of Mordovia (Rub. 7.17 billion, or 143.96 per cent of expenditures), the Taimyr AD (Rub. 5.35 billion, or 188.04 per cent of expenditures), the Republic of Kalmykia (Rub. 3.20 billion, or 230.31 per cent of expenditures), the Republic of Dagestan (Rub. 3.05 billion, or 32.11 per cent of expenditures), the Chelyabinsk Region (Rub. 2.00 billion, or 11.07 per cent of expenditures), the Lipetsk Region (Rub. 1.76 billion, or 20.42 per cent of expenditures). In general, it shall be noted that prediction that many regions will experience deficits is justified and results from the applied method of estimation: first, there were not taken into account the fact that RF subjects might have some sources to finance their respective deficits, second, expenditures (measured in per cent of GRP) were assumed to be at the levels registered in year 2000, therefore, predictions of an increase in real GRPs resulted in a growth in real budgetary expenditures.

However, on the other hand, forecast of the state of regional budgets in year 2001 permits to obtain important information about the impact the undertaken measures will have on the inter-regional distribution of budgetary revenues. Figure 2 demonstrates that the undertaken measures will result in some redistribution of budgetary revenues to the disadvantage for the most well provided RF subjects and in favor of regions with traditionally low budgetary security; however, this trend is not characteristic for all RF subjects: while deficit may significantly increase in the Republics of Tatarstan and Bashkortostan and in the Kemerovo Region, a decrease in deficit, or increase in profit by more than Rub. 2 billion may occur in such RF subjects as the Cities of Moscow and St. Petersburg, the Republic of Sakha, the Krasnoyarsk, Primorski, and Altai Areas, the Vologda, Lipetsk, Chelyabinsk Regions, the Taimyr AD. This situation results from decisions on VAT centralization, introduction of municipal profit tax, lowering of the rate of tax on motor road users, abolition of the tax designed to finance the maintenance of residential housing and objects pertaining to the social and cultural sphere, and distribution of subsidies from the Compensatory Fund in accordance with normative expenditure requirements, what ensures that regional expenditures for subsidized items will be determined not by regional financial potentials (what would favor "rich" regions), but by their expenditure liabilities.

On the other hand, an analysis of the impact of undertaken measures on the ratio between regional budgetary expenditures and revenues measured in per cent of regional expenditures reveals that the most significant budgetary surplus as measured in per cent of expenditures is characteristic of regions with low budgetary security: the Republics of Kalmykia, Tyva, Altai, the Taimyr, Aginski Buryat, and Ust Ordynsk Buryat Autonomous Districts. Therefore,

it is possible to conclude that implemented changes will result in some redistribution of resources in favor of “poor” regions.

It shall be noted that decisive factors behind growth rates of budgetary revenues of regional budgets in year 2001 are, first, the introduction of the municipal profit tax coupled with abolition of the tax designed to finance the maintenance of residential housing and objects pertaining to the social and cultural sphere and, second, the ratio between VAT-generated revenues withdrawn from regional budgets and financial aid from the Compensatory Fund. Therefore, among the “luckiest” winners were, on the one hand, RF subjects registering largest amounts of enterprises’ profits (and household incomes) in year 2000 and, on the other hand, regions with low VAT revenues and considerable want of resources to finance the expenditures for child allowances and implementation of law “On State-Sponsored Assistance to Disabled Persons in the Russian Federation.” For instance, a substantial increase in revenues of in the City of Moscow resulted from an increase in profit tax revenues (Rub. 56 billion), while the tax on motor road users and the tax designed to finance the maintenance of residential housing and objects pertaining to the social and cultural sphere were major factors behind its loss in revenues. Besides, Moscow received a large transfer from the Compensatory Fund, although its amount (Rub. 2 billion) is small in comparison with revenues generated by two taxes mentioned above. Similarly, estimated large budgetary surpluses (measured in per cent of expenditures) characteristic of such regions as the Republics of Kalmykia and Tyva, and the Taimyr AD primary result from an increase in amounts of subsidies from the Compensatory Fund and transfers from FFAR. At the same time, neither losses these regions suffered because of the abolition of the tax designed to finance the maintenance of residential housing and objects pertaining to the social and cultural sphere,

lowering of the maximal rate of the tax on motor road users, nor gains from the introduction of municipal profit tax and redistribution of revenues from income tax were significant, mostly due to small tax bases of these RF subjects.

So, our estimates made on certain assumptions about revenues and expenditures of RF subjects demonstrate that the measures in the sphere of tax and budgetary policies approved in year 2000 will not substantially affect the all-Russian ratio between regional revenues and expenditures in year 2001. However, an analysis of the impact of these measures on the budgetary situation at the regional level reveals that their main outcome will be redistribution of resources in favor of heavily subsidized regions mostly due to distribution of extra revenues of the federal budget resulted from centralization of VAT generated revenues via financial aid and targeted subsidies from the newly formed Compensatory Fund.

TABLE 1.15

Estimated Deficits of RF Subjects' Consolidated Budgets in Year 2001 (Rub. thous., % of Expenditures)

Region	Rub. mil	% of expenditure
Republic of Tatarstan	-11388,7	-17,80%
Orenburg Region	-4783,1	-29,93%
Republic of Sakha (Yakutia)	-4750,1	-17,85%
Republic of Bashkortostan	-4641,8	-9,97%
Samara Region	-3966,5	-19,66%
Kemerovo Region	-2814,4	-16,64%
Moscow Region	-2801,9	-7,62%
Irkutsk Region	-2065,4	-12,31%
Yamal Nenets AD	-2026,5	-6,20%
Perm Region	-1932,9	-8,47%

TABLE 1.15 CONTINUED

Region	Rub. mil	% of expenditure
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Rostov Region	-1694,3	-12,14%
Khanty Mansi AD	-1484,7	-1,52%
Republic of Komi	-1440,5	-12,56%
Belgorod Region	-1364,2	-23,37%
Volgograd Region	-1329,2	-11,85%
Tumen Region	-1005,5	-6,71%
Novosibirsk Region	-742,6	-6,33%
Krasnodar Area	-739,9	-3,93%
Nizhni Novgorod Region	-730,6	-5,38%
Saratov Region	-715,2	-7,87%
Murmansk Region	-664,4	-6,93%
Leningrad Region	-604,9	-6,18%
Ulyanovsk Region	-586,4	-13,51%
Novgorod Region	-496,4	-13,56%
Tver Region	-489,6	-8,12%
Tula Region	-448,1	-6,91%
Astrakhan Region	-445,7	-10,09%
Republic of Karelia	-426,9	-7,28%
Sakhalin Region	-410,9	-6,21%
Orel Region	-355,3	-7,13%
Sverdlovsk Region	-346,6	-1,41%
Republic of Khakasia	-289,2	-11,26%
Koryak AD	-278,6	-22,18%
Kamchatka Region	-272,3	-5,72%
Ryazan Region	-263,9	-5,96%
Kaliningrad Region	-257,2	-5,12%
Evenk AD	-252,2	-26,82%
Khabarovsk Region	-202,0	-1,64%
Republic of Udmurtia	-150,7	-1,48%
Kabardin Balkar Rapublic	-147,5	-3,62%
Kaluga Region	-146,9	-2,57%
Kastroma Region	-133,0	-4,52%
Magadan Region	-110,9	-2,68%

TABLE 1.15 CONTINUED

Region	Rub. mil	% of expenditure
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Smolensk Region	-45,4	-1,06%
Krasnoyarsk Area	24,1	0,09%
Vladimir Region	56,3	1,03%
Republic of Adygey	77,7	4,66%
Arkhangelsk Region	104,3	1,40%
Yaroslavl Region	107,8	1,42%
Kursk Region	113,6	2,33%
Pskov Region	114,9	3,04%
Republic of Buryatia	142,3	2,69%
Komi Permyak AD	180,3	22,94%
Tomsk Region	180,4	2,30%
Ivanov Region	187,9	4,86%
Bryansk Region	196,7	4,21%
Aginski Burat AD	215,2	55,65%
Ust Ordynsk Buryat AD	243,8	31,32%
Nenets AD	259,6	12,03%
Republic of Mari El	334,0	15,19%
Chukotka AD	365,7	16,42%
Karachaevo Cherkess Republic	389,4	27,97%
Voroneg Region	430,7	6,19%
Yevreyskaya AD	477,4	42,56%
Penza Region	495,1	12,58%
Tambov Region	505,0	13,65%
Stavropol Area	506,5	6,30%
St. Petersburg	522,7	1,28%
Kurgan Region	554,9	15,02%
Republic of Ingushetia	662,8	27,87%
Republic of North Osetia	709,3	24,41%
Chuvash Republic	739,3	16,57%

TABLE 1.15 CONTINUED

Region	Rub. mil	% of expenditure
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Kirov Region	842,4	15,10%
Republic of Altai	866,9	80,21%
Omsk Region	992,8	12,57%
Volgograd Region	1034,3	9,99%
Republic of Tuva	1036,3	59,60%
Chita Region	1067,2	21,86%
Amur Region	1175,6	23,33%
Primorski Area	1190,0	9,92%
Altai Area	1267,3	12,53%
Lipetsk Region	1757,7	20,42%
Chelyabinsk Region	1997,2	11,07%
Republic of Dagestan	3047,3	32,11%
Republic of Karelia	3204,7	230,31%
Taimyr AD	5350,3	188,04%
Republic of Mordovia	7173,1	143,96%
Moscow	18742,3	9,74%

Sub-Federal and Municipal Borrowings

In year 2000 the development of the market of sub-federal and municipal borrowings was restrained by persisting lack of confidence of investors in solvency of regional and local administrations. At the same time, the majority of regions succeeded to diminish their indebtedness at the expense of extra revenues collected due to a favorable economic situation.

Budgetary Profit

By end-year the profit of the consolidated regional budget made Rub. 34.0 billion (about 0.49 per cent of GDP)³⁹. The budg-

³⁹ However, it is necessary to take into account the effect of changes in the budgetary accounting: the Budgetary Code stipulates that in 2000 all extra-

etary profit has been registered for the first time since 1994; in 1999 the deficit of the regional consolidated budget made Rub. 1.7 billion (0.02 per cent of GDP).

The profit of the consolidated regional budget was utilized aiming to achieve two goals: to diminish accumulated debts and to increase balances on budgetary accounts totaling to 0.59 per cent of GDP⁴⁰ (see Table 1.16).

As on January 1, 2001, 63 RF subjects administered their budgets with balance surpluses (totaling to Rub. 49.5 billion, or 5.5 per cent of revenues of respective budgets). Two RF subjects accounted for over 60 per cent of the aggregate profit: Moscow (50.2 per cent of the aggregate profit, or Rub. 24.8 billion) and the Khanty Mansi Autonomous District (12.1 per cent, or Rub. 6.0 billion). The average budgetary profit across Federation subjects was at 2.6 per cent of revenues.

Highest profits were registered in the Taimyr (Dolgano Nenetski) AD (13.8 per cent of revenues), the City of Moscow (12.7 per cent), the Nenets AD (11.8 per cent), the Lipetsk Region (10.0 per cent). The Chechen Republic reported a 17.5 per cent profit. Regions utilized the profit mainly to increase their budgetary balances on accounts (only Moscow utilized its profit to repay a part of its internal and external debts).

budgetary funds not envisaged by the Code shall be consolidated into regional and local budgets, what might result in an extra increase in the amount of profit registered by budgetary statistics.

⁴⁰ This amount represents the sum of accumulated profit and revenues derived from sales of state-owned property (including privatization) seen as sources for financing of budget deficit. The amount of revenues derived from sales of property owned by RF subjects and municipally owned property made 0.11 per cent of GDP.

TABLE 1.16.

Net Drawings of Regional and Local Budgets (% of GDP)

Year	1995	1996	1997	Jan. through Aug. 1998	Jan. through Dec. 1998	1999	2000		
							% of GDP	Incl. Rub.- denominated drawings	Incl. forex- denominated drawings
Drawings of sub-federal and local authorities, including:	0,38	0,87	1,43	0,71	0,33	0,15	-0,29	0,11	-0,40
- repayable loans from budgets of other levels	0,07	0,23	0,66	0,05	-0,09	-0,11	-0,03	-0,03	-
- sub-federal (municipal) bonds	н.д.	0,16	0,22	0,08	-0,01	-0,05	-0,27	-0,03	-0,24
- other drawings	0,31	0,48	0,55	0,58	0,43	0,31	-0,1	0,17	-0,16
- decrease in balances on budgetary accounts	...	0,03	-0,18	0,09	0,02	-0,19	-0,30	-0,30	-0,01
Financing of deficit at the expense of drawings and balances on budgetary accounts	0,38	0,9	1,25	0,8	0,35	-0,04	-0,59	-0,08	-0,41

Source: IET calculations basing on RF Finance Ministry data.

At the same time, 26 RF subjects administered their budgets with deficits totaling to Rub. 15.5 billion, or 11.1 per cent of their total revenues. Two Federation subjects accounted for over 70 per cent of the aggregate deficit: the Republic of Sakha (Yakutia) (Rub. 8.2 billion, or 52.9 per cent) and the Orenburg Region (Rub. 2.7 billion, or 17.4 per cent). The average budgetary deficit made 3.7 per cent of the revenues.

Highest deficits were registered in the Republic of Sakha (Yakutia) (52.9 per cent), the Orenburg Region (23.3 per cent), the Koryak AD (31.3 per cent), Evenk AD (23.4 per cent), the Republic of Buryatia (10.1 per cent).

Structure of Borrowing

In year 2000, the total accumulated amount of principal debt of the RF subjects' consolidated budget decreased by Rub. 19.8 billion, or by 0.29 per cent of GDP. While the amount of principal external debt diminished by Rub. 27.6 billion, or 0.29 per cent of GDP, the internal debt of regions and municipalities increased by Rub. 7.8 billion, or 0.11 per cent of GDP.

While the internal debt decreased by 0.06 per cent due to payment of municipal (sub-federal) securities and repayable loans from higher-level budgets, budgetary item "other drawings" (including bank credits and certain categories of loans from higher-level budgets) accounted for its overall increment.

The total amount of interest expenditures (repayment and servicing of debts) made Rub. 142.5 billion, or 13.8 per cent of the total revenues of the consolidated regional budget. The median value of interest expenditures was at 9.1 per cent of revenues of regional budgets.

The external debt accounted for over one fourth (27.7 per cent) of interest expenditures. Out of the total amount assigned for repayment of the external debt (Rub. 32.3 billion), Moscow accounted for 69.0 per cent, St. Petersburg for 20.2 per cent, Tatarstan for 6.9 per cent. Besides, the Leningrad and Moscow Regions, the Republics of Komi and Bashkortostan, and the Yamal Nenets AD assigned funds to repay some of their external debts.

The total amount of external regional borrowings was at Rub. 4.7 billion (St. Petersburg accounted for 94.4 per cent of this amount, other borrowings were made by the Republic of Komi, the Leningrad, Moscow, and Vologda Regions). New borrowings were at or below repayment of external debts. The only region increasing its forex-denominated debt was the Vologda Region (by Rub. 68.1 million).

The aggregate amount of internal regional and municipal borrowings made Rub. 99.2 billion. The largest borrowers were the following RF subjects: the City of Moscow (Rub. 23.9 billion), the Republic of Sakha (Yakutia) (Rub. 9.8 billion), the City of St. Petersburg (Rub. 6.8 billion), the Yamal Nenets AD (Rub. 4.3 billion), the Khanty Mansi AD (Rub. 3.7 billion), the Novosibirsk Region (Rub. 3.8 billion), the Tomsk Region (Rub. 2.5 billion).

The total amount of new borrowings was below the funds assigned to repay debts. Thus, the aggregate indebtedness of territorial budgets decreased by over Rub. 19.7 billion. At the same time a number of regions allowed their debts to grow.

The highest ratio between net drawings and budgetary revenues was registered in regions demonstrating budget deficits: Yakutia (53.9 per cent), the Koryak AD (32.8 per cent), the Evenk AD (25.5 per cent), the Novosibirsk Region (11.3 per cent), the Republic of Buryatia (10.5 per cent). The increase in net drawings is closely related to the amount of budget deficit. For instance, out of 26 RF subjects where budget deficits persisted, only the Orenburg Region succeeded to decrease the amount of principal debt by Rub. 205.3 million at the expense of sales of state-owned property.

At the same time, out of 63 regions registering proficits, 13 RF subjects allowed increases in net indebtedness utilizing borrowings to increase balances on budgetary accounts: the Penza, Perm, Samara, Chelyabinsk, Smolensk, Murmansk and Sakhalin Regions, the Republic of North Osetia – Alania, the Stavropol Area, the Khanty Mansi, Yamal Nenets, Chukotka and Ust Ordynsk ADs. Thus, 51 RF subjects decreased and 38 regions increased their accumulated borrowings.

TABLE 1.17

Administration of Consolidated Budgets of RF Subjects

	Budget revenues (Rub. thous.)	Drawings (% of revenues)	Expenditures for debt repayment and servicing (% of revenues)	Balances on budgetary accounts (% of revenues)	Budget profit (% of revenues)	Wage arrears resulting from under-financing of territorial budgets (% of revenues)
Central Federal District						
Belgorod Region	5 393 712	7,1	8,0	3,9	3,8	0,06
Bryansk Region	4 178 105	2,8	3,3	0,7	0,6	0,08
Vladimir Region	4 981 060	6,4	7,6	3,0	2,6	0,38
Voronezh Region	6 216 641	15,7	17,8	1,4	0,5	2,08
Ivanovo Region	3 482 882	7,8	9,1	1,7	1,4	0,26
Kaluga Region	5 182 920	3,3	3,7	2,3	1,8	0,16
Kostroma Region	2 602 331	18,6	18,0	2,3	-0,6	1,33
Kursk Region	4 442 086	10,1	13,2	1,2	2,4	0,37
Lipetsk Region	8 504 197	0,1	4,8	7,2	10,0	0,03
Moscow Region	35 110 940	4,3	6,2	7,5	6,9	0,12
Orel Region	4 480 177	18,5	18,9	2,2	1,2	0,15
Ryazan Region	3 831 329	5,9	4,5	1,5	-2,7	0,41
Smolensk Region	3 811 118	4,1	6,2	0,9	0,5	0,23
Tambov Region	3 375 898	5,6	7,7	1,1	2,6	0,86
Tver Region	5 606 127	7,5	11,3	1,6	4,4	0,19
Tula Region	6 002 464	7,8	10,8	2,4	4,0	0,59
Yaroslavl Region	6 960 025	4,9	8,0	2,1	3,0	0,07
Moscow	195 851 481	12,2	27,6	4,0	12,7	----
Total	310 013 493	10,1	20,5	4,0	9,5	0,12
North West Federal District						
Republic of Karelia	5 401 577	4,1	7,3	2,2	3,5	0,79
Republic of Komi	10 407 352	10,0	15,8	1,6	2,0	0,54

TABLE 1.17 CONTINUED

	Budget revenues (Rub. thous.)	Drawings (% of revenues)	Expenditures for debt repayment and servicing (% of revenues)	Balances on budgetary accounts (% of revenues)	Budget profit (% of revenues)	Wage arrears resulting from under-financing of territorial budgets (% of revenues)
Arkhangelsk Region	6 745 987	2,9	5,1	1,6	1,5	0,84
Vologda Region	9 495 630	1,0	1,9	3,6	3,1	0,13
Kaliningrad Region	4 413 768	4,6	3,9	2,4	-1,1	0,03
Leningrad Region	9 225 390	4,3	9,7	3,3	5,8	0,30
Murmansk Region	8 662 968	1,5	1,1	4,7	1,6	0,18
Novgorod Region	3 325 285	7,9	12,1	2,2	2,2	0,11
Pskov Region	3 232 618	14,6	13,7	1,1	-4,0	0,55
St. Petersburg	37868164	29,5	40,0	3,4	4,2	0,00
Nenets Autonomous District	2 173 635	0,0	0,0	14,2	11,8	---
Total	100 952 374	14,1	19,5	3,2	3,2	0,23
South Federal District						
Republic of Adygey	1 397 622	9,1	3,9	2,2	-6,0	0,62
Republic of Dagestan	8 753 620	0,0	1,6	6,7	3,7	0,22
Republic of Ingushetia	2 139 606	1,4	1,4	1,5	1,2	0,29
Kabardin Balkar Republic	3 398 126	16,4	15,1	0,9	-6,6	0,29
Republic of Kalmykia	1 217 004	11,7	9,7	1,9	-1,6	---
Karachayevo Cherkess Republic	1 244 702	5,0	7,4	1,0	0,6	0,94
Republic of North Osetia – Alania	2 598 788	7,4	10,3	4,8	0,6	0,60
Chechen Republic	967573	0,0	0,0	17,5	17,5	---
Krasnodar Area	17 005 009	1,1	1,8	4,3	1,5	0,13
Stavropol Area	7 588 280	9,9	14,5	3,0	5,8	0,33
Astrakhan Region	4 057 393	2,5	4,9	3,0	3,2	0,00
Volgograd Region	9 570 544	15,6	16,0	1,4	-4,2	0,29
Rostov Region	12 481 528	2,9	5,1	2,1	0,7	0,03
Total	72 419 795	5,5	6,9	3,4	1,0	0,21
Privolzhski Federal District						
Republic of Bashkortostan	42 768 786	6,5	8,6	3,0	3,2	0,08
Republic of Mari El	1 974 203	12,0	13,5	0,8	1,0	3,86
Republic of Mordovia	4 484 385	16,2	20,3	0,5	1,3	0,44
Republic of Tatarstan	58 380 420	3,7	11,7	1,0	2,6	0,01
Republic of Udmurtia	9 429 585	5,0	8,1	3,3	4,3	0,03
Chuvash Republic	3 999 198	15,6	18,5	1,9	0,8	0,27
Kirov Region	5 002 939	8,2	8,7	1,3	0,9	2,38

TABLE 1.17 CONTINUED

	Budget revenues (Rub. thous.)	Drawings (% of revenues)	Expenditures for debt repayment and servicing (% of revenues)	Balances on budgetary accounts (% of revenues)	Budget profit (% of revenues)	Wage arrears resulting from under-financing of territorial budgets (% of revenues)
Nizhni Novgorod Region	11 693 687	31,8	32,8	12,6	-3,2	0,32
Orenburg Region	11517677	1,3	3,1	2,0	-23,3	0,07
Penza Region	3 513 860	0,5	0,7	1,6	0,5	---
Perm Region	20 517 645	0,9	1,0	3,1	1,2	0,01
Samara Region	18 441 686	3,2	3,3	7,7	2,8	0,04
Saratov Region	8 136 980	21,5	26,5	0,4	0,8	1,22
Ulyanovsk Region	3 664 978	9,6	5,9	1,9	-5,2	0,56
Komi Permyak AD	688 228	12,1	10,1	1,4	-1,5	0,13
Total	204 214 257	7,0	10,3	3,1	0,5	0,22
Ural Federal District						
Kurgan Region	3 270 666	10,8	10,8	0,5	-0,4	3,55
Sverdlovsk Region	22 575 779	7,0	11,4	2,9	3,4	0,54
Tumen Region	13 819 943	1,3	3,3	2,4	3,7	0,19
Chelyabinsk Region	16 166 899	3,7	3,6	2,6	0,8	0,00
Khanty Mansi AD	92 689 481	4,0	3,9	11,6	6,5	---
Yamal Nenets AD	29 320 464	14,6	15,0	0,4	0,9	0,30
Total	177 843 232	6,0	6,8	6,9	4,3	0,20
Siberian Federal District						
Republic of Altai	924 232	16,8	12,1	2,1	-3,9	6,18
Republic of Buryatia	4 272 111	34,0	25,8	0,8	-10,1	2,32
Republic of Tyva	1 606 583	6,2	9,4	1,0	3,8	7,87
Republic of Khakasia	2 255 959	10,9	10,3	1,5	-1,2	1,70
Altai Area	8 778 378	19,2	16,7	0,9	-2,4	1,16
Krasnoyarsk Area	26 229 239	2,5	5,8	7,1	4,8	0,25
Irkutsk Region	15 100 241	4,6	5,7	2,3	1,3	1,16
Kemerovo Region	15 522 158	4,9	9,3	2,8	3,2	1,59
Novosibirsk Region	9 583 766	40,3	34,3	2,1	-8,7	0,49
Omsk Region	7 211 055	22,2	29,4	2,5	2,7	1,31
Tomsk Region	6 850 615	36,7	34,8	4,0	-1,7	0,33
Chita Region	4 395 661	7,2	7,7	1,9	1,3	2,13
Aginski Buryat AD	370 998	10,2	15,5	2,4	7,4	0,16
Taimyr AD	2 933 523	0,8	0,8	18,1	13,8	---
Ust Ordynsk Buryat AD	692 704	11,5	11,4	0,5	0,1	1,10
Evenk AD	677 406	64,3	40,0	3,7	-23,4	3,06
Total	107 404 629	13,6	14,4	3,8	0,8	6,18

TABLE 1.17 CONTINUED

	Budget revenues (Rub. thous.)	Drawings (% of revenues)	Expenditures for debt repayment and servicing (% of revenues)	Balances on budgetary accounts (% of revenues)	Budget profit (% of revenues)	Wage arrears resulting from under-financing of territorial budgets (% of revenues)
Far East Federal District						
Republic of Sakha (Yakutia)	15 459 041	63,7	10,8	5,4	-52,9	1,75
Primorski Area	10 254 394	14,3	10,5	1,1	-3,9	3,03
Khabarovsk Area	10 599 758	7,6	3,7	1,3	-3,6	0,61
Amur Region	4 411 941	21,8	20,6	1,8	-1,5	2,84
Kamchatka Region	4 385 293	5,1	8,8	0,8	3,5	1,57
Magadan Region	3 613 579	9,0	6,5	1,8	-1,8	0,03
Sakhalin Region	6 074 667	8,4	7,7	6,0	3,2	1,42
Yevreyskaya Anomous Region	1 017 455	6,8	7,8	1,8	2,0	0,65
Koryak AD	850 066	47,8	15,0	1,8	-31,3	8,49
Chukotka AD	1992849	12,0	10,6	2,6	0,6	10,22
Total	58 659 043	25,3	9,5	2,9	-15,3	2,06
Russian Federation, total	1031 506 823	10,1	13,8	4,1	3,3	0,39

Source: IET calculations basing on RF Finance Ministry data

The aggregate balances on budgetary accounts increased by Rub. 21.1 billion, or by 61 per cent in real terms, and made Rub. 43.4 billion. Out of all Russia's regions only 9 RF subjects decreased amounts of balances on budgetary accounts. Eight of them: the Arkhangelsk, Kursk, Voronezh, Volgograd, Ryazan Regions, the Republics of Komi, Karachayevo Cherkess and Adygey decreased balances on budgetary accounts less than by 0.2 per cent of total revenues of respective budgets. Only Tatarstan decreased balances on budgetary accounts by over 4.6 per cent of revenues of the Republican budget by repaying over 60 per cent of its accumulated debt.

Increasing balances on budgetary accounts are, to a certain degree, a positive phenomenon, since they satisfy the need of local administration for liquid means. However, in the situation where the majority of regions underfinance budgetary expenditures (yet unsettled wage arrears, urgent need to finance infrastructure projects, numerous instances of overdue indebtedness to creditors) the growth in balances is rather a negative development.

In some instances an increase in balances on budgetary accounts may be attributed to the fact that administration strive to support authorized commercial banks. While as on December 1, 1999, the amount of funds local budgets deposited in commercial banks exceeded banks' claims to administrations by Rub. 2.5 billion, or 0.06 per cent of GDP, as on December 1, 2000, this difference was already at Rub. 37.0 billion, or 0.53 per cent of GDP demonstrating an increase by 9 times as measured in per cent of GDP (see Table 1.18).

However, in December, when after a traditional surge of budgetary expenditures the balances on budgetary accounts fell by almost one third, the amount of claims of commercial banks grew somewhat, what resulted in a twofold decrease in the balance between claims and deposits.

The underdeveloped treasury system is an important factor behind a relative increase in balances on budgetary accounts demonstrated by regional and local budgets. Due to inefficient budget administration budgetary resources are diffused across dozens of accounts, what results in persisting budgetary wage arrears in spite of large balances on budgetary accounts. At the same time, balances on budgetary accounts were affected by an objective process of inflow of unplanned tax revenues related to the favorable economic situation.

Since January 1, 2001, budgetary resources shall be transferred to the Central Bank of Russia, as stipulated by the Budgetary Code. However, this process has not been completed yet, and no exact deadline has been set. Balances on budgetary accounts in commercial banks continue to play a rather important role in a number of regions. For instance, according to estimates made by the St. Petersburg Finance Committee, budgetary resources make about 20 per cent of balances on corresponding accounts of St. Petersburg credit organizations. Therefore, the necessity to ensure the stability of the banking system is given as a reason behind delays in transferring budgetary resources from commercial banks.

TABLE 1.18

**Commercial Bank Financing of Regional Authorities
and Local Governments (Rub. mil.)**

Date	Commercial Banks' Claims to local authorities *	Local authorities' deposits with commercial banks	Balance of debts 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
01.04.00	21 680,5	29 847,9	-8 167,40
01.07.00	22 313,0	41 893,5	-19 580,50
01.10.00	23 385,7	47 341,7	-23 956,00
01.12.00	17 378,7	54 390,0	-37 011,30
01.01.01	18.531.3	36 641.8	- 18 110.5

* State authorities of RF subjects and local governments

Source: IET calculations basing on RF CB data.

In year 2000, the process of reduction (in real prices) of creditor indebtedness of territorial budgets to recipients of budgetary resources resulting in diminishing creditor indebtedness of financed budgetary organizations, which was started in the previous year, was underway. As a result, the overdue creditor indebtedness of budget-financed organizations diminished from 9.8 per cent to 5.4 per cent of the total amount of expenditures of territorial budgets over the period from December 1, 1999 till December 1, 2000 (see Table 1.19).

TABLE 1.19

Indebtedness of Budgetary Organizations Financed from Territorial Budgets (Rub. mil)

	Creditor indebtedness		Debtor indebtedness	Net indebtedness	Net arrears
	Total Bzero	Including arrears			
01.12.98	88 061	63 508	5 430	82 631	58 078
% of annual expenditure*	22.64	16.33	1.40	21.25	14.93
% of GDP 1998	3,27	2,36	0,20	3,06	2,15
01.12.99	92 853	71 720	8 102	84 751	63 618
% of annual expenditure**	14.31	11.05	1.25	13.06	9.80
% of GDP 1999	2,04	1,58	0,18	1,86	1,40
01.01.00	86 486	66 760	9 192	77 294	57 568
% of annual expenditure***	13.33	10.29	1.42	11.91	8.87
% of GDP 1999	1,90	1,47	0,20	1,70	1,27
01.12.00	92 656	70 814	17 355	75 301	53 459
% of annual expenditure***	9.29	7.10	1.74	7.55	5.36
% of GDP 2000	1,33	1,02	0,25	1,08	0,77

* % of annual expenditures of consolidated regional budgets in 1998

** % of annual expenditures of consolidated regional budgets in 1999 r.

*** % of annual expenditures of consolidated regional budgets in 2000 r.

Source: IET calculations basing on RF Goskomstat data

Wage arrears resulting from underfinancing of budgetary organizations from territorial budgets diminished in real terms by more than 60 per cent (from Rub. 8.25 billion to Rub. 3.97 billion,

that being below 0.4 per cent of the aggregate revenues of the consolidated regional budget.

At the same time, considerable wage arrears persist in a number of regions: the Chukotka AD (10.2 per cent of regional budgetary revenues), the Koryak AD (8.5 per cent), the Republic of Tyva (7.9 per cent), the Republic of Altai (6.2 per cent), the Kurgan Region (3.6 per cent) (see Table 1.17).

On the whole, the improving economic situation and higher international credit ranking of the Russian Federation resulted in subsequent improvement of rankings of RF subjects timely servicing their debts (see Table 1.20). At the same time, the credit rankings are still below levels registered in August of 1998, not to mention more favorable 1997.

TABLE 1.20

International Ranking of Russian Regions/Issuer	Moody's			Fitch IBCA			Standard & Poor's		
	August 1, 1998	May 10, 2000	January 1, 2001	August 1, 1998	May 10, 2000	January 1, 2001	August 1, 1998	May 10, 2000	January 1, 2001
Russian Federation	B1	B3	B3	BB-	B-	B	B+	SD	B-
Moscow	B1	Caa1	B3	-	CCC	CCC	B+	CCC+	B-
St. Petersburg	B1	Caa1	B3	BB-	CCC	CCC+	B+	CCC+	B-
Samara Region	B1	Caa1	B3	-	-	-	B+	CCC	B-
Krasnoyarsk Area	B1	Caa1	Caa1	BB-	*	*	-	-	-
Yamal Nenets AD	B1	Caa1	Caa1	-	-	-	B+	CCC-	CCC-
Republic of Tatarstan	B1	Caa3	Caa3	-	-	-	B+	SD	SD
Republic of Komi	B1	Caa3	Caa3	BB-	C	C	-	-	-
Leningrad Region.	-	-	-	BB-	*	*	-	-	-
Moscow Region	B1	Caa3	Caa3	B+	*	*	-	-	-
Sverdlovsk Region	B1	Caa3	Caa3	-	-	-	B+	CCC-	CCC
Nizhni Novgorod Reg.	B1	Ca	Ca	-	-	-	B+	*	*
Kaliningrad Region	-	-	-	B+	CC	CC	-	-	-
Irkutsk Region	-	-	-	-	-	-	B+	CCC-	CCC
Republic of Sakha	Caa3	Ca	Ca	B+	C	C	-	-	-
Belgorod Region	-	-	-	B+	*	*	-	-	-

Note: * - ranking withdrawn

Ranking agencies unanimously rank Moscow, St. Petersburg, and the Samara Region as the most reliable issuers of sub-federal securities. A number of rankings was withdrawn (the Moscow, Leningrad, Belgorod Regions and the Krasnoyarsk Area – by *Fitch IBCA*, the Nizhni Novgorod – by *Standard & Poor's*).

Internal Bond Market

In year 2000 the RF Finance Ministry registered bond prospectuses of 8 RF subjects and 3 municipal entities, as compared with 8 and 6 bond issues by respective categories of issuers in 1999.

Over the year, Rub. 13,042.2 million (1.88 per cent of GDP) worth of bonds were floated and Rub. 14,919.5 million (2.15 per cent of GDP) were redeemed. Thus, the amount of principal debt in Ruble-denominated securities decreased by over Rub. 1,877.3 million, or by 0.27 per cent of GDP.

The largest issuers of sub-federal securities were: St. Petersburg (38.2 per cent of the total floatation), the Khanty Mansi AD (24.7 per cent), Moscow (18.9 per cent), the Tomsk Region (3.8 per cent), the Voronezh Region (2.3 per cent), the Altai Area (2.2 per cent), the Republic of Komi (1.2 per cent), and the Yamal Nenets AD (1.0 per cent).

The highest level of securitization of borrowings was achieved by the Khanty Mansi AD (87.4 per cent of the total borrowings via securities). High levels of securitization of borrowings were also demonstrated by St. Petersburg (44.5 per cent), the Volgograd Region (32.4 per cent), the Ulyanovsk Region (31.3 per cent), the Voronezh Region (30.4 per cent) (see Table 1.21).

TABLE 1.21

Issue of Sub-Federal and Municipal Securities in 2000

Federation Subject	Amount (Rub. thous.)	Amount to Bor- rowings Ratio (%)	Share in the total issue (%)
Voronezh Region	297007	30,43	2,28
Kostroma Region	5180	1,07	0,04
Lipetsk Region	90	0,92	0,00
Smolensk Region	1850	1,20	0,01
Moscow	2461931	10,29	18,88
Republic of Karelia	36772	16,74	0,28
Republic of Komi	149935	14,37	1,15
Arkhangelsk Region	930	0,48	0,01
St. Petersburg	4981875	44,54	38,20
Kabardino-Balkar Republic	30000	5,37	0,23
Stavropol Area	96309	12,77	0,74
Volgograd Region	482178	32,38	3,70
Republic of Mari El	1891	0,80	0,01
Chuvash Republic	73000	11,72	0,56
Kirov Region	94247	23,05	0,72
Ulyanovsk Region	110260	31,27	0,85
Sverdlovsk Region	1004	0,06	0,01
Khanty Mansi Autonomous District	3219148	87,43	24,68
Yamalo Nenets Autonomous District	132170	3,09	1,01
Republic of Khakasia	24445	9,96	0,19
Altai Area	285123	16,88	2,19
Novosibirsk Region	23329	0,60	0,18
Tomsk Region	500000	19,91	3,83
Chita Region	2045	0,64	0,02
Primorski Area	31500	2,14	0,24
Total	13042220	12,56	100,00

Source: IET calculations basing on RF Finance Ministry data

The amounts of floatation of municipal and sub-federal securities fell by more than 1.5 times (from 0.47 per cent of GDP in 1998 and 0.31 per cent of GDP in 1999 to 0.19 per cent of GDP in year 2000) at the background of the general decrease in amounts of regional and local borrowings. The issuance of securities diminished more than fourfold in comparison with 1997 figures (see Table 1.22). The number of issues decreased considerably in comparison with 1997 – 1998 practically to the level registered in 1992 – 1993.

TABLE 1.22

Amount of Sub-Federal and Municipal Securities (% of GDP)

Year	1996	1997	1998	1999	2000
Issue	0,63	0,77	0,47	0,31	0,19
Repayment	0,47	0,56	0,48	0,36	0,46
Net financing	0,16	0,22	-0,01	-0,05	-0,27

Source: IET calculations basing on RF Finance Ministry data

TABLE 1.23

Registered Issue of Municipal and Sub-Federal Securities in 2000

Issuer	Term	Purpose	Issue of bonds in 1999
Moscow	2 months to 5 years	Repayment of debts and financing of budgetary deficit	Yes
St. Petersburg	1 year to 30 years	Restructuring of debts	Yes
Chuvash Republic	1 year	Financing of budgetary deficit	Yes
Volgograd Region	6 months to 1 year	Financing of budgetary deficit	Yes
Republic of Komi	1 month to 1 year	Repayment of debts and financing of budgetary deficit	No
Tomsk Region	1200 days	Restructuring of debts	No
Primorski Area	6 months to 36 months, and 5 to 7 years	Financing of budgetary deficit	No
Kabardino-Balkar Republic	1 to 5 years	Financing of budgetary deficit	No
Republic of Mari El	6 months to 5 years	Financing of budgetary deficit	No
Volgograd	90 days to 5 years	Financing of budgetary deficit	Yes
Kostroma	3 months to 2 years	Financing of budgetary deficit	Yes
Yekaterinburg	1 to 5 years	Financing of budgetary deficit	No

Source: RF Finance Ministry

Only six regions could borrow on the market of sub-federal and municipal securities amounts exceeding the par value of redeemed bonds and interest payments: St. Petersburg (net borrowings at Rub. 357.0 million), the Volgograd Region (Rub. 55.9 million), the Tomsk Region (Rub. 49.0 million), the Republic of Komi (Rub. 42.5 million), the Khanty Mansi AD (Rub. 25.5 million), the Kostroma Region (Rub. 2.0 million).

The secondary stock market of sub-federal issuers remained rather narrow over the whole year 2000 with only few issuers present: St. Petersburg, Moscow, the Orenburg Region, the Republic of Komi, and the Chelyabinsk Region. At the same time, only St. Petersburg bond market is of liquid nature (over 90 per cent of stock

exchange turnover of RF subjects' securities in years 2000 and 1999).

Due to the lack of confidence in sub-federal and municipal budgetary guarantees, regional and local governments failed to draw on cheap domestic resources to finance infrastructure projects. As demonstrated by the rapid development of the corporate bond market in Russia in 1999 through 2000, the market demands Ruble-denominated securities, therefore, the present macroeconomic situation permits to mobilize substantial funds at minimal real interest rates.

The key constraints on the development of the market of sub-federal and municipal borrowings are institutional factors, first of all, the underdeveloped procedure for recovery of debts made by regional and local governments. Dozens of RF subjects fail to comply with court rulings requiring the repayment of debts to creditors and owners of defaulted securities. Thus, in early 2000, over 34 regions defaulted on bank credits, 40 – on guarantees, 54 – on agri-bonds, 24 Federation subjects and 8 cities – on loans and sub-loans in the framework of the projects sponsored by the World Bank and EBRR.

As a result of such practices the RF Finance Ministry officially refused to review guarantees issued by RF subjects as a satisfactory security for credits granted in the framework of investment financing programs sponsored by the federal budget, although bank guarantees still remain a valid security instrument for this purpose⁴¹.

Therefore, the observed proficit of regional budgets is, rather, of involuntary nature: regions repay accumulated debts, but are un-

⁴¹ The sub-borrowing from international financial organizations guaranteed by RF subjects continues. The total amount of sub-borrowings by RF subjects and municipalities in the framework of World Bank projects makes about US \$ 700 million.

able to borrow. In a number of instances statistics formally registering new borrowings in fact reflect non-market restructuring of earlier loans. In spite of the fact that processes of debt settlement are underway in a number of RF subjects, it is apparent that the flawed legal protection of creditors' rights is blocking potentially effective borrowing.

At the same time debts of regional and local administration concentrate in state-controlled Sberbank, Vneshekonombank, and Vneshtorgbank. As in mid-2000, these banks already accumulated two thirds of claims of commercial banks to territorial authorities.

These "state-controlled" banks give new credits even to extra-heavily-subsidized Republics having substantial overdue debts. As a result, a large portion of the "market" debt has been in fact transferred to the federal level.

In this situation it is necessary to concretize the rights of creditors of recover debts of territorial authorities. It seems appropriate to approve a federal law stipulating the procedure of debt settlement related to insolvent subjects of the Russian Federation and municipal entities.

The next-important factor to improve the attractiveness of the market shall be the lowering of risks related to the impact of higher-level authorities on regional and local budgets.

First, it is necessary to ban the wide-spread practices where higher-level authorities assume unfunded expenditure mandates and finance actual mandates in full via the newly created Compensation Fund. Second, an effective system of inter-budget transfers and a mechanism for determining the prorating of regulatory taxes between RF subjects and municipal entities shall be put in place. The present instability of these revenue sources is an important factor negatively affecting the standing of issuers. At last, the federal authorities shall demand to increase transparency of territorial budg-

ets, since the lack of transparency prevents new borrowings and implementation of policies answering the interests of the constituents on the part of regions and municipalities.

Form our point of view, the problem of new borrowings is also extremely important for territorial authorities in the aspect of financing programs aimed to develop local social and economic infrastructures, primarily public utility networks. Rapid aging and deterioration of public utility infrastructure clearly reflected via the increasing failure rates, which literally exploded in a number of regions in Siberia and Far East in the winter of 2000 – 2001, urges to attract dozens billion Rubles worth in investment over next five to seven years.

TABLE 1.24

Commissioning of Public Utilities

Year	Water supply networks, km	% of 1990	Sewer networks, km	% of 1990	Heating networks, km	% 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	205,0	14,1
1999	841,8	11,2	130,3	13,2	193,9	13,3
2000	929,5	12,4	147,1	14,9	153,8	10,6

Source: IET calculations basing on RF Goskomstat data

At the same time, over last decade the commissioning of public utility infrastructure objects has been steadily declining. For instance, by year 2000 the annual commissioning of water supply, heating, and sewer networks decreased by 7 to 10 times as com-

pared with 1990 figures, moreover, in year 2000 the slump in commissioning of heating networks made 20 per cent in comparison with 1999 figures at the background of the overall recovery.

Attraction of investment to public utility infrastructure may be effective only in case the institutional structure of management of housing and public utilities is improved, primarily in the aspect of tariff policies, what is paramount for realization of commercially profitable investment projects. In case this problem is successfully settled (the seriousness of the situation requires to implement politically unpopular measures), the next important issue will be putting in place financial mechanisms aimed to boost the inflow of investment resources. Improved solvency of regional and local governments may render the market of sub-federal and municipal securities capable to ensure the settlement of this urgent problem (reconstruction of public utilities).

Moscow Borrowings

In year 2000 Moscow budget registered a profit at Rub. 22.5 billion. The revenues grew by 1.5 times as compared with 1999 figures and made Rub. 193.5 billion, or 5.7 per cent over the budget targets. The extra revenues assigned to finance the creditor indebtedness amounted to Rub. 12 billion, while Rub. 11 billion were expended to repay debt liabilities, and Rub. 4.5 billion were earmarked to substitute borrowings.

In year 2000 Moscow budget assigned Rub. 8.5 billion to service the public debt, Rub. 30.4 billion – to repay the principal. The total amount of the public debt borne by the Moscow government decreased by 28 per cent over year 2000 and made, as on January 1, 2001, Rub. 56.1 billion, or 30.6 per cent of the revenue targets set for year 2001. B 2000 r. According to the estimates of the Moscow

government, on January 1, 2002, the amount of its public debt shall be at Rub. 38 billion, of 19.5 per cent of budgetary revenues.

In May of 2000, the Moscow government redeemed its first Eurobond loan (US \$ 500 million) issued in 1997. The government could achieve a considerable expenditure saving due to the anticipatory purchase of US \$ 220 million worth of bonds on the secondary market at a discount.

As stipulated by the Moscow program of public borrowing for year 2001, Rub. 13.4 billion shall be expended to repay the internal debt, and US \$ 698 million to repay the external debt. The target internal borrowing is set at Rub. 9.6 billion (including Rub. 5.5 billion in securities) repayable in 1 to 5 years; the external borrowing shall make US \$ 450 million repayable in 5 to 10 years.

All new borrowings shall be assigned to restructure the existing debt, not new investment projects. The amount of accumulated debt shall be diminished by Rub. 22.5 billion.

The renewal of floatation via public auctions and stimulation of the secondary market of Moscow bonds at MICEX shall become important steps toward an increase in liquidity of city Ruble denominated securities.

St. Petersburg Borrowings

Extra revenues of St. Petersburg budget (as compared with the initial budget for year 2000) made Rub. 3.2 billion. The public debt of St. Petersburg diminished by Rub. 2.2 billion down to Rub. 12.578 billion over year 2000. The share of budgetary expenditures assigned to service the debt made 5.6 per cent (7.8 per cent in 1999). In 2004 it is planned to diminish the share of expenditures allotted for debt servicing down to 1.7 per cent of the total budgetary expenditures.

Over year 2000, St. Petersburg anticipated the redemption of US \$ 80.3 million worth of bonds (over one fourth of the US \$ 300 million external loan issued in 1997), thus saving on coupon payments US \$ 13.6 million and US \$ 5.9 million on redemption of bonds at par value.

In year 2001 St. Petersburg plans to anticipate redemption of US \$ 100 million worth of bonds. The redemption shall be financed as follows: 30 per cent at the expense of city budget profit, and 70 per cent at the expense of borrowings (bonds or other securities). The remaining US \$ 119.7 million worth of bonds maturing in 2002 shall be redeemed at the expense of new external borrowings (if available) or budgetary profit.

As the plan to anticipate redemption of St. Petersburg bonds was announced, the current yield of the bonds on the secondary market decreased from 14 to 16 per cent down to 12 per cent per annum.

Legislative Regulation of Borrowing and Debt Policies of RF Subjects

Major changes related to the legislative regulation of the market of sub-federal and municipal borrowings are stipulated by the enactment of federal law No. 116-FZ of August 5, 2000, "On Amendments to the Budgetary Code of the Russian Federation."

First, principal changes were made in Article 92 of the Code "Budget Deficit." The maximal limit of deficit for RF subjects was increased from 5 to 15 per cent, for municipal entities – from 3 to 10 per cent of the amount of internal budgetary revenues (i.e. excluding financial aid from higher-level budgets). It is, however, stipulated that in case revenues generated by sales of property are envisaged by an annual budget law, this limit may be exceeded by the amount of such revenues.

The Budgetary Code abolished the prohibition to utilize borrowings for servicing and repayment of debts of RF subjects and municipal entities (as it was previously set in Article 92). Now Article 104 of the Budgetary Code permits to utilize borrowings for financing budgetary expenditures related to repayment of debt liabilities.

Articles 95 and 103 were amended to exclude the mention about external sources available to finance budgetary deficits of RF subjects. Article 96 was amended to supplement the sources of financing available to municipal budgets with loans from higher-level budgets, revenues generated by sales of municipally owned property, and changes in balances on budgetary accounts. Therefore, municipal budgets were equalized with budgets of RF subjects in terms of the structure of available sources of financing.

Article 112 prohibited new borrowings by Federation subjects and municipal entities infringing upon the following norms:

- The maximal amount of accumulated debt (equal to revenues of a Federation subject or municipal entity, financial aid from higher-level budgets excluding);
- Or the maximal rate of expenditures for servicing debts of organizations financed from the budget (15 per cent of the total amount of budgetary expenditures of a Federation subject or municipal entity excluding utilization of borrowings to restructure and repay accumulated debts).

The Budgetary Code prohibited all Federation subjects to borrow from external sources after January 1, 2002 (the previous version permitted such borrowings for the regions not receiving financial aid aimed at equalization of budgetary security). The right of external borrowings in amounts at or below annual payments of external debt (in the respective year) was retained only for regions refunding their accumulated external debts.

The prohibition to increase external debts of RF subjects was aimed to prevent the regions from assuming forex-related risks capable to seriously increase budgetary debt burden in case of a sharp Ruble devaluation in the absence of reliable hedging instruments.

However, it is necessary to note that this ban deprives the Russian economy of a rather large amount of portfolio investment available if guaranteed by regional and municipal budgets. Therefore, territorial authorities will have to compete with private borrowers on the domestic market, what may result in heightening of the negative effect of state loans superseding private investment via further increase in interest rates caused by the scanty supply of long-term credit resources by residents.

The reorientation towards the domestic market will also contribute in a relative shortening of duration of debt liabilities issued by territorial authorities, what increases budgetary risks.

Introduction of the institute of debt register stipulated by the Budgetary Code shall become the key prerequisite for the development of the market of sub-federal and municipal borrowings, since this institute envisages a transparent system of public accountability of territorial authorities across all types of borrowings. Another important step promoting transparency of the market is the introduction of new requirements concerning the information the issuers are obliged to disclose in the course of realization of bond issuance programs stipulated by RF government decision No. 754 of 30.09.2000 "On State Registration of Normative and Legislative Acts Containing Terms of Issuance of Securities of Subjects of the Russian Federation or Municipal Securities and on Reporting on Conducted Issuance."

1.5. The Government Securities Market

The internal debt market. Throughout 2000, two sectors with different dynamics of their main indices could be distinguished within the GKO-FSB market (see Fig. 1). During the first half of the year the weighted average yield of the rouble bonds was going down from 50-55% to 20-25% per annum, the tender volume on the secondary market was rising from 3 to 5 billion roubles per week in February - March, while in April - May it declined to 1-3 billion roubles.

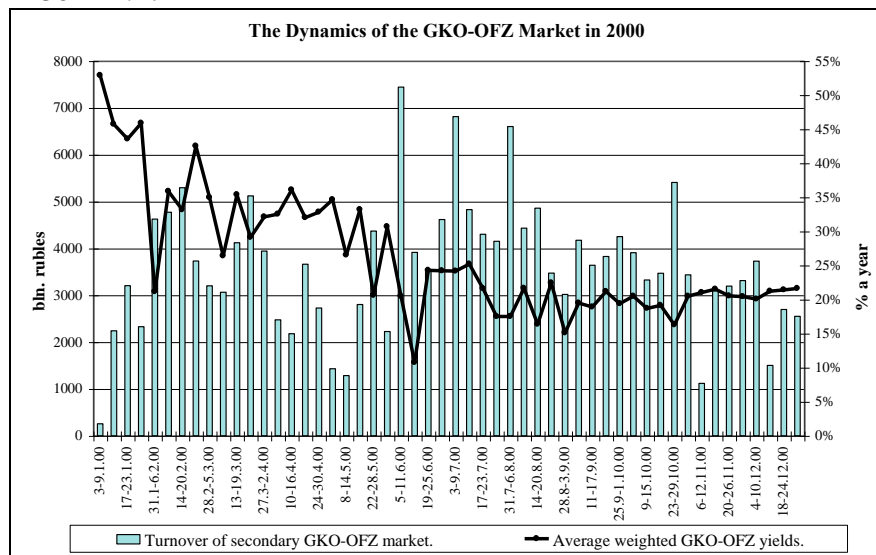
On February 23, 2000, for the first time since August 12, 1998, a redemption of government bonds took place - the FSBs of Series #25022, total value 11.5 billion roubles. On the same day the Ministry of Finance of the RF held offering auctions of two new issues of government short-term bonds (GKO). The GKOs of Series # 21138 (bond issue volume of 2.5 billion roubles, redemption date September 6, 2000) were placed only among non-residents - the holders of the "C" accounts in Russian banks, while the bonds of Series # 21139 (2.5 billion roubles, redemption date May 31, 2000) were for both residents and non-residents.

The participation of non-residents, just as it had done at the auctions in December 1999, produced an extremely low yield of the applications granted. Thus, the weighted average yield of GKOs # 21138 was negative (-0,54% per annum). It is noteworthy that resident investors filed their applications at lower prices, and the weighted average yield of GKOs # 21139 exceeded 20% per annum. At the next auction on April 19, 2000 the participation of non-residents also made it possible for the Ministry of Finance to place the bonds at a very low level of yield of the granted applications. Thus, the cutting-off price for the GKOs # 21137 was set at 100% of their face value, while the average weighted price of the

distributed bonds reached the level of 100.16% of their face value which corresponds to the yield to maturity of -0,28% per annum.

By the end of March, the yield to maturity of the most tradeable series of FSBs and GKO (to be redeemed in 2000-2001) was 20-30% per annum, of the series of longer bonds - 38% per annum, at most. In this situation, when the CBR during March twice lowered the refinancing interest rate (on March 7 from 45% to 38% per annum, on March 21 from 38% to 33% per annum), it was simply following those trends that were typical of the internal debt market.

FIGURE 1.17



In the second half of 2000 the average yield to maturity on the market was stabilized at the level of 20% per annum. Since June 2000 the secondary market turnover demonstrated a certain growth, its average weekly level was about 4 billion roubles, in some weeks as high as 7-8 billion roubles. The consolidation of the rouble exchange rate made the investments in the GKO-FSB even more at-

tractive for non-residents - the holders of the "C" accounts who were intending to withdraw their financial assets from Russia.

Nevertheless it should be noted that in June - July of 2000 the transactions between residents became dominant on the internal debt market of the RF whereas in late 1999 - the first quarter of 2000 the bonds distributed among the non-residents holding the "C" accounts were the most liquid ones. In mid-year the yields of all series were below the refinancing interest rate of the CBR, and the effect of the negative yields of the issues for non-residents became weaker because by that time the main bulk of these bonds had been removed from the market.

In the middle of 2000, though the effective yields to maturity of the GKO and FSBs were negative, the participants of the market were demonstrating a demand for rouble securities because at that time they represented the most profitable and liquid asset on the domestic financial market (as compared to interbank credits, currency transactions, shares and the deposits at the Bank of Russia).

However in November and December the tender volume again went down to weekly 2-3 billion roubles. The effective rouble yield which in the first months of the year 2000 was at the level of a monthly rate of 1,5% to 2%, in the second half of the year was floating around zero level. The redemption in November of the last series of the GKO for the non-residents holding the "C" accounts, on the one hand, contributed to lower market turnovers, but on the other, provided the possibility of a more realistic estimation of the average weighted yield of bonds because the yield of these particular issues was persistently negative.

By the end of 2000 the GKO-FSB market became less liquid and attractive for investors. By that time there were almost no short-term securities on the market (only one GKO series issued in 2000 was in circulation), and at the beginning of 2001 fell the dates

of redemption of the 3-year FSBs that had not participated in debt restructuring in 1998-1999, and their holders obviously will not be eager to invest in new long-dated securities.

On the whole, in 2000 the Ministry of Finance of the RF held seven auctions with the purpose of distributing new series of the GKO with turnovers of 3 to 7 months and total value of 19.5 billion roubles, two issues of bonds were distributed only among non-residents (total value of 5 billion roubles). The expressed demand for the securities exceeded the supply almost by 65% and amounted to 32.1 billion roubles. The total volume of the distributed GKO was over 15.8 billion roubles, the revenues of the Ministry of Finance amounted to 15.3 billion roubles. The average weighted yields at the auctions were at the level of 12.34% per annum (without the issues for non-residents - 14.90% per annum).

The government currency bonds market (ICBs (internal currency bonds) and Eurobonds). Throughout 2000, several periods can be distinguished with different rates of changes of the quotations of Russian currency bonds (see Fig.1.18 and 1.19). The retirement of President of the RF B.N. Yeltzin and the nomination of V. Putin as Acting President of the RF, as well as the early presidential election, all produced a beneficial influence on the market situation at the beginning of the year. In January 2000 the quotations of the ICBs grew from 2 to 12 percent points. The greatest growth was demonstrated by the 4th and the 6th ICB tranches, to be redeemed in 2003 and 2006. Thus the yields of the ICBs in fact returned to the level of prior to August 17, 1998 (17% to 40% per annum).

FIGURE 1.18

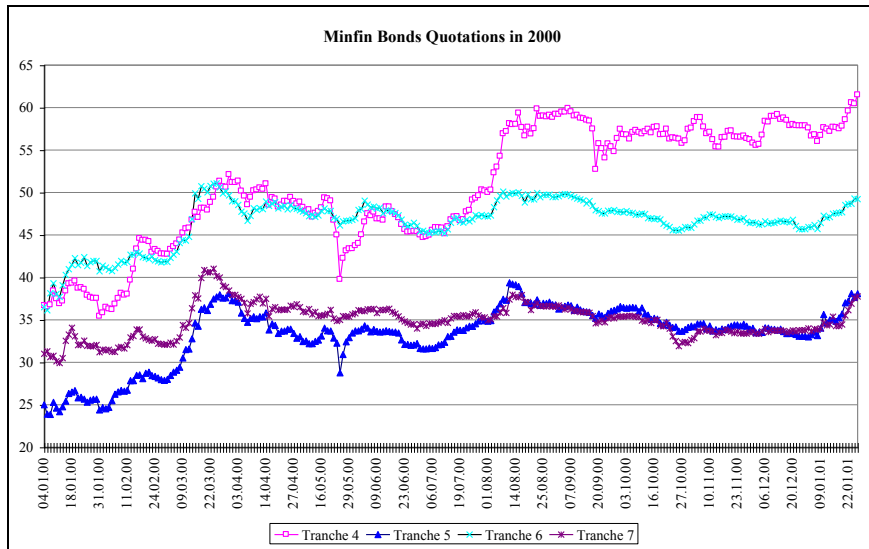
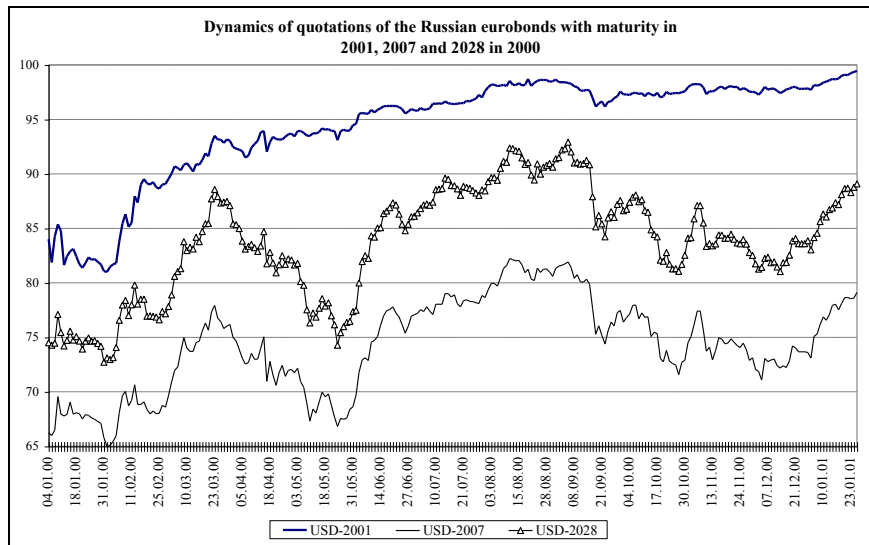


FIGURE 1.19



On February 11, 2000 during the negotiations in Frankfurt, Russia reached an agreement with the London Club about writing-off 36.5% of her debt and restructuring the rest of it. As of the beginning of February, Russia's debt due to the London Club was about \$ 31.8 billion. According to the agreements, in the 2nd and the 3rd quarters of 2000 Russia issued two tranches of Eurobonds with total value of about \$ 21.1 billion. The main sum of the debt (PRIN) is to be converted into Eurobonds with the turnover term of 30 years, with a 7-year period of grace and 6-month coupon payments. The interest rate on the bonds is set at 2.5% per annum during the second year, at 5% per annum from the second through the 7th year, and at 7.25% per annum for the subsequent years. The overdue interest (IAN) is to be converted into 10-year bonds with the coupon rate of 8.25% per annum.

It should be noted that the terms of the achieved agreements has turned out much less favourable for Russia that initially intended (it was planned to write off between 50% and 70% of the debt). Even if all the other creditors of the USSR (except the owners of the 4th and the 5th ICB tranches) agree to restructure the debt on the same conditions as those agreed upon with the London Club, the payments on the debt of the USSR in the next 7 years are going to be at least \$ 8 billion a year (see Fig. 1.20). It is obvious that it would be difficult for Russia to pay her debts to the extent just specified, and so the goal of a radical reduction of the debt burden, despite all the efforts, has not been achieved.

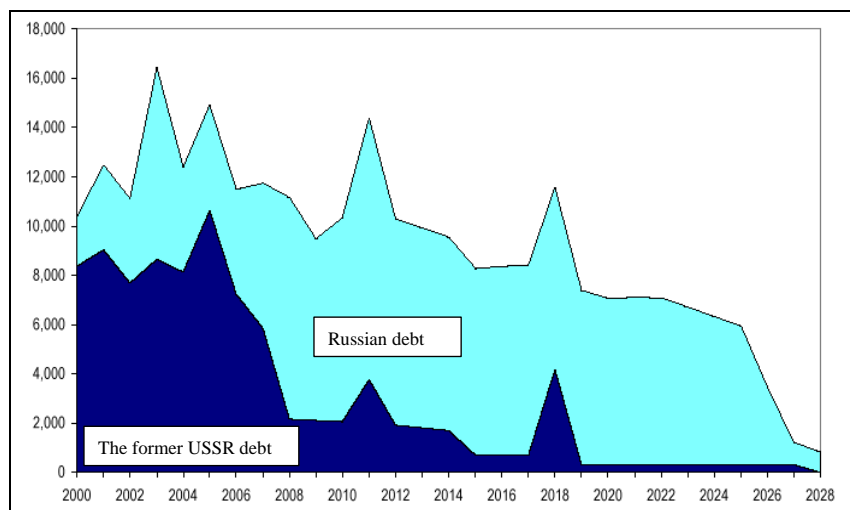
Nevertheless, the results of the negotiations produced a positive effect on the changes of the quotations of Russian securities. In the second decade of February the prices of short-term ICBs and Eurobonds went up on the average by 3-5 percent points.

all terms of redemptions became even more rapid. Thus, by March 24 the prices of the ICBs rose by 8-10 percent points (or by

20-35%). The achieved level of prices corresponds to the yield to maturity of 13-18% per annum. The yield of the ICBs of Series 4 which still has a strong probability of default in 2003 went down to 28-29% per annum. The principal factors influencing this dramatic growth of prices were optimistic expectations associated with the outcome of the presidential election in Russia and the stability in the budgetary sphere. The prices of Russian Eurobonds during the same period grew by 5-8 percent points (or by 7-12%). Their yields to maturity are floating between 13% and 15.5% per annum which corresponds to the levels of bond yields in the countries with international credit ratings similar to that of Russia.

FIGURE 1.20

The schedule of the payments of Russia's external debt in 2000-2028



Source: The investment company "Branswick Warburg".

In March 2000 the growth of the quotation of securities with However since the end of March, a correction of prices was seen on the Russian currency debt market. By mid-May the prices of the ICBs

went down to the mid-March level, and the prices of Eurobonds - to the level of the first half of February 2000. Only the prices of the issue of Eurobonds redeemable in 2001 remained at a stable level, its yield to redemption does not exceed 13.2-13.5% per annum. The Eurobond yield curve was concave with an upward "hunch" in the middle, its maximum corresponding to the bonds redeemable in 2003-2007. The bond priced continued to go down in June.

Beginning with the second half of July 2000, the rapid growth of the quotations of almost all kinds of securities was revived. The greatest growth was demonstrated by the bonds of Tranche 4 of the ICBs. In 1.5 months their price increased approximately by one-third (from 45-46% to 60% of their face value), thus providing their owners with a profit of over 700% in the annual estimates. The growth of the prices of other ICB series and Eurobonds was less noticeable (by 4-8 percent points). Nevertheless, the yield to maturity of all kinds of liabilities decreased below 20% per annum (except Tranche 4 of the ICBs - 25%), while the yield of the Eurobonds redeemable in 2001 - below 10% per annum. The main factors responsible for this growth of prices were favorable expectations of investors concerning the probability of timely redemption of the "Soviet" ICB series, the elevation of the long-term credit rating of Russia to the B level, as well as the successful revival of the agreement on Russia's debts to the London Club.

On August 17, 2000 the Ministry of Finance of the RF terminated the admittance of applications for the exchange of Russia's liabilities to the London Club for the new Russian Eurobonds to be redeemed in 2010 and 2030. A total of 98% of the debt was exchanged, judging by the results of the revival, the nominal size of Russia's foreign debt decreased by about \$ 10.5 billion. The cost of servicing the new Eurobonds in 2001 will be about \$ 600 million.

In the second half of September 2000 the prices of debt liabilities on the world financial markets demonstrated a considerable fall. Thus,

the ICB quotations decreased as compared to the beginning of the month by 2-4 percent points (the ICBs of Series 4 - by 6 percent points), and Eurobonds lost up to 10 percent points of their face value (the series to be redeemed in 2001 - by 2 percent points). Thus, the yield to maturity of the ICBs rose to 16-30% per annum, and that of Eurobonds - to 12-16% per annum. An exception was represented by the 30-year Eurobonds issued within the framework of the restructuring of the debt due to the London Club: the yield to maturity of these securities went up but has not exceeded 7.5-8% per annum.

This dramatic fall in prices during the second half of September was explained by a coincidental emergence of a number of independent factors. These are, in the first place, the technical corrections of the prices of Russian securities after their rapid rise from May through the first half of August. Secondly, there is a growing uncertainty on the world financial markets associated with the anticipation of a crisis on the financial market in the USA. In this situation a number of large-scale investors reduce their share of the securities issued by the developing countries in their portfolios. Thirdly, in late summer and early autumn many investors estimated the risk associated with the uncertainty of the prospects of the economic situation in Russia and its political stability as high because of the problems that could arise during the procedure of the approval of the Budget Law for 2001 by the Federal Assembly and the reform of the upper chamber of the parliament.

After a considerable fall of the prices of Russian securities on the international financial markets at the beginning of the third decade of September 2000, in late September - the first half of October their quotations were growing. However in the second half of October 2000 the prices began to go down again. By the end of the month the quotations of the ICBs fell to the level of July - early August 2000, and those of Eurobonds to the level of May - June 2000 (with the exception of the shortest series of these securities). Thus the yields to maturity of the

ICBs are staying between 16.5% and 29.5% per annum with a "reverse" shape of the yield curve (high rates of short bonds and low rates of long bonds), while the yields to maturity of Eurobonds are between 8% and 16.5% per annum (the yield curve has the traditional concave shape).

In October the main cause of the falling prices of Russian liabilities was the generally growing instability on the world financial markets associated with the crisis in the Near East and negative anticipations as regards the situation on the American stock market. The diminishing interest of investors to Russian bonds was seen simultaneously with money withdrawal from the bonds of other developing countries.

During November 2000 the prices of the Russian currency debt liabilities remained almost stable, with a slight tendency for lowering quotations only at the end of the month. The yield of the ICBs stayed at the level of 16.5-21% per annum for distant series and about 30% per annum for Tranche 4 of the bonds. The yields of Eurobonds are between 11% and 16,5% per annum (of the bonds to be redeemed in 2030 - about 7.5% per annum). The negative factors influencing the general economic situation were the threat of the debt crisis in Argentina and of the currency crisis in Turkey, as well as money withdrawal from the securities of the developing economies and their transfer in the USA government securities.

In December 2000 the external debt market of the RF was demonstrating an opposite trend. On the one hand, by the end of the year there was a certain growth of the quotations of the shortest series # 4 of the ICBs and Eurobonds. On the other, the prices of the other ICB series remained stable or went down. Thus, the yields of Russian bonds in December 2000 were 11.5% to 16.5% and those of the ICBs - 20% to 30%. The main factors influencing the price movement of Russian se-

curities were the changing situation on the world financial markets, while there were no significant internal factors.

When analyzing the general trends on the market throughout the year, it should be noted that the results of the year 2000 demonstrated a considerable growth of quotations of all securities. The yields of Russian Eurobonds (without coupon payments) were about 22-25%, and of Tranche 4 of the ICBs - over 80% in currency. At the same time the actual level of the yields of Russian currency securities (primarily Eurobonds) is low enough, considering the rather high probability of crises on the markets of the developing countries (for examples those of Argentina and Turkey).

In January 2001 the growth of the quotations of Russian currency bonds became more rapid. Thus, by January 25 the prices of the ICBs increased by 7-15%, and the prices of Eurobonds - up to 7,5%. It is remarkable that mediums (Tranche 5 of the ICBs and Eurobonds to be redeemed in 2007) demonstrated the greatest growth rates, nevertheless the "hunch" on the middle segment of the Russian securities yield curve remained. The general level of the yields to maturity of the ICBs showed only a slight decrease (to 27.5-28% per annum on the shortest tranche of the ICBs, and 15.5-20% - on the other series). The yields of Eurobonds showed a stronger decline; below 10% per annum on the issue redeemable in November 2001, to 7% per annum on the 30-year bonds, under 15% per annum on medium series).

In our opinion, considering the current international market situation (high degree of uncertainty on the financial market in the USA, decreasing oil prices) and the internal problems of the Russian economy (collapsed negotiations on the restructuring of the debts due to the Paris Club), this growth of the prices of Russian securities can be explained only by the effect of the delayed demand for Russian securities in the portfolios of large-scale international investors.

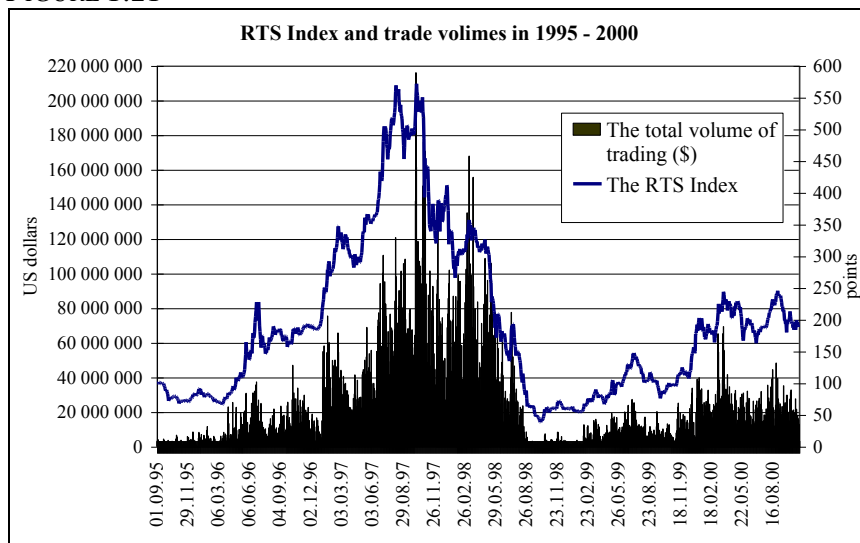
1.6. The Russian Stock Market

Despite a number of positive factors that were present during 2000, the change of prices on the Russian stock market was disappointing for the majority of investors. A considerable lowering of the level of political risks during the last year, the tax reform, the improvement of the budget situation, and the highest rates of economic growth since the beginning of reforms gave investors some hope, at least, that the profitability of an average market portfolio is going to be positive. Nevertheless, on the whole during the year 2000 the RTS index fell from 177.71 to 143.29 points, or -19.37% (see Fig. 1.21). At first sight, this response of the stock market to the favorable change in macroeconomic and political situation in this country looks paradoxical. In face of a sufficiently developed institutional base of financial markets, the lowered risk level in any country, other conditions being equal, leads to an increase in the volume of foreign investments and, as a rule, to increased asset prices - in this particular case the prices of Russian shares. Consequently, the phenomenon of lowered share prices on the Russian stock market in 2000 deserves a special consideration.

The lowering of both the share prices of domestic companies and the RTS index by the end of the year 2000 cannot be studied separately from the analysis of the situation on the stock market in 1995 – 2000. The retrospective changes of the RTS index shown in Fig. 1 indicate that during 1996 – 1998 the market was displaying a very stable directed (upward or downward) trend. The development of the institutional base of the Russian stock market, the well-known political events that took place in the country, the world financial crisis and the domestic August 1998 crisis, as well as the

changed macroeconomic situation in the country⁴², at various periods of time were regarded by investors as very serious fundamental factors creating a stable trend of the share price movement.

FIGURE 1.21



The situation changed dramatically in 1999 – 2000. During the long fall in share prices between October 6, 1997 (the RTS index was 571.66 points) and October 9, 1998 (42.55 points), the stock index fell by 92.6%. This substantial decrease in share prices was the result of large-scale capital withdrawal from the Russian stock market by foreign and domestic investors because of a rapid growth of the levels of virtually all kinds of risks associated with the investments in Russia, and the decline of the country's reputation on the world financial markets. Thus, by the beginning of 1999 investors lost their interest in the Russian stock market to a considerable degree. The RTS turnover in 1999 was exactly 6 times lower than

⁴² See annual reviews of the IET for the previous years.

in 1997 and 3.7 times lower than in 1998 (see table 1.25). At the same time, the low turnovers of the Russian stock market made it easier to manipulate and created the basis for its speculative growth⁴³. On the whole, in 1999, in a situation of a very low turnover, the RTS index grew by 201.6%, thus making the Russian stock market the most profitable one among the world stock markets.

TABLE 1.25

	RTS index	Changes in RTS index (% per year)	Total tender volume in RTS (\$ billions)	Changes in total tender volume in RTS (% per year)
1995 г.*	82,92	-	0,189	-
1996 г.	200,50	141,80%	2,946	1459,1%
1997 г.	396,86	97,94%	14,022	375,9%
1998 г.	58,93	-85,15%	8,659	-38,2%
1999 г.	177,71	201,58%	2,335	-73,0%
2000 г.	143,29	-19,37%	5,568	138,5%

* - data for September-December 1995.

In our view, it was this dramatic growth of Russian share prices in 1999 on a low-liquid market that became the reason for the “paradoxical” fall in the RTS index in 2000. The signs of gradual improvement of the economic situation in the country began to appear already in early 1999, and in the second half of that year few investors or economists had any doubts that 2000 would be the year of growth. Thus the expectations of investors regarding the prospects for normalization of the economic situation in 2000 were reflected in share prices as early as at the end of the year 1999.

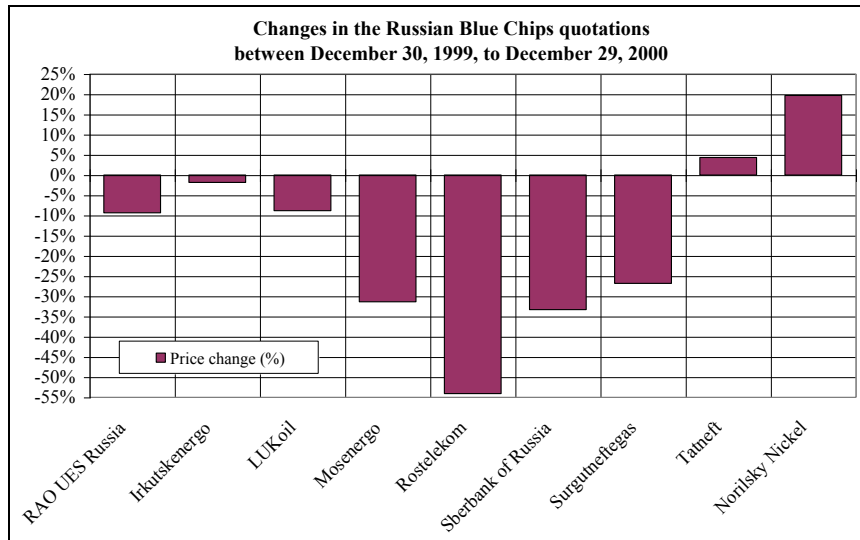
In 2000 stock market turnover noticeably increased. In particular, last year the RTS turnover was \$ 5.568 billion which is by 138.5% higher than the same index for the year 1999 (see table 1).

⁴³ As a very characteristic example the growth in quotations of shares during the last shortened session on December 31, 1999 can be noted when the RTS index rose from 150.01 to 177.71 points, i.e. by 18.5%.

At the same time, the increased investors' interest in the Russian stock market did not create a stable upward trend. A retrospective analysis of the changes of the RTS index in 2000 shows that there has indeed been formed a side trend around the level of 200 points which was also characteristic of the RTS index during the second half of the year 1996. However this trend is rather relative because during last year the domestic stock market again demonstrated quite a high level of changeability of both the quotations of shares and the index. Two highest values of the RTS index in 2000 documented on March 24 and August 29 are 243.92 and 245.49 points, respectively (see Fig. 3). These values of the RTS index are approximately 46% higher than the minimum index value as of December 21, 2000, of 132.07 points.

By the results of the year 2000, the majority of Russian blue chips demonstrated lowering of prices (see Fig. 1.22). Among the most liquid securities, the greatest price lowering was demonstrated by the shares of "Rostelecom" (-54.1%), "Sberbank RF" (-33.3%), "Mosenergo" (-31.4%), "Surgutneftegaz" (-26.8%), the RJSC "EES Rossii" (-9.3%), and "LUKoil" (-8.8%). At the same time, in 2000 the more than doubled turnover in the RTS did not produce any substantial change in the total share of liquid securities in the total RTS turnover as compared to the year 1999. In particular, the results of the year 2000 has shown that the rate of ordinary shares of the RJSC "EES Rossii" within the RTS turnover was 40.0% (27.9% in 1999), the shares of "LUKoil" - 17.4% (24.4%), of "Surgutneftegaz" - 8.9% (21.3%), of "Tatneft" - 6.1% (3,2%), of "Mosenergo" - 4.8% (7.1%). Thus in 2000 r. the total share of the five most liquid securities in the total RTS turnover was 77.2% (84.6% in 1999).

FIGURE 1.22



To explain the aforesaid dynamics of share prices, let us take a look at the situation on the Russian stock market in 2000 within the context of the changing risk level. Here the following directions of these changing risk levels are considered to be especially important:

- the changing political situation;
- the improved macroeconomic situation and the changed relationships with the international financial organizations;
- the dynamics of oil prices on the international markets;
- the situation developing on the international financial markets.

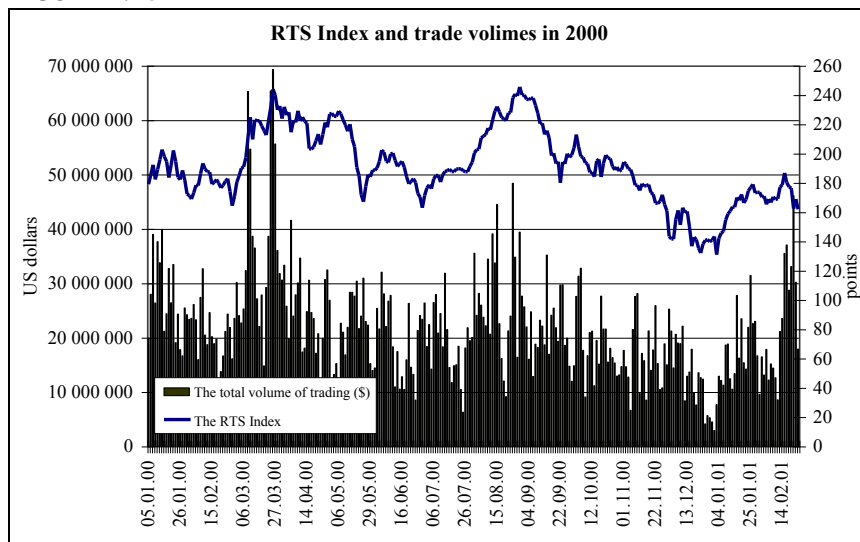
We are going to take a brief look at each of these directions.

The changing political situation. In January 2000, a marked lowering of political risk level was seen in Russia. The retirement of B. Yeltzin on December 31 was probably the main political event of the end of the year 1999. The delegation of power to the then acting President V. Putin produced stabilization of the domestic political situation, because the process of such a delegation was

conducted in full conformity with the Constitution of the RF, and Prime Minister's rating had reached quite a high level which indicated that his chances to win in the presidential election were high.

The victory of V. Putin in the first round of the presidential election also resulted in a lowering of the political risk level throughout the country because the strongest alternative candidate had been a Leftist. Many investors had predicted such an outcome, and this resulted in price growth on the stock market (see Fig. 1.23).

FIGURE 1.23



At the same time, as early as in April 2000 the changes in the political situation lost their formerly dominant role on the Russian stock market. At the end of March, when the outcome of the election became clear, many investors reduced their speculative activity on the market. As a result, in face of the falling tender volume, Russian share prices also began to gradually go down. At first sight, this situation lacked logic: under the conditions of pre-election uncertainty share prices demonstrated rapid growth, and later, when

political risks became considerably lower, investors lost their former interest in the stock market. This happened because in April 2000 a number of negative factors emerged among which one can distinguish dramatic fluctuations on the international financial markets, declined oil prices, uncertainty about the outcome of the negotiations between the government of the RF and the international financial organizations, as well as an increased pressure of the international community on Russia in connection with the continuing war in Chechnya (the PACE decision on the possible expulsion of Russia from the European Union). It were these factors that caused the correction of Russian share prices despite the important changes in the political sphere.

In the summer of 2000 the majority of investors clearly understood that the executive authority intends to revise its relationships not only with the regions but also with large-scale Russian businesses. Obviously the issue of the order of the formation of the Federation Council had an economic as well as a political aspect. In the case of strengthened President's control in the regions with a simultaneous loss by the governors of some of their functions in Moscow their relations with the regional businesses underwent a change.

In the summer of 2000 the struggle between various oligarchic groups for the ability to influence the government became more acute. For the investors working on the Russian stock market this process was an evidence of the growing risk of unfavorable changes in the structure of the stock capital of major Russian monopolies. With different degrees of political involvement this process also affected the RJSC "EES Rossii", "Gazprom" and "Rossiiskii Nikel". The conflict between the Procurator-General's office and the "MOST" group that produced a great impact both inside the

country and abroad became an additional factor that frightened investors away from the Russian financial markets.

Against this background, a large number of internal political and economic factors exerted virtually no positive influence on the stock market. Among them, one can point out the active work of the State Duma (the enactment of the amendments to the Federal Law “On Joint-Stock Companies” aimed at strengthening the legal defense of the interests of small-scale shareholders, the approval of the chapters of the second part of the Tax Code of the RF on the VAT, the single social and income taxes and excises) and the approval by the government of the RF of the long-expected medium-term economic programme.

In August 2000 the attention of the investors working on the Russian stock market was by no means concentrated only on the changes of the economic and financial situation on the market. The tragic events in the Poushkin square in Moscow, the disaster of the “Kursk” submarine and the fire on the Ostankino TV tower stirred a wide-range public response and empathy. At the same time, these events gave rise to a wave of criticism of the Russian authorities in some domestic and foreign media which undoubtedly was a negative factor influencing the Russian stock market.

In the fall of 2000 the events associated with Russian home and foreign policy provided the investors working on the domestic stock market with no serious reasons for optimism. In particular, during this period the contradictions between the President’s Administration and some Russian media companies which were calling for a revision of the methods for solving the “Chechen problem” became especially acute. The firm stand of the President as regards the policy in Chechnya and the Russian oligarchs which he himself confirmed at the EU summit in Paris gave no reasons to

hope that the risks associated with the domestic political situation in Russia might be lowered.

The improved macroeconomic situation and the changed relationships with the international financial organizations. Despite the visit of the IMF mission to Moscow at the end of January 2000, few of the investors expected any rapid decisions to be made by the Fund regarding the allocation of a credit tranche of \$ 640 million. The IMF mission was concerned with the content of the macroeconomic program of the Government of the RF in the area of monetary and tax policy, as well as the execution of the previous agreements with the Fund. Nevertheless, as early as in 1999 the Ministry of Finance of Russia when planning the payments due on the external debt in the first quarter of the year 2000 did not take into account the resources that could be provided by this tranche. Underlying all this was the assumption that the main reason for Russia's "credit isolation" was the continuation of the hostilities in Chechnya and the high political risks associated with the approaching presidential election, and not the degree of success of the macroeconomic measures taken by the government.

On January 6, 2000 the international rating agency "Moody's Investor Service" raised the rating of Russia's long-term national currency borrowings from "Ca" to "Caa2". The predicted rating of Russia's long-term foreign exchange borrowings of "B3" was also raised from "negative" to "stable". Among the causes of the improved ratings the betterment of the general economic situation in 1999 and the increased tax revenues were singled out as the most important ones.

In the first half of February an agreement was achieved between the Government of Russia and the London Club on writing-off 36.5% of the debt with subsequent restructuring of the remaining part (for more details see the section on the government securi-

ties market). Despite the lack of conformity in the investors' estimates of the results of the negotiations on the conditions for restructuring the PRINs and IANs bonds into which the debts of the former USSR had been restructured one should note that the settlement achieved with major private creditors increased the investment attractiveness of Russian financial markets, including the stock market. The achievement of an agreement between the Government of the RF and the London Club made it possible for the international rating agency "Standard & Poor's" to raise the rating of Russian Eurobonds and internal currency bonds from "CCC" to "CCC+".

The changes that took place in mid-2000 in the area of economic policy gave a rather contradictory message to the investors working on the Russian stock market. On the one hand, during the first half of the year 2000 a number of steps were taken to strengthen the vertical hierarchy of the state authority and to begin a real economic reform. In July the President of the RF made several rather successful visits abroad, including the trip to Okinawa for the G-8 summit where an agreement with Germany was achieved on a delay in the payments due in 1998–1999 dealing with the external debt of Russia, and the Government of the RF approved the economic programme for the years 2000–2001.

A change in the macroeconomic situation, the successful steps taken by the Russian leadership while carrying out the economic reform, and the enactment of the government decree on restructuring the debt due to the London Club allowed the international rating agency "Standard & Poor's" at the end of July to raise Russia's rating on her external debt obligations and internal borrowings to "B-". At the end of August 2000 the rating agency "Fitch IBCA" also raised the rating of Russia's external debts. In particular, the rating of Russian Eurobonds was raised from "B-" to "B" (Russia's

Eurobonds emitted in the framework of restructuring the former USSR debt due to the London Club were also rated as “B”), the bonds of the Ministry of Finance of the RF of Series 4 and 5 were rated as “CCC”, the bonds of the Ministry of Finance of Series 6 and 7 were rated as “CCC+”.

On the other hand, at the G-8 meeting Russia did not succeed in convincing the leaders of the developed countries that it was necessary to restructure the debts due to the Paris club. The other two factors that negatively influence investors have remained the on-going military operations in Chechnya and the activity of the Procurator-General’s office, the FSB and the tax police against some of the largest Russian companies. However in case when the authorities refuse to reconsider the results of privatization deals (which was confirmed at the President’s meeting with the leading Russian businessmen at the end of July 2000), the increased control over Russian companies, in particular in the sphere of taxation, can be regarded altogether as a positive factor contributing to greater transparency and attractiveness of Russian companies to foreign investors.

At the joint session of the International Monetary Fund and the World Bank in Prague in late September the positive changes that occurred in the macroeconomic situation in Russia during the last year were noted. At the same time the talks between Russia and the IMF became noticeably more difficult. At the meeting of the Executive Committee of the IMF that took place shortly before the joint IMF-WB session a decision was made on tightening of credit on the part of the Fund, particularly through shortening the term of credit repayment and increasing interest rates on large loans. Besides, a certain role was played also by the growth of international oil prices, which, as the representatives of the IMF and the Paris Club believe, provided additional revenues for the Russian budget and thus

made the need to attract external funding and restructuring of payments less urgent. The difficulties encountered during the negotiations in Prague created a threat to certain parameters of the Draft Law “On the Federal Budget for the Year 2001”⁴⁴.

A certain cooling of relations between the government of the RF and the IMF which became obvious by mid-November 2000 became an important factor reducing the probability of successful negotiations between Russia and the Paris Club on the restructuring of her foreign debt whereupon the volume of payments in 2001 totals about \$ 3.2 billion. In a report prepared by the IMF it has been noted that after the August 1998 crisis the tempo of the structural reforms in Russia was very low. Despite the criticism by the IMF and the still unclear prospects of the outcome of the talks between the government and the Paris Club on the possibility of foreign debt restructuring, the international rating agency “Moody's Investor Service” in mid-November raised the rating of Russian foreign exchange borrowings from “B3” to “B2”, as well as the rating of bank deposits in foreign currency from “Caa1” to “B3”. However the rating of Russian Eurobonds and the rating of federal bonds emitted after March 1, 1999 remained unchanged (“B3” in both instances). In December 2000 the international rating agency “Standard & Poor's” raised Russia's currency rating from “SD” (selective default) to “B-“. Besides, the rating of “D” for the third tranche of the internal currency bonds was annulled. The bonds emitted in accordance with the restructuring of this tranche were rated as “CCC+”.

In December 2000 Russia, Germany and France had consultations at the government level concerning the possibility to settle the

⁴⁴ The Draft Law “On the Federal Budget for the Year 2001” included an item of financing by the IMF of about \$ 1.75 billion. At the same time, in 2001 Russia is obliged to pay to the IMF about \$ 1.58 billion.

problem of the debts to the Paris Club by its partial repayment with blocks of shares of largest Russian companies. The most commonly shared point of view of creditors was that Russia did not need any restructuring of her repayments on external debts because the results of the year 2000 demonstrated a very high level of tax revenues, an increased positive trade balance, stabilization of the exchange rate of the national currency, a considerable increase in the volume of the gold and currency reserves of the CB, and a noticeable growth of the GDP. Technically speaking, to achieve an agreement on the mechanisms of offsetting the payments due on external debts by transferring blocks of shares to foreign creditors will be possible only after a detailed discussion that might take months. A rather important problem complicating the implementation of this scheme is the low level of protection for minority shareholders in Russian corporations.

The declaration of the Russian Government at the very beginning of the year 2001 that it had no intention in the first quarter of 2001 to make debt payments due to the Paris Club led to a rather harsh response on the part of the creditors. The creditors' position confirmed at the G-7 meeting of the ministers of finance in Palermo prevented the Russian Government from achieving its aim of restructuring and writing-off of debts in 2001. At the same time the alternative option of "not paying the debts" which is being widely discussed in Russian political circles could lead to an "investment isolation" of the country as well as to a domestic political crisis. Despite a certain opposition on the part of the "left wing" within the State Duma, in February the Law "On the Federal Budget for the Year 2001" was changed to the effect that a part of the additional revenues may be redistributed for paying the external debts. At the same time the government began to pay its debts due to the Paris Club without waiting for the amendments to the budget to be

approved by the Federation Council. In February 2001 Russia made a payment of about \$ 1.206 billion on the debts due to the Paris Club, and in March a further payment of \$ 41.5 billion is planned. In the nearest future the schedule of payments due on the indebtedness of \$ 298 million accumulated in 2001 is going to be agreed upon with the Paris Club. Besides, in January and February Russia transferred \$ 118.5 and 233.87 billion to the IMF, respectively. On the whole, in 2001 Russia is obliged to pay \$ 3.73 billion to the Paris Club.

Another important event that happened in February 2001 was the visit of the IMF mission to Moscow. During this visit the parties involved succeeded in finding an agreement on their yearly and quarterly targets as well as on the measures of the economic policy to be taken by the Russian Government in the year 2001. At the same time, once again the government and the IMF did not come to any agreement as regards concrete measures of the former's structural policy, primarily in the banking system, natural monopolies, tax and budget systems. These measures are seen by the Fund as a necessary condition for granting Russia Precautionary Stand-By Arrangements in case of an unfavorable development of the situation on the financial and commodity markets and a danger of non-execution of the Budget Law.

The dynamics of oil prices on the international markets. Throughout the year 2000 the situation on the international oil markets was one of the main factors influencing the demand on the financial markets in the developed and developing countries. The measures taken by the OPEC member countries in order to stabilize oil prices during last year were not sufficiently effective. Thus, for example, shortly before the 109th OPEC conference that was held in late March 2000 in Vienna, many investors were expecting a fall in oil prices. At the conference a decision was made to increase the

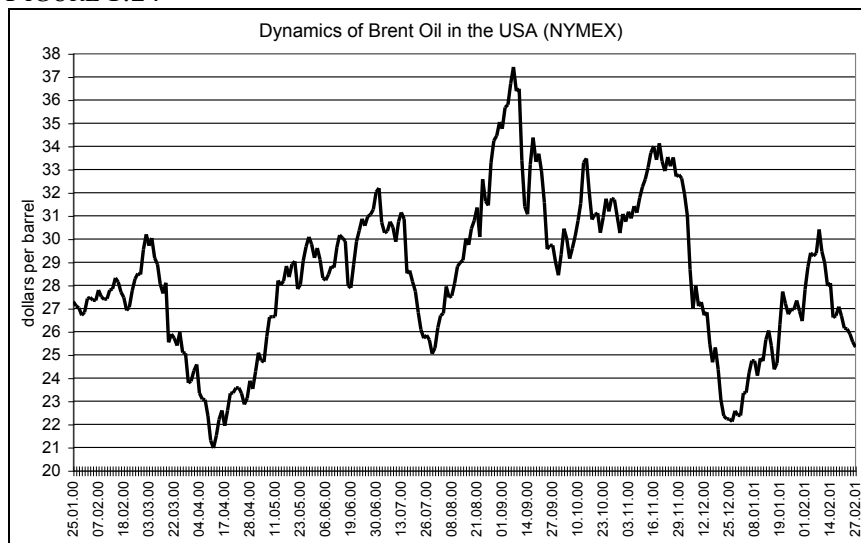
quota of oil extraction by 8.7%, and the allowable volume of sale of oil and oil products by 6.3%. As a result, between February 28 and March 30, 2000 the price of “Brent” in the nearest futures contracts at the NYMEX went down from \$ 28.47 /barrel to \$ 23.85 /barrel, or approximately by 16.2% (see Fig. 1.24).

In mid-April the OPEC member countries reached an agreement on the mechanism of reducing the volume of raw oil production in the case when oil price stayed below the level of \$ 22 /barrel for at least 20 days. Nevertheless, already in May - June 2000 the international oil prices reached the level of \$ 28-30/barrel which caused anxiety among a wide range of investors and politicians in many developed countries. Despite the following agreement achieved at the OPEC meeting in Vienna on June 21, 2000 where it was decided to increase the quotas of the member countries for extraction and sale of oil by 708.000 barrels per day, by the end of June international oil prices demonstrated a further increase. In particular, between May 31 and June 28 the prices of “Brent” in the nearest futures contracts at the NYMEX grew from \$ 29.19 /barrel to \$ 31.06 /barrel, or approximately by 6.41%.

Another remarkable fact is that oil prices started to go up shortly before the OPEC meeting and reached a peak after the decision to increase the quotas was made. Most probably, this can be explained both by the time when the OPEC decision was enacted (on July 1, 2000) and the very small increase of the quotas as compared to the existing considerable international demand on oil. In this situation of a certain interest was the rather benevolent response of the USA to the increased international oil prices in face of the current deficit of oil products on the domestic market of that country. For Russia, on the contrary, the high level of the international oil prices created the basis for a more rapid economic growth and in-

creased the attractiveness of the investments in domestic oil companies.

FIGURE 1.24



The declaration of the Saudi Arabian government about its intention to increase the volume of oil export without coordinating this decision with the other OPEC members, made in early June, 2000, produced a change in the situation on the world oil markets. In particular, between June 30 and July 28 the price of “Brent” in the nearest futures contracts at the NYMEX fell from \$ 32.03 /barrel to \$ 25.05 /barrel, or approximately by 21.8%. However, later growth of oil prices on the world markets altered the expectations of market participants. Between July 31 and August 31, 2000 the price of “Brent” in the nearest futures contracts at the NYMEX grew from \$ 25.30 /barrel to \$ 35.07 /barrel, or approximately by 38.6%.

From the point of view of the investments on the Russian stock market, the high oil prices on the world markets were acting as a

rather positive factor because they created a high demand for the shares of Russian oil companies. At the same time in the second half of the year 2000 the high oil prices caused a growing concern among the portfolio investors in the developed countries because they increased the expenses of many companies on energy carriers which influenced their levels of profitability and dividend rates. Thus, for example, in September the growth of oil prices stopped to play a positive role on the Russian stock market which had been characteristic of the second half of the summer of 2000. Between July 28 and September 7, 2000 the prices on “Brent” in the nearest futures contracts at the NYMEX grew from \$ 25.05 /barrel to \$ 37.43 /barrel, or approximately by 49.4%. Since September the high contract prices of oil were regarded by investors as a key factor that produced a destabilization of the stock markets both in the developed and developing countries.

At the OPEC summit on September 10 in Vienna a decision was made by the member countries to increase the quotas of extraction and export of oil by 800,000 barrels per day, or by 3.2%. Nevertheless, the OPEC decision was not sufficient for returning oil prices to the level below \$ 28 /barrel. This forced the USA to make the decision on supplying in October 2000 to the market about 30 million barrels out of the national oil reserve. The leaders of major European countries also confirmed their readiness to resort to similar measures. As a result, from September 8 onward the oil prices on the world markets were going down and by September 28 reached the level of \$ 29 /barrel. However there was no further decrease in oil prices.

The beginning of the heating season in the majority of the developed countries as well as the declaration of the leadership of Iraq of a possible reduction, beginning with November 1, 2000, of the volume of its oil export to the world markets in response to a new

deterioration of the country's relations with the USA, triggered another growth of prices. Judging by that month's results, between September 29 and October 29 the prices of "Brent" in the nearest futures contracts at the NYMEX grew from \$ 28.44 /barrel to \$ 30.68 /barrel, or approximately by 7.9%. At the same time the actual growth of the international oil prices above the level specified by the OPEC member countries (\$ 28 /barrel) for 20 days allowed the cartel on October 30, for the fourth time during the year 2000 to make a decision on an increase of the quotas of extraction and export of oil (this time by 500,000 barrels a day).

At the end of 2000 the international oil prices demonstrated a considerable fall. Between November 30 and December 28 the prices of "Brent" in the nearest futures contracts at the NYMEX fell from \$ 32.62 /barrel to \$ 22.39 /barrel, or approximately by 31.4%. Previously, during the year 2000 such a low level of oil prices was seen only in the first half of April. Among the causes of this decrease of the international oil prices at the end of 2000 the following phenomena should be noted. As early as at the beginning of January the market saw some evidence of an increase of the reserves in the USA oil reservoirs which gave the market participants some guarantees of curbing the growth of the international oil prices. After that it became known that Iraq whose oil production is about 3% of the world output had settled the controversial issues with the UNO concerning the programme "Oil for Food" and is intending to resume its oil supply to the world market. Noteworthy were also the reduced economic growth rates in the developed countries which can result in a lowered international demand for oil, as well as the fact that the forecasts of an extremely cold winter of 2000-2001 turned out to be far too pessimistic.

In January of 2001 the international oil prices went up once again which, on the one hand, increased the demand for the shares

of Russian oil companies, and on the other, became an additional factor complicating the negotiations between the government of the RF and the Paris Club. Between November 30 and December 28 the price of “Brent” in the nearest futures contracts at the NYMEX fell from \$ 32.62 /barrel to \$ 22.39 /barrel, or approximately by 31.4%. Between December 29 and January 30, 2001 the prices of “Brent” in the nearest futures contracts at the NYMEX fell from \$ 22.38 /barrel to \$ 26.89 /barrel, or by 20% (see Fig. 4). Investors expected this growth of the international oil prices in January because at the end of the year 2000 the OPEC leadership made a declaration on a possible reduction of oil production by the member countries of the cartel. At the beginning of 2001, despite a certain pressure on the part of the USA, the OPEC representatives declared that the decision on the reduction of the volume of oil extraction had already been made. At the OPEC conference on January 17 in Vienna an agreement was reached concerning only the reduction of the volume of oil extraction which became 1.5 million barrels per day thus corresponding to 5% of the total oil output in the member countries of the cartel. In February 2001 the international oil prices once again demonstrated a very high changeability. Between February 1 and 8 the prices of “Brent” in the nearest futures contracts at the NYMEX grew from \$ 26.46 /barrel to \$ 30.41 /barrel, or by 14.9%. However after that the international oil prices began to go down and by the end of February reached the level of \$ 25.29 /barrel. The fear of a further drop in oil prices under the influence of seasonal factors as well as in connection with a potentially decreased demand on oil on the part of the USA and European countries forced the OPEC leadership to make a number of declaration on a possible decrease of the quotas by a further 1-2 million barrels per day.

The situation developing on the international financial markets in 2000 influenced the Russian stock market to the greatest degree. The dramatically increased level of volatility of prices at the financial markets of the developed countries became one of the main reasons for the lowered activity of large-scale investors on the developing markets. Already at the very beginning of the year 2000, an instantaneous fall in quotations was apparent on some of the leading stock markets. The growing fear of the investors of a further increase of the discount rate during February 1-2, 2000 raised the profitability level of treasury bonds. Thus, for example, on January 4, 2000 the Dow Jones Industrial Average index went down from 11357.51 to 10997.93 points, or by 3.17%. For the last time so substantial a fall on the American market occurred only in the autumn of 1998. Investors in Western Europe had similar concerns. The danger of a possible inflation growth forced the Bank of England to make, on January 13, a decision to raise the interest rate again from 5.5% to 5.75%. In early February 2000 the USA FRS decided to raise the interest rate of interbank overnight loans by 0.25 points, to the level of 5.75%. The Bank of England followed the example and raised its interest rate from 5.75% to 6%.

In late 1999 – early 2000 an interesting tendency revealed itself on the stock markets in the USA and other developed countries. Many investors were regarding the shares of high technology companies as a sector of the financial market that was the least dependent on the negative influence of the increasing interest rates. As a result, the share prices of capital intensive companies went down, and those of high technology companies were growing. Thus, for example, between January 31 and February 28, 2000 the Nasdaq Composite index including a large number of high technology companies went up by 19.2%, while the Dow Jones Industrial Av-

erage index including mostly capital intensive companies went down by 8.2%.

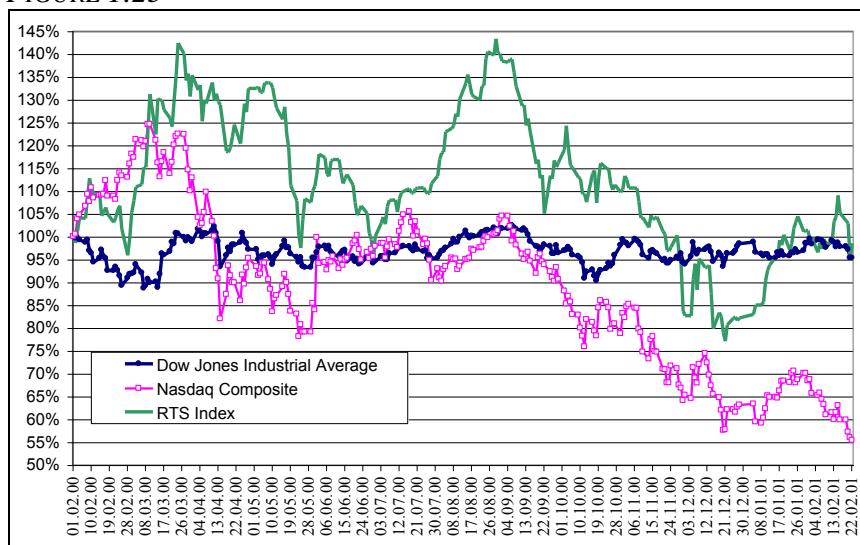
On March 21, 2000 the USA FRS decided to raise the main interest rate on interbank overnight loans by another 0.25 points to the 6.0% level. This decision was taken despite the recent predictions of a stabilization of inflation in the USA economy. Obviously, the factor that had influenced this decision of the FRS was the expected lowering of oil prices that would decrease the potential expenses of companies and thus contribute to a more rapid economic growth in the USA.

In April 2000 the situation on the international financial markets produced a very negative impact on the Russian stock market. The attention of international investors fully switched over to the situation developing on the markets in the USA and the European Union. The instantaneous fall in asset prices on the developed and developing markets was the manifestation of a whole complex of interrelated problems. Perhaps the most important of them was the lack of coordination between the rates of economic growth in the USA and European countries. The rapid growth of American economy increased the probability of intensification of the inflation process in the USA. While pursuing the policy of curbing the rate of inflation, the FRS was gradually raising the discount rate thus increasing the cost of attracting credit for American companies. At the same time the high interest rates led to the flow of capital from the European markets to the USA. The European Central Bank did not raise its interest rate to a level comparable to the American one. As a result, the euro exchange rate as compared to dollar was persistently decreasing. This became an additional factor responsible for the investors' preference for American financial assets.

Another problem that became especially acute in the spring of 2000 was the rapid growth of high technology companies in the

USA. The rise in the first few months of 2000 of the Nasdaq index that includes the high-tech shares (see Figure 1.25) in a certain sense was the result of the FRS's policy of raising interest rates. The formation of a "bubble" of prices of high-tech shares became evident after the companies published their results of the first quarter of 2000 which demonstrated an absence of any superprofits. Moreover, some of them were subject to pessimistic forecasts concerning both the reduced sales market volumes and the threat of corporate split-up (for example, the Microsoft company). As a result, investors found the price level in the high technology sector to be considerably overestimated which led to a sharp correction of quotations and stock indices in the USA and other countries.

FIGURE 1.25



On May 16 the FRS in a single move raised the discount rate by 0.5 percent points to 6.5% per annum. This measure had been expected by investors; however the risk of a further growth of the interest rate in the USA was not lowered. The high growth rate of the

American GDP in the first quarter of 2000 and the low unemployment rate remained as a warning of the possible threat that the inflation processes could become more intensive. At the same time, the Central Bank of Europe on May 25, 2000 left the level of interest rates on short-term bank loans at the same level of 3.75% per annum. In this connection it is necessary to point out the different motivation underlying the policies pursued by the USA FRS and the CB of Europe. During the first half of 2000 the main goals of the European CB were to stimulate the economic growth in the EU countries and to protect the euro. The goal of the FRS, on the contrary, was to decrease the rate of inflation in the USA economy.

In June 2000 the situation on the international financial markets became stabilized. On June 8 the Central Bank of Europe raised the interest rates on short-term loans at once by 0.5 percent points to the level of 4.25% per annum. At the end of July 2000 the USA FRS made a decision on preserving the discount rate at the then existing level of 6.5%. Thus, the gap between European and American discount rates became somewhat smaller. Nevertheless, in July 2000 the situation on the international financial markets once again caused investors' concern. In the focus of attention was the sector of the US high-tech financial results were not very high also in the second quarter of 2000. Consequently, in the second half of July alone the NASDAQ index went down from 4274 to 3663 points, or approximately by 14.3% (see Fig. 1.25). This substantial fall of the American index led to a diminished interest of portfolio investors regarding the developing markets where quotations in the majority of cases also went down.

In this context of a particular interest is the higher degree of dependence of the Russian share market on the tendencies that were observed in July 2000 on the American stock market. As is shown on Fig. 5, in the second half of July, while the American stock indi-

ces were sliding down the RTS index remained stable and at the very end of the month even demonstrated a certain growth. Obviously, such a development of the situation became possible because of the above-noted favorable changes in the economic and political situation in Russia.

In early September 2000 forecasts appeared of a deterioration of the situation on the world financial markets. The decision of the European Central Bank to raise the interest rates on short-term bank loans by 0.25 percent points to 4.5% per annum made at the very end of August caused a decrease of the euro exchange rate as compared to dollar and a decrease in the demand for the shares of European companies. Between September 1 and 20 the euro exchange rate as compared to dollar went down by 5.7% to an unprecedented lowest level of 0.8472 \$/euro. This rapid rate of devaluation of the European currency forced the ECB in cooperation with the CB of Japan and the USA FRS to carry out large-scale interventions on the currency market.

The destabilization of the world markets in September was also associated with the above-noted growth of oil prices and modest results of the activity of large high-tech companies in the USA in the third quarter of 2000. As a result the majority of the stock markets both in the developed and the developing countries demonstrated a considerable lowering of quotations, and the fall of the prices of Russian shares was, as usual, the most noticeable. In October 2000 the situation on the world financial markets remained unstable. Despite the decision taken at the meeting of the USA FRS Committee on the operations on the open market on October 3 that the discount rate remain at the same level (6.5% per annum), the share prices on the American stock market in early October were still sliding down. Between September 1 and October 12, 2000 the NASDAQ Composite index that includes the shares of high-tech

companies went down from 4234.3 to 3074.7 points, or by 27.4%. The Dow Jones Industrial Average index calculated on the basis of the shares of the “old economy” companies during the same period decreased by a smaller value (10.7%). In October the reason for investors’ anxiety became the declaration of the FRS which despite the preservation of the discount rate at the existing level did not reflect any evidence of stabilization of the macroeconomic situation in the USA or the latest forecasts of a low level of profitability of some high technology companies in 2001.

In November 2000 the situation on the world financial markets continued to deteriorate. The decrease of the NASDAQ Composite index that had been continuing from early September 2000 was already 35.6% by the end of November (see Fig. 1.25). Among the causes of the decrease in share prices in the USA, the developed European countries, and the developing markets one should point out the uncertainty of the outcome of the presidential election in the USA throughout November, the high oil prices and the lowered rates of economic growth in the developed countries. The financial crisis in Turkey that began in November and led to a withdrawal of international investors and a very rapid fall in the asset prices in this country contributed to the already grave situation on the world financial markets.

In mid-December 2000 the final results of the lengthy presidential election in the USA were announced, and this had been playing the role of a destabilizing factor during the last few months of last year on both the developed and the developing markets. At the same time at the end of 2000 the already noticeable slowdown of the economic growth in the USA and other developed countries became one of the most widely disputed issues. On the one hand, the deceleration in the growth of the American economy reduces the probability of inflation growth. In this respect, the policy of raising

the discount rate pursued by the USA FRS in 2000 has achieved its goal. On the other hand, today many investors are afraid to invest in the shares of American companies because their profits in 2001 may be considerably reduced which will become reflected in the levels of the rate-related and dividend yields. In case the rate of the economic growth in the USA in 2001 is lowered at least to 3%, this variant of the development of the situation seems quite realistic. Besides, the possible worsening of the economic conditions in the USA in the coming year might make its impact also on the situation in the developed European countries whose rates of economic growth are markedly lower, as well as on the situation in the developing countries. A rather important factor that influences investors has become the financial destabilization that occurred in a number of developing countries and required a certain interference on the part of the IMF. Particularly, in 2000 a decision was made on granting a stabilization credit of \$ 39.7 billion to Argentine and of \$ 7.5 billion to Turkey.

The pessimistic outlook that was characteristic of the situation on the world markets between August and December 2000 influenced most strongly the prices of high-tech shares. The decrease of the NASDAQ Composite index during this period was already 39.2% (see Fig. 5). In December the most pronounced decrease of the stock indices was noted in South-East Asia where the high technology sector was traditionally strong.

In January 2001 the majority of the world stock markets demonstrated a growth of asset prices. One of the most important reasons for investors' optimism was the decisive position of the USA FRS which was striving to prevent a "crash landing" of the American economy. In early January the FRS decreased the refinancing interest rate to the level of 6% per annum, while the discount rate was decreasing first to 5.75% and then to 5.5% per an-

num. The decision to further cut these rates was made again in the USA at the end of January. At the same time it is very difficult now to predict whether the actions of the FRS could be of any noticeable effect in the present situation bordering on economic recession. The levels of sales and industrial output show that the process of slowing down of the rates of the US economic growth is becoming more and more intensive. If the reduction in rates turns to be sufficient to overcome this tendency, the GDP growth in that country in 2001 could be 3% at most. In this situation, from the point of view of investment attractiveness, the European countries (where the interest rates still remain at the same level and the GDP growth can be as much as 4%) as well as the countries of South-East Asia (with the GDP growth reaching 5%) would appear in a winning position, with the exception of Japan where the rates of economic growth are also lowering.

In an alternative situation, if the actions of the FRS are taken too late or are for some reason not effective enough, the American economy will enter a period of recession which will have a negative influence on the indices of the economic activity and stability of the financial markets all over the world. Most strongly this might influence the countries with developing markets where the rates of the economic growth as well as the situation on the stock and currency markets are to a great degree dependent upon the volume of investments from the developed countries. The actions of the USA FRS have become an important element in the speculation on the financial markets. Many investors expect that the FRS will further decrease its interest rates because the latest data on the state of the USA economy has demonstrated a further slowdown of its growth rate. At the same time, this active policy in the area of interest rates has its negative side. The largest American banks have already reduced their crediting of the economy despite the fact that their ac-

cess to credit has become easier. Evidently, the process of commercial credit rationing will go on until the level of the interest rates in the USA becomes stable.

Another important event of early 2001 that has especial importance for the Russian stock market became the continuation of the financial crisis in Turkey. The lira devaluation, the foreign capital outflow, a dramatic fall of prices on the asset markets, and, finally, the political crisis in many respects resembled the events of 1997-1998. Nevertheless, in face of an uncertain situation in the USA the crisis in Turkey was not regarded by international investors as a key theme. The aftermath of the global financial crisis of 1997-1998 led to a considerable reduction of the international investment portfolios on the developing markets. This circumstance considerably lowers the probability of transmitting the financial crisis syndrome to other emerging markets.

Thus, due to an unstable situation on the international financial and commodity markets the results of the activity on the Russian stock market in 2000 were, undoubtedly, somewhat disappointing for investors. At the same time the level of share prices that during 1999 had exhibited a dramatic growth was already reflecting the expectations of a relatively positive alteration of the macroeconomic and political situation throughout the year 2000. Last year should be regarded from the viewpoint of a growing investors' interest in the domestic stock market which will probably become a more important factor than the 19% decrease of the RTS index in 2000, especially considering the fact that between December 1998 and December 2000 the RTS index and, consequently, Russian share prices grew approximately by 140%.

SECTION 2. REAL SECTOR OF THE ECONOMY

2.1. Macro-structure of Production

Production of GDP: Dynamics and Structure

Production of Goods and Services

In year 2000, for the first time over the last decade, the Russian economy demonstrated exceptionally high growth rates. The economic recovery took place at the background of a favorable situation of external economic operations and internal economic and political stability. Acceleration of growth rates was registered across practically all macroeconomic parameters. By end-2000, growth in GDP made 7.7 per cent as compared with 1999 level, investment in fixed assets increased by 17.7 per cent, gross industrial output grew by 9.0 per cent. An increase in manufacture of goods was supported by the developed over the years of reform services market infrastructure. Commercial freight increased by 4.8 per cent as compared with 1999 figures, while wholesale turnover grew by 8.5 per cent and communication services were up by 13.1 per cent. As production of goods grew by 8.6 per cent, the volume of market services increased by 8.0 per cent.

Sector of services oriented towards the consumer market showed more smooth growth dynamics. In spite of the fact that in year 2000 retail turnover increased by 8.9 per cent, while paid consumer services were up by 5.7 per cent, the consumer market volume was only at 85.0 per cent of the pre-crisis 1997 figures after the collapse of 1998 – 1999. The persistence of scanty effective household demand was the key factor constraining the expansion of

demand in this sector. While real incomes grew by 9.1 per cent in year 2000, the system of base parameters characterizing living standards remained considerably below 1997 indicators. Real household incomes were at 74.9 per cent of 1997, wages – at 82.4 per cent, real gross pensions were at 74.2 per cent.

The clearly pronounced asymmetric growth in production, household incomes, and final demand taking place at the background of the economic surge does not allow to appreciate the economic situation unambiguously. Although the outcome of economic operations in year 2000 was, certainly, successful, the look across key indicators of social and economic development reveals that the Russia's economy has not overcome the consequences of the downfall in production caused by the crisis taking place in October 1997 through August of 1998 yet.

TABLE 2.1

Key Macroeconomic Indicators: Dynamics in 1997 through 2000, % of the previous year

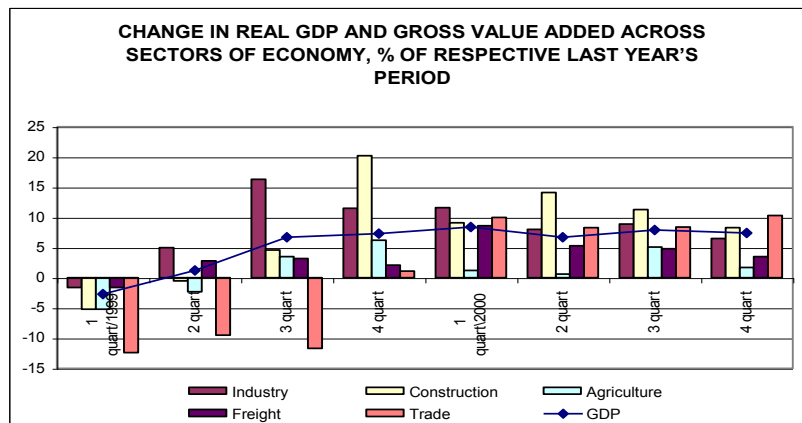
	1997	1998	1999	2000
Gross Domestic Product	100,9	95,1	103,5	107,7
Base sectors output of goods and services	-	94,2	104,6	108
Industrial output	102,0	95,1	108,1	109,0
Investment in fixed assets	95,0	93,3	105,3	117,7
Agricultural produce	101,3	86,8	104,1	105,0
Freight	96,6	96,6	105,8	104,8
Retail turnover	104,7	96,7	92,3	108,9
External trade turnover	101,7	84,7	86,7	129,7
Real disposable household cash incomes	106,3	81,9	85,8	109,1

Source: RF Goskomstat

Changes in inter-sectoral proportions were a distinctive feature of years 1998 to 2000. The production of goods grew at a faster rate from 42.9 per cent of GDP in 1998 to 46.7 per cent in 2000. Positive GDP growth dynamics generated by increasing production

across base sectors of the economy have been registered since the 2nd quarter of 1999. In year 2000 industrial production and construction were behind some acceleration in the pace of economic development. While in the first half-year of 1999 growth in industrial output only made up for the last year's setback in production, the following period demonstrated a clearly noticeable trend toward economy coming out on the path of economic growth.

FIGURE 2.1



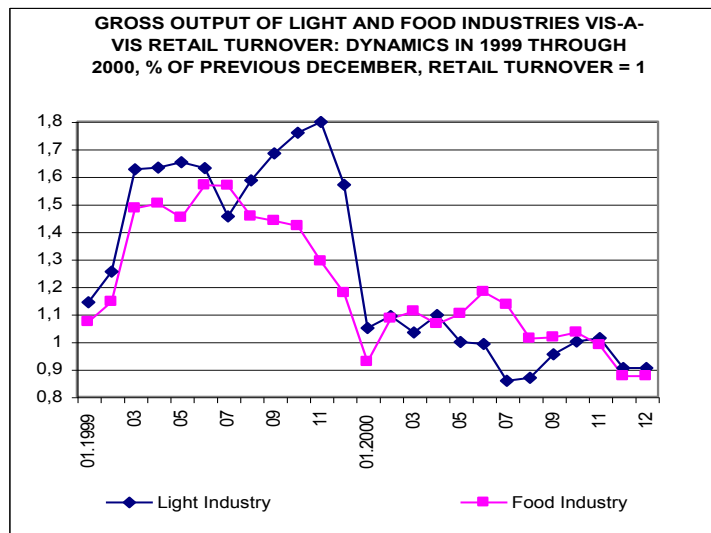
Source: RF Goskomstat, RF Ministry for Economic Development

Two stages may be singled out in the process of economic recovery:

- Active import substitution taking place in end-1998 through the first half of 1999 due to Ruble devaluation at the background of relatively low prices of natural monopolies' products, a sharp decline in imports, and restrained growth in wages;
- Expansion of domestic and external demand taking place since the second half of 1999 related to the improving situation on world markets and an increase in household incomes and returns of enterprises.

At the first stage the consumer sectors traditionally oriented towards the domestic market have found themselves in the most favorable situation. Production of consumer goods grew by 8.7 per cent in 1999, thus outpacing the total increase in industrial output. The contribution of consumer sector in the growth of industrial output made 13.2 per cent in 1999 as compared with 8.4 per cent in 1998. In year 2000 the contribution of consumer sector was at about the previous year's level. A comparison between monthly growth dynamics in the output of light and food industries with dynamics registered in retail turnover demonstrates that import substitution and Ruble devaluation were gradually exhausting their potential in these industries (see Figure 2.2). Light industry reacted most keenly to fluctuations of the domestic market. Expansion of light industry production more and more depends on technical and economic characteristics of production capacities, worn out by about 75 per cent.

FIGURE 2.2



The transition to the investment growth model is a distinctive feature of the second stage of economic growth recovery. As financial standing of enterprises improved and accumulation grew, an increase in demand for capital goods has been registered since the second half-year of 1999. In year 2000 this trend considerably intensified driven by expanding investment demand for products of domestic mechanical engineering on the part of export-oriented industries. In year 2000 output of investment complex increased by 31.3 per cent in comparison with 1998 levels. Growth of output of mechanical engineering and construction materials producing industry generated expansion of production of related industries. Expanding domestic consumption of construction materials accompanied by growing external demand for these products positively affected acceleration of output rates in the metallurgical and chemistry-lumber complexes. While output of mechanical engineering increased by 15.5 per cent as compared with 1999 figures, the production index of ferrous metallurgy made 115.6 per cent, non-ferrous metallurgy – 111.3 per cent, chemistry and petro-chemistry – 114.3 per cent. Mechanical engineering accounted for 30 per cent of the increase in industrial output in 1999 through 2000, while metallurgical complex contributed 25 per cent.

TABLE 2.2

**Gross Industrial Output by Production Complexes: Dynamics
in 1998 through 2000, % of the previous year**

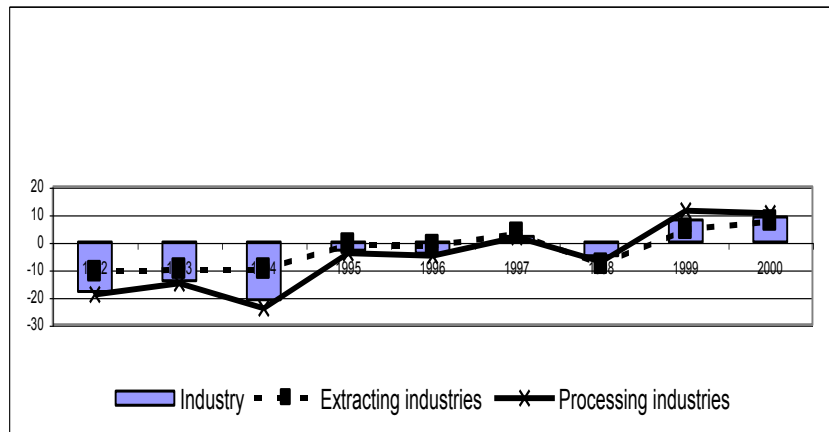
	1998	1999	2000
Industries	98,4	108,1	109
Fuel and energy complex	97,5	101,7	104,0
Metallurgical complex	93,5	111,3	113,4
Chemistry and lumber complex	95,3	119,8	112,3
Investment complex	92,8	114,6	114,4
Consumer complex	97,1	108,7	108,6

Source: Calculated basing on RF Goskomstat data

Industries: Processing Sector

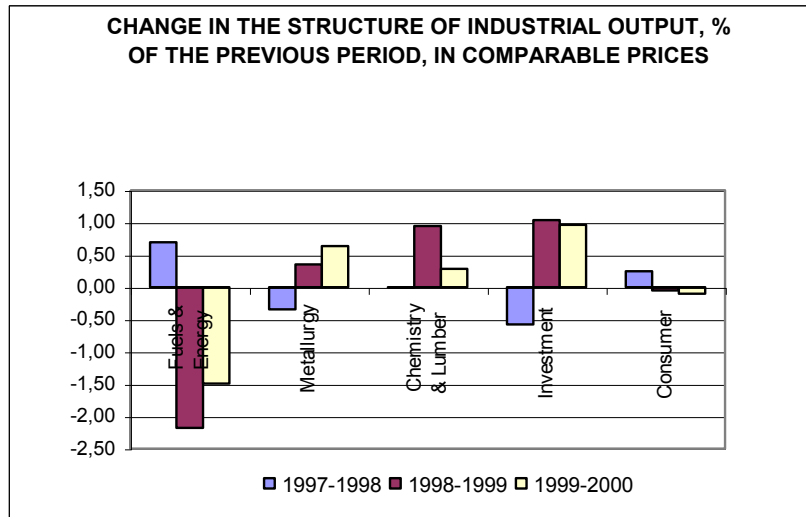
A faster growth in processing industry in comparison with extracting industry was a distinctive feature of the economic surge occurring in 1999 through 2000. The increase in the output of processing sector was at 23.0 per cent as compared with 1998 levels, while that registered in extracting industry made 12.1 per cent. An increase in the share of processing industries in the structure of industrial output has been observed for the first time since the start of reforms.

FIGURE 2.3



Over the last two years, structural changes in industries have been taking place at the background of outpacing growth rates registered in the industries of investment complex. Intensifying investment activity observed since the 4th quarter of 1999 initiated acceleration of growth in mechanical engineering industries, construction materials producing industry, and in demand for construction services. Growth in investment demand gave a new impetus to the development of industries producing intermediate goods.

FIGURE 2.4



An increase in the share of capital-forming industries in the structure of production positively affected the investment environment of the national economy. While in 1992 through 1998 dynamics of mechanical engineering depended on the rate of output in motor industry, over two last years the situation has changed. Increasing scope of production was observed across practically all sub-industries of the mechanical engineering complex. Outpacing rates of growth has been demonstrated by instrument making, industry of communications facilities, basic engineering industries supplying the market with investment goods for transport, agriculture, oil extracting industry. The increasing price competitiveness of domestic mechanical engineering (as compared to imported analogs) bolstered expanding production of equipment for industries related to the consumer complex. An increase was observed in production of import substituting equipment such as electric train cars, passenger cars, electric engines.

The economic recovery was observed also in the defense industries complex. While the output of defense complex grew by 25.2 per cent as compared with 1999 levels, the increase in civilian products made 21 per cent. Production of competitive civilian products salable on domestic and foreign markets increased across all industries of the defense complex. Output of aircraft construction industry grew by over 37.5 per cent in comparison with 1999 figures, civilian shipbuilding registered an increase at 9.3 per cent, while civilian airspace industry demonstrated a 22 per cent growth. Civilian exports of the defense complex made US \$ 645 million in year 2000.

TABLE 2.3

Output dynamics across Mechanical Engineering Industries, % of the previous period

	1995	1996	1997	1998	1999	2000
Industry, total	97	96	102	94,8	108,1	109,0
Mechanical engineering	91	95	104	92,5	115,9	115,5
Including						
Railroad	73	97	81,1	87	108,9	107,4
Metallurgy	95	93	85,2	70,6	91,8	130,2
Electrical engineering	93	79	93,5	85,7	127,0	130,1
Chemical and oil engineering	96	76	95,6	96,1	120,7	119,5
Machine tool and equipment engineering	87	66,6	84,9	82,3	99,6	111,5
Instrument making	110	70	105,8	103,4	140,8	118,4
Motor industry	97	100,2	112,6	88,5	114,7	103,3
Communications facilities industry	42	33,5	123,2	93,7	95,7	330,0
Tractor and agricultural mechanical engineering	64	59	91,9	70,7	159,3	148,4
Mechanical engineering for light and food industries, household appliances	65			90,6	115,8	109,5

Source: RF Goskomstat

However, in spite of the positive development trends observed in mechanical engineering, its contribution in the industrial output growth is considerably below the share of raw materials complex. This fact may be explained both by the legacies of the Soviet period, and by specifics of business situation observed over recent years.

In the second half-year of 2000, the effect of factors initiating deceleration of growth in processing industries heightened. Outpacing rates of price rise registered in primary energy resources, the real appreciation of the Ruble, and wage increases were behind changes in the competitive environment of the domestic market. As a result, in the 4th quarter of 2000 there was registered a deceleration of growth in profits and investment, and falling volume of exports of processing industries. Even more tough constraints were observed alongside with aforementioned business processes. From that time technical and economic condition of fixed assets at enterprises and lack of equipment have emerged as a factor seriously affecting the potential for a further growth in production.

An analysis of capacity utilization reveals that a substantial part of equipment has to stay idle due to its physical wear and tear, as well as obsolescence. The utilization ratio of capacities varies rather considerably. Raw resource industries due to a low share of added value demonstrate much higher utilization rates as compared with the processing sector. Utilization ratios vary even within same industries.

In year 2000 capacity utilization was at its peak for the first time in the last decade making 50 per cent in industry on the whole, 77 per cent in oil industry, 69 per cent in electric power industry, 66 per cent in ferrous metallurgy, lumber, wood-working, and pulp and paper industries. An intensive activation of reserve capacities was behind the recovery of economic activity; however, there is a

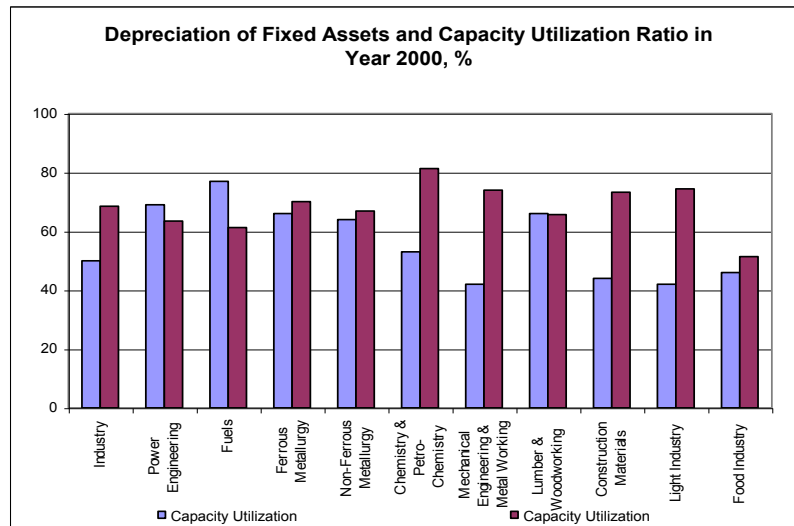
limit of capacity utilization. The technical and economic condition of production capacities emerge as a factor constraining growth rates and competitiveness of domestic products.

On the whole, raw materials industries may meet an increase in demand by putting into operation available idle capacities, since the quality of raw materials depend rather on the place than method of extraction. New technologies in these industries, as a rule, facilitate cost cutting, boost labor efficiency, increase in output of by-products, etc. However, the load on extracting industries demonstrating a combination of worn out capacities and high utilization rates is at the critical level.

The potential for increase in output of processing industries, especially technology-intensive ones, is determined by the quality of equipment and applied technologies. A considerable depreciation of fixed assets in processing industries results in the lowest capacity utilization and is a factor checking their potential for further growth.

The ratio between depreciation indicators and the age structure of fixed assets is a clear illustration that modernization shall be urgently intensified. Mechanical engineering is lagging behind other industries in terms of capacity utilization. A prolonged investment pause resulted in the conservation of mechanical engineering structure, and in the situation of transition to the model of economic growth basing on investment the lack of equipment and machinery emerged as a factor constraining expansion of production in the economy. The situation is aggravated by the fact that mechanical engineering being inadequate to market quality requirements is unable to achieve a level of sales necessary to generate funds sufficient for a massive investment in modernization of its capacities.

FIGURE 2.5



Source: RF Ministry for Economic Development

Changes in dynamics and structure of domestic demand were underway at the background of heightening competition among domestic producers and between domestic and imported goods. The situation is aggravated by the fact that as household incomes grow and the competitive price advantage of domestic producers diminish, there are forming conditions for an increase in import of both consumer and investment goods. This situation is provoking a slowdown in the rate of growth in processing industries.

The potential for further expansion of production across a number of goods has been more and more determined by dynamics of investment and innovative development strategies. Obsolete equipment and production technologies, low efficiency of labor are considerable constraints on the expansion of aggregate supply and changes in its structure. In this situation, taking into account the high market capacity and gradually recovering of effective demand foreign

producers take a stronger hold of the Russian market. Contraction of investment operations on the part of domestic producers may result in the surrender of their newly taken up position and unfavorable changes in the competitive environment. In this connection the trend toward gradually decelerating monthly rates of growth in industrial output, which has been observed since April of year 2000, is a alarming sign, the more so that this process developed at the background of persisting financial wellbeing of enterprises and a growing gross national savings.

Oil and Natural Gas Sector

The situation of the oil and natural gas sector of the Russia's economy in year 2000 was determined by an extremely favorable price situation on the world oil market. Since about 60 per cent of the domestically produced raw or processed oil are exported, while domestic prices are considerably below world levels, world oil prices are in fact the key factor determining the financial standing of Russian oil industry. In year 2000 world prices of oil and oil products were considerably above levels registered over the last decade. The average world oil price calculated as the average price of US oil imports was at US \$ 27.66 per barrel in year 2000, i.e. was by 60.7 per cent above the level registered in the previous year (see Table 2.4).

The extremely high world oil prices and Ruble devaluation resulted in very favorable situation of the Russian oil and natural gas sector. A considerable growth in outputs, profits, and investment in the oil industry were distinctive features of year 2000. In year 2000, the total extraction of oil and natural gas condensate made 323.2 million metric tons, i.e. increased by 6.0 per cent in comparison with the previous year's level, while primary oil processing grew by 2.7 per cent. Output of gasoline increased by 3.6 per cent, diesel fuel – by 4.9 per cent, while fuel oil output decreased by 1.7 per

cent. The growth in oil extraction was achieved mainly by putting into operation idle boring wells. Newly operated wells accounted for 12.0 million metric tons, or 68.3 per cent of the overall increase in oil output over the year. The specific weight of idle boring wells in the total capacities decreased from 24.3 per cent in the end of 1999 to 22.5 per cent by end-2000. Investment activity sharply intensified: production and surveying oil drilling increased by 67.5 per cent and 27.8 per cent respectively over year 2000, while the commissioning of drilling wells grew by 53.7 per cent in comparison with the previous year's figures.

TABLE 2.4

World Oil Prices in 1997 through 2000, US \$ per barrel

	1997	1998	1999	1999 4 quart	2000 1 quart	2000 2 quart	2000 3 quart	2000 4 quart
Brent, UK	19,12	12,76	17,86	24,06	26,94	26,70	30,24	29,59
Urals, Russia	18,33	11,83	17,18	23,62	26,15	25,02	27,15	27,78
OPEC oil basket	18,68	12,28	17,47	23,42	26,11	26,32	29,24	28,59
Average US imports	18,50	12,12	17,21	23,01	26,84	26,55	29,11	28,04

Source: OECD International Energy Agency, U.S. Department of Energy.

There was also observed some improvement in quantitative and qualitative indicators of oil processing. The degree of processing increased from 68.7 per cent in 1999 to 70.0 per cent in the last year. At the same time, the output of oil products subjected to higher-degree processing grew by 12.1 per cent. The share of non-ethylated gasoline in the total production increased from 89.3 per cent in 1999 to 96.2 per cent in year 2000. The output of high-octane gasoline as a share of the total production grew from 40.3 per cent to 41.4 per cent.

As an analysis of information on production and export of oil and oil products reveals (see Table 2.5), the bulk of extra oil output in year 2000 was exported (either directly, or as oil products). Net

oil and oil product exports were at 200.2 million metric tons, i.e. increased by 15.7 million metric tons in comparison with the previous year (including an increase by 10.2 million metric tons at the expense of oil exports and by 5.5 million metric tons at the expense of oil product exports). In other words, precisely growth in exports was the key factor behind increasing oil outputs in year 2000 (growth in exports accounts for more than 80 per cent of increase in oil extraction). As a result, the specific weight of net oil and oil product exports in the total oil production made 61.9 per cent. At the same time, the overall recovery of economy resulted in an increase in domestic consumption. According to our estimates it grew by 2.5 million metric tons, or by 2.1 per cent over year 2000.

TABLE 2.5

**Russian Energy Resources: Output, Consumption, and Exports
in 1990 through 2000**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Oil, mil. t.											
Output	516.2	462.3	399.3	353.9	317.8	306.8	301.3	305.6	303.4	300	322
Total exports	220.3	173.9	137.7	122.6	129.8	122.3	126.0	126.9	137.1	1345	1445
Export outside CIS	99.7	56.5	66.2	79.9	91.7	96.2	105.4	109.8	117.9	1157	1276
Export to CIS	120.6	117.4	71.5	42.7	38.1	26.1	20.6	17.1	19.2	188	169
Net exports	201.5	155.8	127.0	112.2	121.6	113.8	117.2	119.0	129.2	1285	1387
Domestic consumption	269.9	266.2	231.4	196.5	151.4	150.4	131.3	132.2	125.1	1205	1230
Net exports, % of output	39.0	33.7	31.8	31.7	38.3	37.1	38.9	38.8	42.4	421	429
Oil products, mil. t.											
Total exports	50.6	46.1	43.0	47.4	47.3	47.0	57.0	60.6	53.8	569	619
Export outside CIS	35.0	27.0	25.3	35.3	39.1	43.5	55.0	58.4	51.2	539	584
Export to CIS	15.6	19.1	17.7	12.1	8.2	3.5	2.0	2.2	2.6	30	35
Net exports	44.8	40.3	40.9	45.2	44.8	42.6	54.4	56.6	51.0	513	615
Oil and oil products, mil. t.											
Net exports (oil and oil products)	246.3	196.1	167.9	157.4	166.4	156.4	170.0	173.4	178.3	1845	2002

TABLE 2.5 CONTINUED

Net exports (oil and oil products), % of oil output	47.7	42.4	42.0	44.5	52.4	51.0	56.4	56.7	58.8	605	619
Natural gas, bill. cub. m.											
Output	640.6	643.4	641.0	618.4	607.2	595.4	601.1	571.1	591.0	5907	5842
Total exports	249.2	246.8	194.4	174.4	184.3	192.2	198.5	200.9	200.6	2054	1938
Export outside CIS	96.0	91.0	87.9	95.9	109.3	121.9	128.0	120.9	125.0	1311	1338
Export to CIS	153.2	155.8	106.5	78.5	75.0	70.3	70.5	80.0	75.6	743	600
Net exports	179.2	177.8	187.4	168.4	180.3	188.3	193.9	196.4	197.6	2013	1897
Domestic consumption	461.4	465.6	453.6	450.0	426.9	407.1	407.2	374.7	393.4	3894	3945
Net exports, % of output	28.0	27.6	29.2	27.2	29.7	31.6	32.3	34.4	33.4	341	325
Aggregate indicators											
Oil and natural gas output, mil. t. (oil equivalent).	1092.7	1041.4	976.2	910.5	864.3	842.7	842.3	819.6	835.3	8366	8490
Net oil, oil product, and natural gas exports, mil. t. o. e.	407.6	356.1	336.6	309.0	328.7	325.9	344.5	350.2	356.1	3657	3709
Domestic consumption, oil and natural gas, mil. t. o. e.	685.1	685.3	639.6	601.5	535.6	516.8	497.8	469.4	479.2	4709	4781
Net oil, oil product, and natural gas exports, % of oil and natural gas output	37.3	34.2	34.5	33.9	38.0	38.7	40.9	42.7	42.6	437	437

Note: data on the geographical distribution of exports in 1990 through 1991 reflect export outside the former Soviet Union and export to former Soviet Republics.

Source: RF Goskomstat, RF Energy Ministry, RF State Customs Committee, OECD International Energy Agency, authors' calculations.

Expanding domestic demand stimulated a hike of domestic prices of oil and natural gas sector products generating a noticeable price upward trend over the year. As a result, domestic oil prices in dollar terms were practically at the pre-devaluation level by end-

year, while oil product prices exceeded it (see Table 2.6). At the same time, extremely high world oil prices resulted in the ratio between domestic oil (producer) prices and export prices below 25 to 29 per cent over the whole year (excluding in December).

TABLE 2.6

Domestic Oil, Oil Product, and Natural Gas Prices (US \$) in 1997 through 2000 (average wholesale price at enterprise level, US \$ per metric ton

	1997 Decem- ber	1998 Decem- ber	1999 June	1999 Decem- ber	2000 July	2000 Decem- ber
Oil	63,1	16,4	20,7	37,0	42,9	54,9
Gasoline	169,6	63,4	76,0	171,9	152,9	199,3
Diesel fuel	170,0	52,9	78,2	125,0	138,4	185,0
Fuel oil	73,8	22,0	24,2	46,1	49,9	79,7
Natural gas (US \$/thous. cub. m.	6,6	2,1	2,3	2,2	2,7	3,1

Source: calculated according to RF Goskomstat data.

Export of oil and oil products expanded from 191.4 million metric tons in 1999 to 206.4 million metric tons in year 2000, or by 7.8 per cent (7.1 per cent for oil and 8.8 per cent for oil products). Crude oil exports have still dominated the oil export structure. Diesel and oil fuel made the major share in oil product exports. The share of exports in diesel fuel production was at 48.6 per cent in year 2000, fuel oil made 52.6 per cent, gasoline – at 15.4 per cent (it shall be noted that in 1999 the share of exports in production of gasoline was only 7.2 per cent). At the same time, it needs mentioning that the government in fact restrained oil product exports by setting special balance domestic supply targets for oil companies. Natural gas exports contracted by 5.6 per cent due to falling exports to CIS countries. The major share of energy resources (88 per cent of oil, 94 per cent of oil products, and 69 per cent of natural gas) was exported outside the CIS.

The hike of world oil prices resulted in sharply growing forex-denominated proceeds of the Russia's oil exports. The aggregate value of Russian oil exports and staple oil products (gasoline, diesel and oil fuels) increased from US \$ 18.82 billion in 1999 to US \$ 34.89 billion in year 2000, or by 85 per cent. As compared with pre-crisis 1998, when this indicator was at mere US \$ 13.96 billion, the value of oil and oil product exports grew by 150 per cent. As a result, the specific weight of oil and oil products in the total Russia's exports made 33.2 per cent in the previous year.

At the same time, Ruble devaluation and rising world oil prices were behind contracting oil product imports. For instance, gasoline imports was at mere 44 per cent of the level registered in the previous year, while its specific weight in the total gasoline resources decreased from 1.2 per cent in 1999 to 0.5 per cent last year (for reference: in the first half of 1998, i.e. prior to Ruble devaluation, the specific weight of imports in total gasoline resources was at 8.7 per cent).

As an analysis of long-term dynamics of Russian energy sector exports reveals, the aggregate net oil and oil product exports, although having demonstrated some upward trend over last years, still remains considerably below the levels observed in the late 1980s – early 1990s. Statistical data demonstrate that over the last decade net oil and oil product exports have decreased from 246.3 million metric tons in 1990 to 200.2 million metric tons in 2000, i.e. by 19 per cent. At the same time, a sharp contraction in domestic oil consumption (as per our estimates, it fell from 269.9 million metric tons in 1990 to 123 million metric tons in year 2000, i.e. more than twofold) was behind an increase in the specific weight of oil and oil product exports in the total oil production from 47.7 per cent to 61.9 per cent over this period, while natural gas demonstrated some

growth both in volumes of export, and in the specific weight of exports in the total output.

At the same time, according to our estimates, the aggregate net oil, oil product, and natural gas exports contracted from 407.6 million metric tons in oil equivalent terms in 1990 to 370.9 million metric tons in oil equivalent terms in 2000, or by 9 per cent. At the same time, the specific weight of net exports in the total oil and natural gas output increased from 37.3 per cent to 43.7 per cent. In this sense, the export orientation of the oil and natural gas sector seemed to intensify; however, it shall be remembered that this was due rather to contraction of hydrocarbon production resulting from falling domestic consumption, decreasing export to the near abroad, and deteriorating conditions of extraction than absolute increase in export volumes (to the contrary, they decreased).

High world oil prices registered in year 2000 were behind a sharp increase in profits of the oil sector of the economy. The total profits (balanced proceeds) generated in the oil industry (including both oil extraction and oil processing) increased from US \$ 6.32 billion in 1999 to US \$ 10.42 billion in year 2000, or by 65 per cent. At the same time, oil industry generated 40.4 per cent of the total profits of the national industry at large and 27.8 per cent of the total profits of the Russia's economy. Growth in oil sector proceeds resulted in a considerable increase in budgetary tax revenues, at the same time allowing oil companies to considerably increase investment reduce overdue payables (see Table 2.7).

For dynamics of the key indicators of development of the oil and natural gas sector characterizing production, domestic and external sales, investment activity, and payments see Figures 6 to 9.

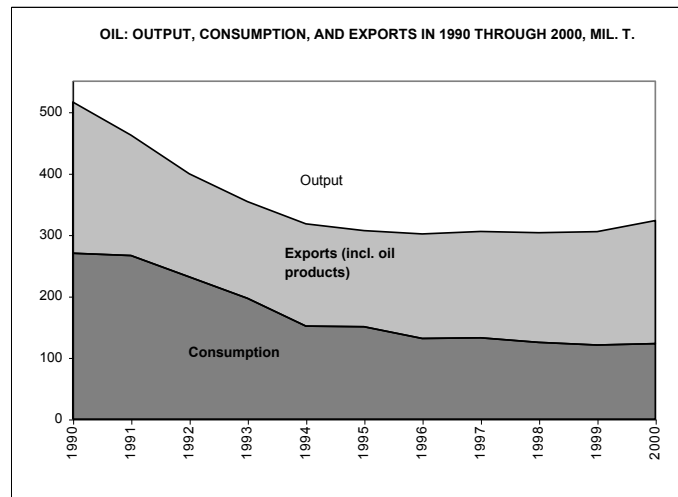
TABLE 2.7

**Oil Industry: Financial Indicators in 1997 through 2000,
US \$ billion.**

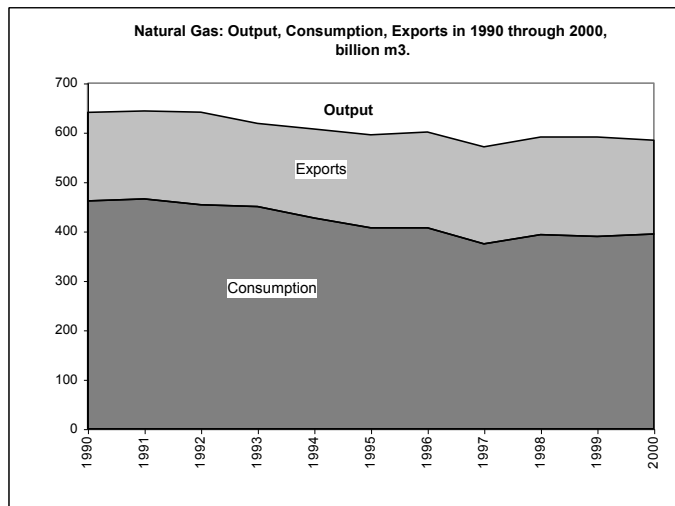
	1997	1998	1999	2000
Proceeds from oil and staple oil product exports	21,09	13,96	18,82	34,89
Profits (balanced proceeds)	3,52	0,60	6,32	10,42
Overdue payables (by end-year)	6,79	2,41	1,61	1,35
Including to the budget	2,53	0,66	0,43	0,27

Source: calculated basing on RF Goskomstat data.

FIG.2.6

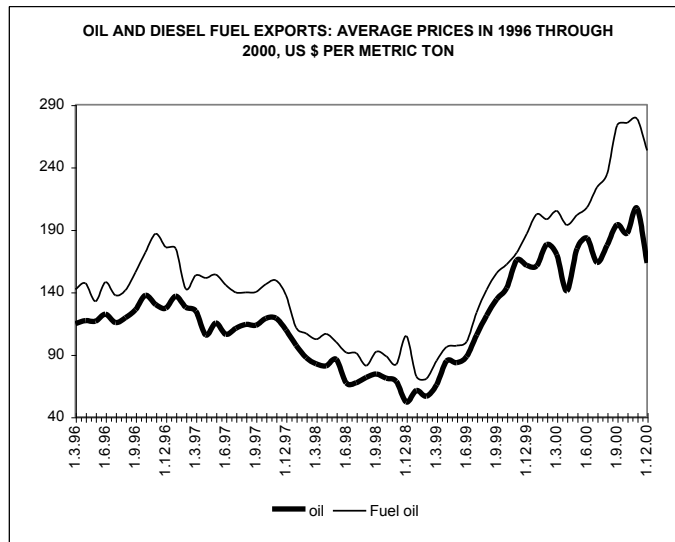


Source: RF Goskomstat, RF Energy Ministry, RF State Customs Committee, OECD International Energy Agency, authors' calculations.

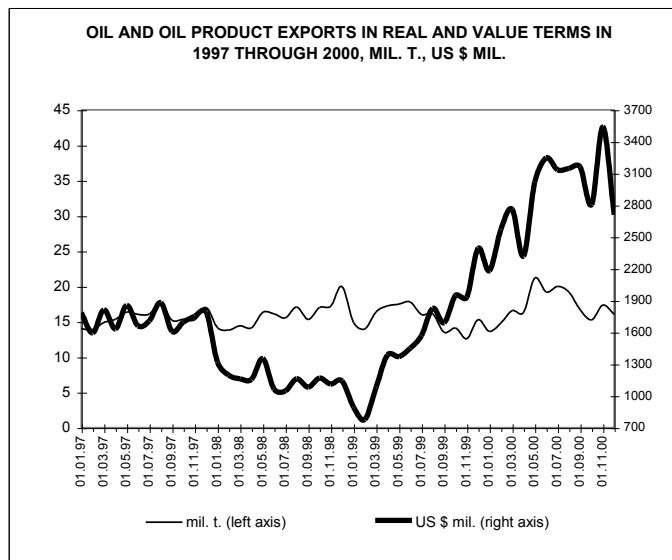


Source: RF Goskomstat, RF Energy Ministry, RF State Customs Committee, OECD International Energy Agency, authors' calculations.

Fig. 2.7

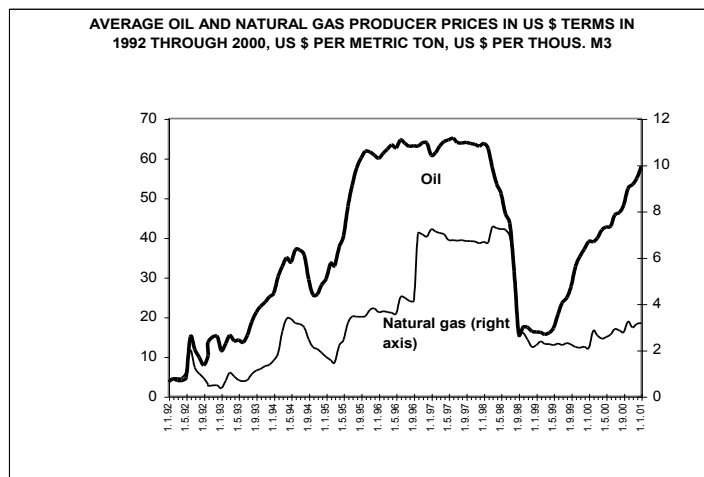


Source: Calculated basing on RF Goskomstat data.

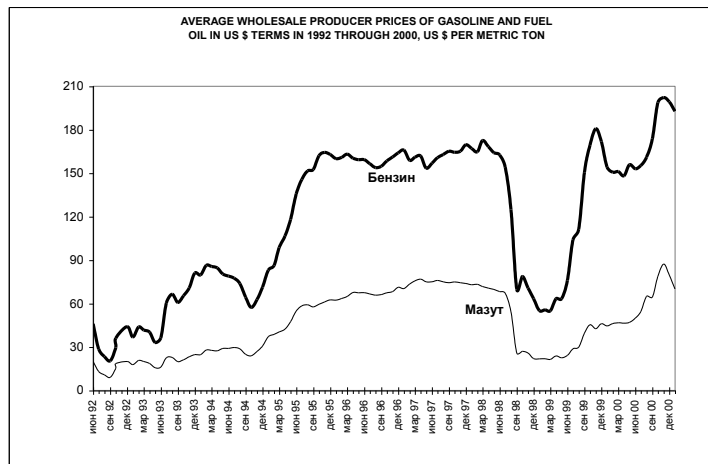


Source: Calculated basing on RF Goskomstat data.

FIG. 2.8

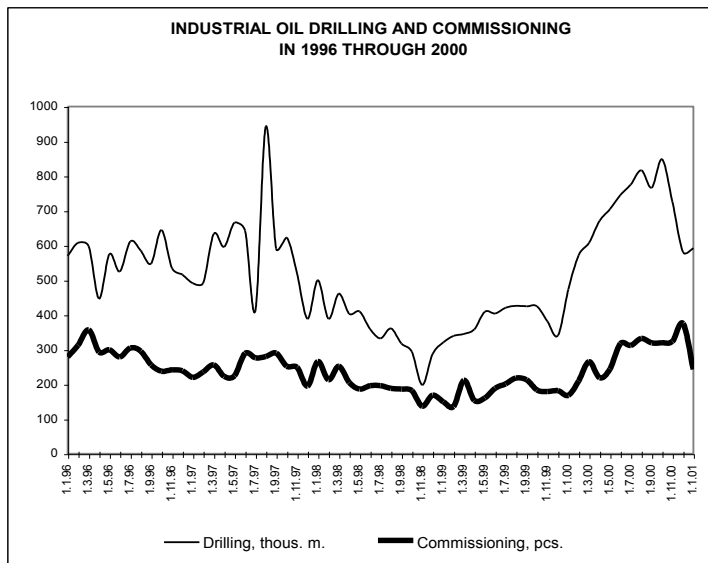


Source: Calculated basing on RF Goskomstat data.

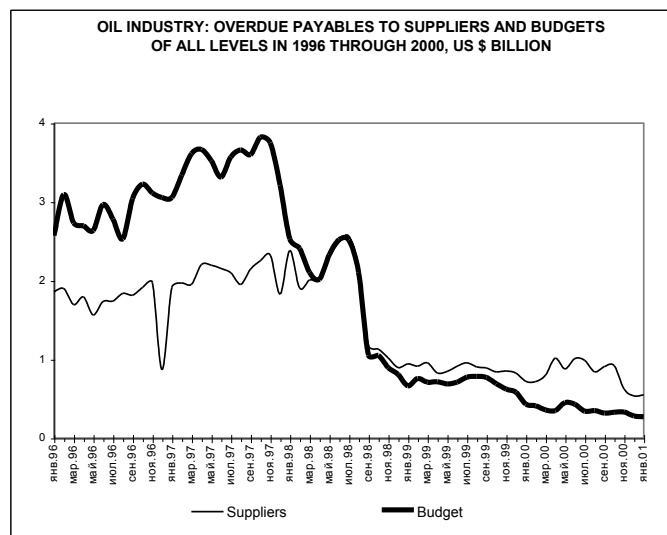


Source: Calculated basing on RF Goskomstat data.

FIG.2. 9



Source: RF Goskomstat.



Source: Calculated basing on RF Goskomstat data.

Changes in the Structure of GDP Formation: Revenues and Production Profitability

In 1999 through 2000, changes in the dynamics and structure of GDP formation generated by shifts in revenues were affected by Ruble depreciation and rising world prices of Russia's staple exports. In year 2000, the aggregate revenues of the national economy made Rub. 1,186.8 billion and by 1.62 times exceeded the levels registered in the previous year. Increasing profitability of production of goods and services in the situation of economic growth has been observed over two last years. The share of loss-making enterprises and organizations in the economy at large decreased from 53.2 per cent in 1998 to 41.6 per cent in year 2000. Improving indicators of financial operations were registered across practically all sectors of the economy. In year 2000, production profitability in the economy at large made 17.7 per cent, industry demonstrated a 27.7

per cent profitability. As production expanded and revenues grew, the inflow of tax revenues in the budgetary system also increased. The share of net taxes on production and import in GDP increased by 2.7 percentage points as compared with 1999 figures.

TABLE 2.8

Gross Domestic Product Formation as Broken down by Revenue Source, % of the total

	1995	1996	1997	1998	1999	2000
Total GDP, including:	100,0	100,0	100,0	100,0	100,0	100,0
Wages, including concealed remuneration	45,2	49,6	50	47,6	42,3	41,3
Net taxes on production and imports	11,9	13,5	14,5	14,2	14,6	17,3
Gross profit and gross mixed revenue	42,9	36,9	35,5	38,2	43,1	41,4

Source: RF Goskomstat, RF Ministry of Economic Development

The share of industries in the aggregate profits of economic sectors was up to 65.8 per cent as compared with 56.1 per cent in 1998, at the same time output of goods outpaced dynamics of services. The essence of structural shifts taking place in the formation of gross industrial profit in 1999 through 2000 was its redistribution from the processing sector to the fuel and energy complex and raw material industries. According to some estimates, the share of extracting industries and the primary processing sector in the total industry-generated profits expanded by almost 35.0 per cent.

TABLE 2.9

Production Profitability across Base Economic Sectors and Industries in 1993 through 2000, %

	1993	1994	1995	1996	1997	1998	1999	2000*
Economy total:		14,0	15,8	4,8	6,3	8,1	18,5	17,7
Industries	32,0	19,5	20,1	9,2	9,0	12,7	25,5	27,3
Power engineering	25,5	18,6	17,5	14,3	14,1	12	13,7	16,9
Including:								
Fuels	19,0	9,4	20,8	11,7	13,1	15,7	44,5	75,8
Ferrous metallurgy	48,5	20,8	22,1	5,0	3,6	10,3	28,2	27,3

TABLE 2.9 CONTINUED

	1993	1994	1995	1996	1997	1998	1999	2000*
Non-ferrous metallurgy	43,6	33,2	32,7	10,4	11,4	33	57,4	58,3
Chemistry and petro-chemistry	38,5	25,1	19,5	5,0	2,8	7,8	21,4	18,9
Mechanical engineering and metal working	43,5	26,3	20,8	10,9	8,0	10,0	17,3	15,7
Lumber, wood working, pulp and paper industries	32,8	16,1	21,8	-5,5	-5,5	5,0	23,9	19,2
Construction materials	31,3	19,9	17,9	8,0	5,6	5,2	8,6	13,3
Light industry	36,2	18,9	9,3	1,0	-1,5	0,9	9,5	11,1
Food industry	23,5	16,6	16,3	5,5	8,4	12,8	13,0	10,8
Construction	27,8	23,2	23,3	11,6	11,2	6,8	9,2	12,6
Freight	15,4	10,3	15,1	2,9	6,8	10,6	27,3	32,0
Communications	28,1	26,2	39,2	27,3	27,4	29,4	33,6	56,6
Trade	15,6	2,0	9,8	0,5	0,2	2,6	4,9	9,7

*) calculated as per estimates of RF Ministry of Economic Development

Source: RF Goskomstat

A favorable price situation on the world market of fuel and natural resources was behind a considerable increase in production profitability demonstrated by export-oriented industries of the extracting sector and the primary processing complex. Besides, at the present ratio between domestic and external prices a substantial amount of gains generated by increasing Ruble costs of products sold for foreign exchange turns into profits. The specific weight of fuel industry enterprises in the total amount of forex-denominated inflows into enterprises' accounts increased from 10.9 per cent in 1999 to 22.6 per cent in year 2000, the respective indicators of ferrous metallurgy showed a growth from 4.6 per cent to 6.2 per cent. This effect was heightened by a domestic market trend toward faster rates of growth in prices of intermediate goods vis-à-vis price dynamics demonstrated by final demand goods. Relatively low tariffs on products and ser-

vices of natural monopolies also contributed in the redistribution of gains in favor of consumers, especially taking into account the large share of the freight and energy components in costs borne by industries of fuel and metallurgy sectors.

As a result, export-oriented (oil, natural gas, ferrous and non-ferrous metallurgical) industries could substantially increase their respective profitability, and their share in the aggregate profits of the economy at large increased from 26 per cent in 1999 to 45 per cent in year 2000. These developments allowed the industries mentioned above to radically improve their financial standing – to do away with the deficit of internal current assets and relieve the debt burden. Due to increased profitability fuel industry and metallurgy were able to intensify their investment operations at the expense of their internal financial resources as well as domestic and external borrowings.

The situation was less favorable for processing industries oriented toward the domestic market. Taking into account the cost-intensity characteristic of these industries, the hike in prices of intermediate goods was a factor constraining the rates of profit growth and contributing in decreasing profitability. The industries were plagued by the deficit of internal current assets, what affected enterprises' solvency and hampered their innovation and investment activities.

A comparison of output dynamics and structure, investment, and labor reveals that the economy is experiencing a massive redistribution of resources in favor of a limited number of capital-intensive industries in extracting and primary processing sectors.

FIGURE 2.10

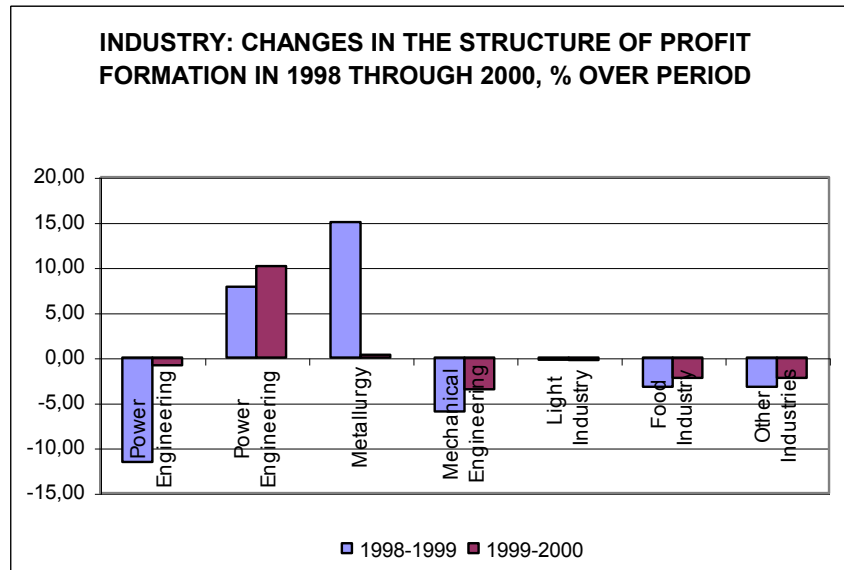


FIGURE 2.11

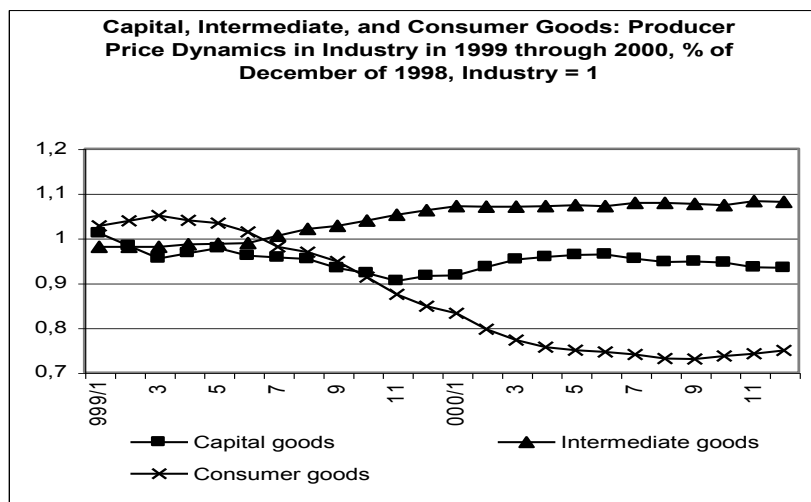
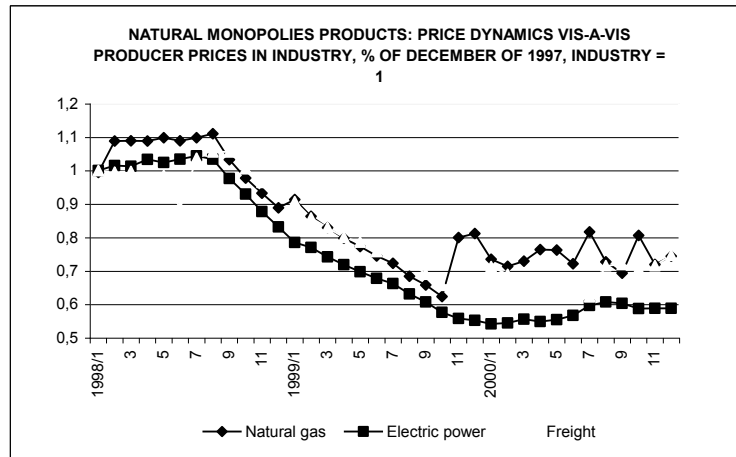


FIGURE 2.12



It shall be pointed out that in year 2000 enterprises of oil extracting and oil processing industries, as well as those in ferrous and non-ferrous metallurgy experienced the most intensive increase in the number of jobs taking place at the background of growing wage differentiation between extracting and processing sectors of the economy. For instance, while in early 2000 nominal wages in fuel industry was by 3.1 times higher than in mechanical engineering and by 6.2 times exceeded wages paid in light industry, by end-year this gap widened, making 3.6 and 7.2 times respectively. These developments resulted in decreasing wages in processing industries and services. Taking into account the fact that processing industries and services employ about 90 per cent of economically active population, while wages form almost 80 per cent of cash household incomes, the low effective demand on the part of these citizens is a serious factor constraining the rate of economic growth.

In 1999, due to Ruble devaluation profits generated by base industries increased by almost 3 times, while nominal gross wages

grew by 1.4 times. As a result, in 1999 the gross profit of the economy in GDP increased up to 43.1 per cent as compared with 38.2 per cent in 1998, while the share of wages decreased down to 42.3 per cent from 47.6 per cent. In year 2000 profit growth rates by 1.2 times outpaced the rise in wages. Due to constrained growth rates demonstrated by household incomes and at the current structure of consumer and producer prices in industry and construction the share of wages in GDP remained at about the level observed in the previous year.

Concealed labor remuneration (not-reported wages) persists as a serious problem. According to RF Goskomstat, concealed wages account for up to one fourth of the actual labor remuneration, or 12 to 15 per cent of GDP. The major factor behind various forms of concealed remuneration of labor is the wish of employers, especially in small businesses, to cut down on taxes and contribution to state extra-budgetary funds. This problem may be settled only by improving tax legislation and changes in income taxation rates.

In year 2000, the social psychological climate was positively affected by a change in the labor market situation and growing sense of employment security on the part of the population. The unemployment calculated according to the ILO methods decreased by almost 1.8 million people and was about 6.9 million strong, while the number of officially registered citizens out of work decreased by almost one third over the same period. As the economy recovered, demand for labor increased. The number of vacancies enterprises reported to employment agencies made about 751.0 available jobs by end-2000, as compared with 588.0 vacancies reported in the previous year. The job-seekers per vacancy ratio decreased from 6.6 to 1 in January of 1999 to 1.6 to 1 in December of year 2000.

Changes in part-time employment levels shall be taken into account in order to evaluate trends developing on the labor market. Both employers and, however paradoxically, employees were interested in the existence of this phenomenon. In the situation of low demand for labor part time workers often prefer to retain whatever jobs they have understanding that it is impossible to find full-time employment. The substantive aspects here are both part time workers' economic interests (an opportunity to make some money on the side and free time) and social considerations (retention of official employment status). Employers are guided mainly by financial considerations: lump sum social benefits they have to pay to the dismissed in accordance with the legislation currently in force cost employers more than small wages even paid over a prolonged period, or granting of vacations without pay. Besides, human resource managers of a number of enterprises, especially at first stages of the reform, proceeded from the assumption that production technologies and labor utilization patterns would be preserved. Hence the wish of some employers to maintain redundant labor resources. Apparently, market reforms failed to change the structure of labor demand so drastically as envisaged in the course of the transformation. A factor behind this failure is the faulty system of labor legislation, social guarantees, and taxation.

GDP Utilization: Factors and Trends

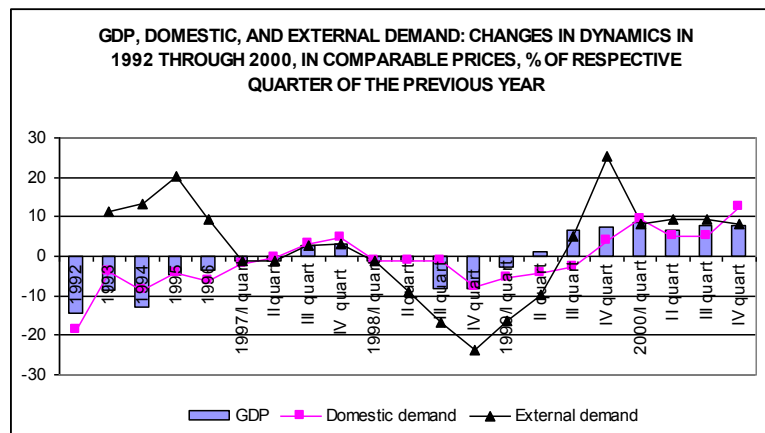
External Demand

Actual rates of growth in the real sector were much above targets set in the budget for year 2000. Brisk domestic business activity generated by Ruble devaluation permitted, other things being equal, to expect a 104 to 105 per cent growth in GDP. However, the dynamic development of the world market of raw, fuel, and energy

resources gave a new impetus to the growth of the home economy in year 2000. A comparative analysis of changes in GDP dynamics and structure over the years of reform reveals that while in 1992 through 1996 the growing external demand was a factor compensating for contraction of the domestic market, the situation has been changing over next years.

Simultaneous growth in domestic and external demand taking place in the Russian economy in 1999 through 2000 was a distinctive feature of the Russian economic recovery. As open economy is forming, the cumulative effect of external factors becomes more profound. On the one hand, almost twofold contraction of imports, as compared with pre-crisis levels, provided the space for intensive expansion of domestic production of goods and services. On the other hand, increasing export-generated revenues were behind substantial changes in the structure and dynamics of final demand.

FIGURE 2.13



Source: author's calculations basing on RF Goskomstat and RF Ministry of Economic Development data.

TABLE 2.10

**Dynamics of GDP Utilization as Broken Down by Components,
% of the previous year**

	1998	1999	2000 (estimate)
Gross Domestic Product	-4,9	3,2	7,6
Expenditures for final consumption	-2,3	-3,5	7,9
Households	-3,6	-5,3	10,3
Government	0,6	0,9	1,6
Gross accumulation	-31,3	9,3	16,2
Capital accumulation	-11,2	2,4	15,0
Net exports	111,0	60,2	-1,9
Exports	-0,3	9,4	8,4
Imports	-11,0	-15,6	14,3

Source: RF Ministry of Economic Development, Customs statistics of RF foreign trade

An active balance of external trade registered in year 2000 made over US \$ 61 billion as compared with US \$ 34 billion in 1999, and growth in net exports accounts for almost one third of the increment in the volume of GDP in year 2000. The necessary market infrastructure formed over the years of reform, as well as accumulated experience and a change in motives guiding Russian businesspersons were in place, what facilitated effective utilization of external factors.

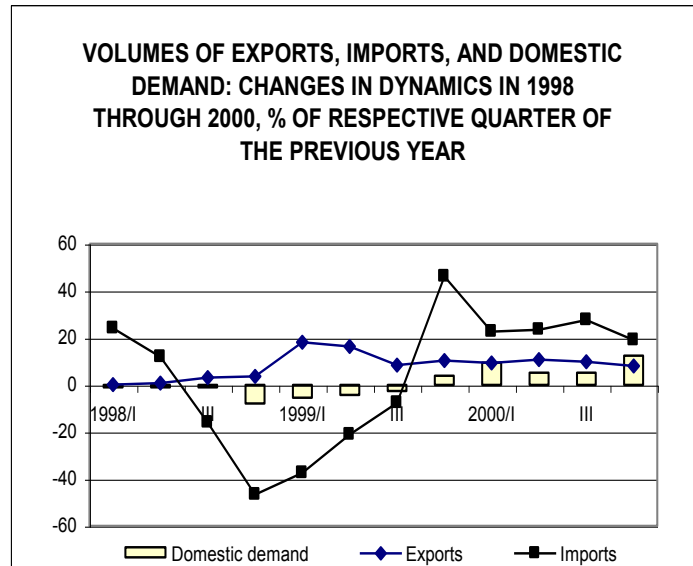
While analyzing the strength of the Russian economy, it shall be emphasized that the combination of external factors affecting the growth in production was different in 1999 and 2000. While in 1999 the key factor behind the growth in production was Ruble devaluation, which enhanced the effectiveness of external operations, the rising world prices of energy resources and non-ferrous metals were a driving force in year 2000. Since the second half-year of 1999 it has been observed that devaluation effects were gradually wearing off, while the influence of the second group of factors no-

ticeably weakened by end-2000. As a result, the dynamics of macroeconomic indicators registered over the year demonstrate that economic growth has been gradually decelerating.

In year 2000 the volume of imports again grew at a faster rate than exports and GDP. While some deceleration of increase in the volume of exports may be explained by developments on world markets of raw materials, internal factors accounted for an intensive growth in imports.

An analysis of the sector of trade reveals that in spite of considerable Ruble devaluation the Russian economy has failed to create new niches for domestic products either on the world or domestic market. In year 2000, the expansion of domestic demand initiated by the export-oriented sectors of the economy based on the continued growth in production of a rather narrow segment of the national economy.

FIGURE 2.14



A factor behind low competitive effectiveness of domestic products is the fact that economic growth in 1999 through 2000 mainly relied on more intensive utilization of operating and reserve production capacities. The lack of substantial shifts in commissioning of new capacities accounted for the failure to consistently implement import substitution policies and to diversify export flows. A more pronounced trend toward an increase in the share of imports has observed in the structure of commodity resources both on the consumer market and the market of material and technical products since the beginning of year 2000. The specific weight of imported consumer goods in the total amount of commodity resources (in comparable prices) increased from 38 per cent in the first quarter of year 2000 to 43 per cent in the fourth quarter. Growth in imports was also facilitated by the real appreciation of the Ruble. As a result, according to the Ministry of Economic Development in year 2000 net exports were at 98.9 per cent of the level registered in the previous year. It is a very alarming signal for the Russian economy, since decreases in net exports as a rule result in decelerating growth rates.

Domestic Demand: Final Consumption

Growing profits of the economy generated in the foreign trade sector have considerably affected the proportions of final consumption in GDP. Over year 2000, gross capital accumulation demonstrated outpacing growth rates in comparison with other elements of the final GDP utilization. More brisk business activity in the Russian economy accounted for the fact that growth in investment demand generated almost one fourth of the volume of GDP. However, the redistribution of GDP resources in favor of the investment component and the rest of the world resulted in a more pronounced

trend toward falling share of expenditure for final consumption of goods and services observed in year 2000.

TABLE 2.11

**GDP Utilization Structure in 1998 through 2000,
by quarters, % of the total**

	1998				1999				2000			
	Quarters											
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Utilized GDP	100	100	100	100	100	100	100	100	100	100	100	100
Expenditure for final consumption	77,8	77,6	72,7	80,1	72,8	70,7	62,6	70,0	65,0	63,9	57,6	64,2
Households	55,9	52,5	53,6	55,4	58	51,4	46,4	48,9	48,7	44,4	42,1	44,1
Government	18,5	21,2	16,3	20,8	12,1	16,4	13,8	18,1	14,2	16,8	13,2	17,3
Gross accumulation	22,4	22,1	22,6	0,4	11,4	16,0	15,4	22,7	10,9	14,6	24,3	16,0
Capital accumulation	15,2	17,9	18,0	17,7	13,7	15,2	15,4	18,0	13,7	16,1	18,3	21,4
Net exports	-0,2	0,3	4,7	19,5	15,8	13,3	14,7	20,4	24,1	21,5	18,1	19,8

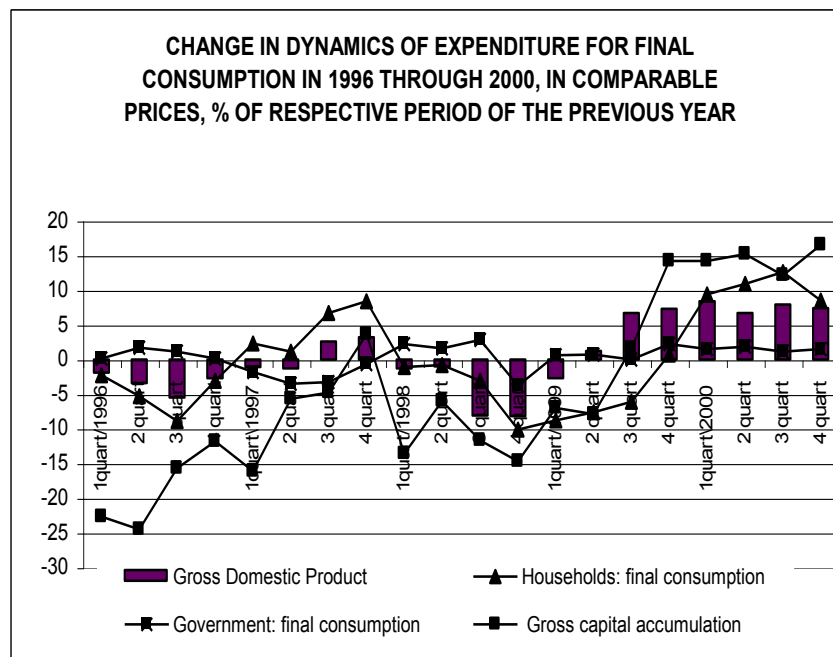
Source: RF Goskomstat

In 1999, production expanded at the background of low consumer demand. As a result, the aggregate expenditures for final consumption fell by 3.5 per cent over the year, and household expenditures experienced a decrease by 5.3 per cent, while real household incomes were at 85.8 per cent of the previous year's level. In year 2000, real household incomes increased by 9.1 per cent, as they were driven by a rather steady growth in wages and pensions. An increase in final consumption accounts for almost two fifths of the increment in GDP. However, the sharp deterioration of living standards caused by the crisis of 1998 persisted in spite of the positive dynamics registered over the year. Real household incomes were at 93.6 per cent, real wages – at 95.6 per cent, and real

gross pensions – at 77.6 per cent of the levels observed in the relatively prosperous year (1997).

The formation of a potential for growth in production accompanied by increasing business proceeds resulted in the alleviation of some social problems. Thus, wage arrears generated by under-financing of budgets of all levels made Rub. 4.9 billion on January 1, 2001, as compared with Rub. 10.2 billion on the same day in year 2000. Besides, all pension arrears shall be repaid in year 2000.

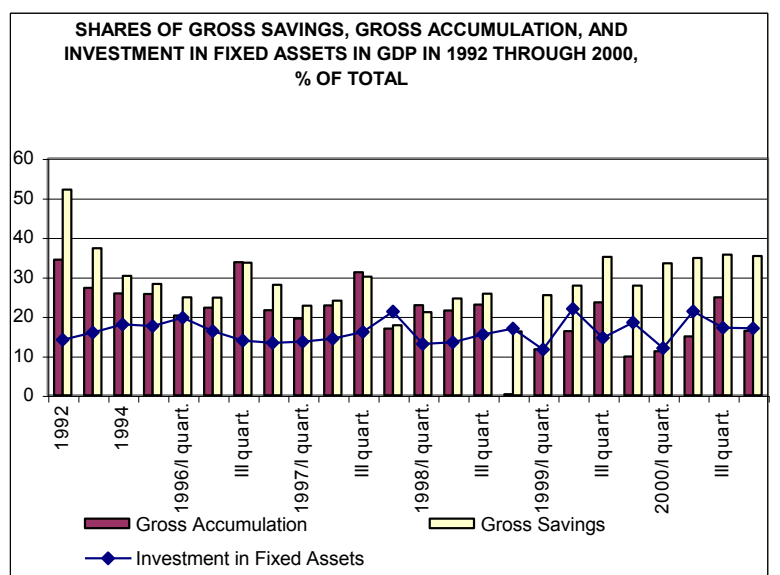
FIGURE 2.15



Increasing production profitability coupled with growing export receipts (since 1999) accounted for the fact that for the first time since the beginning of reforms there has been regis-

tered an upward trend in the share of accumulation. In year 2000, the share of savings in GDP made 36.2 per cent as compared with 29.4 per cent observed in 1999, and 22.1 per cent registered in 1997.

FIGURE 2.16



Domestic Investment Demand

A distinctive feature of year 2000 was growth in investment outpacing overall GDP dynamics. Positive stable dynamics of production, as well as growth in domestic and external demand observed in 1999 through 2000, resulted in changes in the investment sector situation. Increasing profitability allowed the business to turn to investment projects. However, it would be prematurely to define this situation as an “investment boom.” The character of investment

operations is most illustrative of the mixed developments taking place in year 2000.

An increase in investment registered in year 2000 was mainly generated by exceptionally favorable external situation of Russian exporters. Accordingly, the share of fuel, energy and transport complexes in the structure of investment expenditures for reproduction of fixed assets increased by almost 8 percentage points as compared with 1999 figures. The expanding investment demand revealed the fact that the domestic mechanical engineering is unable to supply the market with high-quality material and technical resources. The lack of modern equipment becomes a considerable factor constraining industrial growth. The expansion of competing import of machinery and equipment with emphasis on second-hand resources became a distinctive feature of year 2000.

Taking into account the fact that low investment activity persisted in the past, the scope of investment in fixed assets did not meet the real demand for renovation and modernization of the production capacities, what negatively affected the effectiveness of the economy. The problem of investment maneuver in favor of industries producing goods and services with higher degrees of value added, which would be able to increase the competitive effectiveness of the Russian economy, remained unsettled.

Greater scope of savings in the economy has aggravated the problem of their transformation. An extremely slow pace of reforms in the financial sector of the economy resulted in a persistently falling participation of banking capital in the crediting of the real sector. Internal funds of enterprises remain the major source of investment, since the mechanism of inter-sectoral capital mobility does not work.

Investment dynamics were also negatively affected by the persistence of low household incomes. The present level of effective

household demand on the consumer market constrained expansion of production of goods and services. Besides, by end-2000 decelerating rates of growth in profits, accelerating inflation rates, and a considerable rise in prices and tariffs of natural monopolies were factors negatively affected investment dynamics.

In spite of an extremely favorable combination of the world price situation and persisting effect of Ruble devaluation, the investment climate did not change in year 2000. Lacking structural transformations were behind the failure to normalize interaction between the financial sphere and the real sector. The persistence of high risks and the unfavorable business and investment climate was determined by the instability of the legislative environment. Inadequate normative and legal acts failing to guarantee the protection of ownership rights, corporate governance, fair competition, business transparency are a factor constraining investment operations on the part of both domestic and foreign capital.

This situation accounted for the fact that in year 2000 investment operations developed under influence of quite opposite trends. On the one hand, there was registered a high rate of growth in investment and expansion of domestic sources of financing, on the other hand, calculations reveal that the capital flight from Russia remained high over year 2000.

In the situation of economic growth it became clear that the management of investment is in disagreement with dynamic restructuring processes underway in the Russian economy. The formation of a national investment model of economic development in the framework of the long-term governmental strategy for years 2000 – 2010 shall eliminate these negative factors.

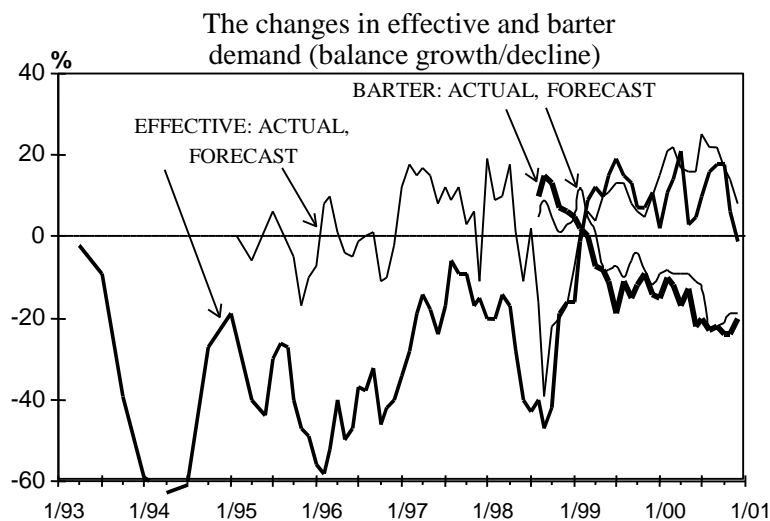
2.2. The situation in industry¹

The specific features of the industrial dynamics in the year 2000

The official statistics indicate that in the year 2000 industrial production maintained a high rate of growth. The main causes for this usually referred to are the devaluatory effect, the favorable situation on the external raw materials markets and the investment demand resulting from the above circumstances. All these factors are integrated into a single force by the fact that they are forming a normal effective demand for the industrial products of Russian enterprises thus permitting the manufacturers to obtain "real" money. The importance of barter and other non-monetary schemes is decreasing. The industrial growth acquires a "healthy" monetary character. The absolute increase in output continued until the end of the year 2000. Nevertheless, at the end of the year the increase in effective demand was halted. These circumstances make it necessary to consider the two types of demand (effective - in exchange for money, and barter - that is, in exchange for the products of other enterprises) as the basis for understanding the industrial growth in the post-crisis period.

¹ This section is based on the materials of the market surveys targeting the managers of industrial enterprises and conducted by the IET once a month since September 1992 so as to cover all the territory of the Russian Federation. The panel comprises 1,400 enterprises employing more than 20% of the total industrial manpower. The panel is biased toward large enterprises within each of the 61 subindustries specified. The return of the questionnaires has been approximately 70%.

Fig. 2.17



As far as Russian industry is concerned, the year 1999 was the first in the latest seven years when an absolute increase in effective demand was achieved. Prior to February 1999 the responses from the enterprises had not registered even a single occasion of an increase of this index, and the reports of decreasing volumes of sales for money had always been predominant. A particularly dramatic drop in demand was noted in late 1994, late 1996 and mid-1998 (see Fig. 2.17). In March 1999, the proportion of the reports on an increase in the number of sales for money for the first time exceeded the proportion of those registering a decline in sales: the balance of changes thus became positive. The increase in sales for money continued in Russian industry until the end of the year 1999 and well into the year 2000. The most intensive growth of effective demand was registered in April, 2000.

Nevertheless, the dynamics of effective demand during the past year was unstable. The minimum rate of the increase in the sales of

industrial products for money was registered in January, May-June and the last months of 2000. The discontinuation of the increase in effective demand in November and December looks especially "unpleasant". Firstly, it had been preceded by a relatively long period of decreasingly optimistic forecasts of the changes in demand. Secondly, by December the balances of the finished stock went up by eight points in two months, and as a result came very close to zero. This circumstance is a clear sign of the appearing limits to the demand level. Thirdly, in the fourth quarter of the year 2000 the estimates of both the manpower surplus and that of industrial capacities demonstrated a change in their former trends conditioned by the forecasted demand levels. The proportion of the enterprises with redundant resources had shown a relatively rapid decline in October 1998, reaching its absolute minimum in July 2000. Then the surveys registered a five-point increase in these indices. It is evident that the enterprises had encountered their most serious problems since the beginning of the post-crisis industrial growth.

At the branch level, the results of the year demonstrated an increase in effective demand in all branches of industry except for the food industry. In the first and the third quarters of the year the latter was experiencing mostly an absolute reduction in sales for money, but by the end of the year the situation began to improve, and in December the growth rate became one of the highest in industry. The positive results in the light industry were relatively modest because this branch had experienced an intensive fall in the demand for its products in April-June; nevertheless, following a rather intensive increase in sales during the second half of the year, the light industry managed to approach the end of the year with a positive balance of the changes in effective demand. The most intensive increase in the realization of products for money in the year 2000 was registered in the electric power industry. It was only at the begin-

ning of the year that the balances of changes of the index were slightly negative; by the end of the year the reports of increasing sales were significantly more numerous than those of a decrease in sales - the power consumers were beginning to pay for it with "real" money. The metallurgical, chemical and petrochemical industries as well as mechanical engineering had a positive balance by the end of the year because the effective demand for their products had generally risen. Positive annual results were also demonstrated by the basic sub-industries within the machine-building branch. A decrease in demand was registered only for the products of light engineering and the food processing machinery industry, railroad engineering and the aircraft industry. The most intensive increase in sales occurred in petrochemical engineering, road-building machinery, machine-tool construction, production of means of communication and in electrotechnical machine building.

The dynamics of barter demand for industrial products had an opposite tendency. The increase in barter operations as registered by the surveys since August, 1998 (when the index was included in the regular questionnaire of the surveys conducted by the IET) had slowed down by early 1999. In April 1999 the surveys for the first time registered an absolute decrease in the barter volume in Russian industry. This process continued until the end of 1999 and throughout the year 2000. The most intensive decrease in barter was registered in the second half of the past year. This decrease was observed during all the months of 2000 in all industrial branches and subindustries. By the annual results, the electric power industry has become an absolute champion of "debarterization". In machine building the most intensive decrease in direct barter operations was registered in power machine building (which is quite natural, considering the situation in the electric power industry), petrochemical engineering, instrument-making and electronics. As a result, the

share of barter in the total realization of industrial products significantly decreased (see Table 2.12).

TABLE 2.12

The share of barter in total realization of product, %

	1996	1997	1998	1999	2000
Electric power industry				21	4
Ferrous metallurgy	63	64	59	23	17
Nonferrous metallurgy	42	38	13	5	31
Chemical and petrochemical	58	60	55	27	18
Machine-building	46	60	55	22	15
Timber, w/w, pulp and paper	45	51	42	29	21
Construction industry	45	54	72	29	22
Light industry	51	58	44	26	14
Food industry	30	21	28	18	14

Source: Surveys conducted by the IET.

On the basis of the results of the surveys conducted by the IET the interaction of the two types of demand at the microlevel can be estimated. For this purpose, a matrix of conjunction between the questions on the changes in effective and barter demand $M(XbYt)$ was plotted, where Xt represents the actual changes of effective

demand in survey t , Y_t is the actual changes of barter demand, (+) means the growth of the index, (-) - its decrease, (=) - no changes.

			Y_t	
		+	=	-
	+	++	+=	+ -
$M(X_t, Y_t):$	X_t	=	= +	= =
	-	- +	- =	- -

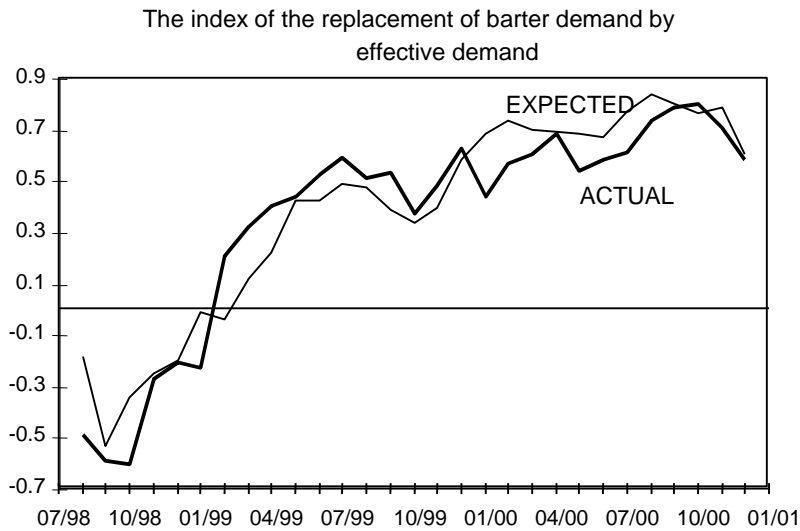
The number of the elements above the main diagonal of the matrix determines the share of those enterprises where effective demand was replacing barter demand. The number below the main diagonal determines the share of the enterprises in an opposite situation - when barter demand was replacing effective demand. On the basis on the off-diagonal numbers the replacement index can be derived, similarly to the coefficient of the shift in expectations suggested by Kawasaki and Zimmermann.² The replacement index is calculated as the relation of the difference between elements above and below the diagonal elements and their amount; it can be expressed by the values within the range of -1 to +1. The positive values represent the cases when barter demand is being replaced by effective demand, while the negative values represent the opposite situation. The greater the absolute values of the coefficient, the more intensive is the replacement process.

The dynamics of the values of the replacement index (see Fig. 2.18) indicates that since August 1998 (when the registration of the changes in barter demand was first introduced) until January 1999 barter demand was replacing effective demand. But the intensity of the replacement, after reaching its maximum in October 1998, began to decline. In February 1999 for the first time the replacement

² Kawasaki, S. and Zimmermann, K.F. (1986), Testing the Rationality of Price Expectations for Manufacturing Firms, *Applied Economics* 18, 1335-47

of barter demand by effective demand was registered. This relation was maintained until the end of 1999 and throughout 2000.

FIG. 2.18

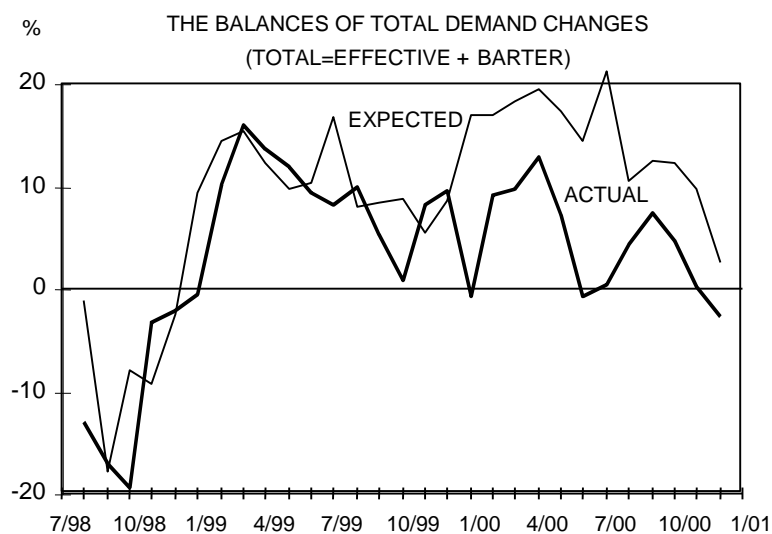


Thus, the calculation of the replacement index has confirmed the suggestion which could be derived from the dynamics of effective and barter demand that since 1999 the latter began to be replaced by effective demand. This process reached its maximum level in October 2000. At that time the surveys registered one of the lowest levels of references to nonpayments and low domestic effective demand characterized as the factors inhibiting the output growth in Russian industry. Nevertheless, later the replacement intensity has begun to decline.

When it is assumed that the total demand for industrial product is constituted by the sum of effective and barter demand, the above mentioned matrices of the relations between the changes of the two types of demand could provide a basis for the assessment of the dynamics of the total demand for industrial products. The number of

the matrix elements above the second diagonal represents the share of the enterprises which reported an increase in only one type of demand or even in both types. If one type of demand was increasing, the other at least was not going down. Thus, this index indicates the share of the enterprises whose products met a growing demand. The number on the second diagonal determines the share of the enterprises with a declining total demand. Here either both types of demand were decreasing, or only one type. The elements set on the second diagonal determine the share of the enterprises with no changes in total demand. The sums thus calculated represent the responses to the question regarding the changes of total demand: "increased", "has not changed", "declined.". Now the calculation of the traditional balances of the changes in total demand becomes clear (see Fig. 2.19).

Рис.2.19



The increase in total demand was first registered in February 1999, then this index continued to grow with various intensity

throughout the past year, although the general trend was negative. The year 2000 began with an absolute reduction in total demand, but later the rate was reversed and reached its maximum in April. But in May the decrease in the growth rate started again, and in June and July this index was showing no growth at all. Another discontinuation of the increase in total demand was registered in November. In December, the negative tendency continued: the total demand started to decline with such an intensity which had not been registered since November, 1998. Thus, the year 2001 is begun by industry in the presence of demand limits which are the strongest in the past two years. If the dynamics of normal effective demand is not restored in the next few months, the enterprises will be forced to return to unreliable schemes of realization of their products which will happen clearly against their will (see Table 2.13).

TABLE 2.13

The distribution of responses to the question: “Would your enterprise like to get rid of nonmonetary settlements with due regard to its interests”, %

	10.1999		5.2000		10.2000	
	Да	Нет	Да	Нет	Да	Нет
Total industry	90	10	92	8	86	14
Electric power industry	96	4	100	0	100	0
Ferrous metallurgy	92	8	83	17	100	0
Nonferrous metallurgy	64	36	93	7	84	16
Chemical and petrochemical	93	7	77	23	87	13
Machine-building	92	8	96	4	87	13
Timber, w/w, pulp and paper	83	17	89	11	78	22
Construction materials	92	8	85	15	93	7
Light industry	90	10	90	10	88	12
Food industry	86	14	80	20	75	25

Sources: Surveys conducted by the IET.

As it is evident from the results of the surveys, the negative tendencies in Russian industry intensified at the beginning of the year 2001. The enterprises responded to the significant decrease in effective demand by halting the output growth, reevaluating their finished stocks and lowering the volumes of barter operations. The expectations concerning barter are indicative of the readiness on the part of the manufacturers to resort again to nonmonetary schemes of realization of their products if the situation continues to deteriorate. But the forecasts of output and effective demand demonstrate that the manufacturers are hoping for the restoration of a normal (monetary) industrial growth after the January holidays.

In January, 2001 most of the market indices in industry continued to show a negative trend. Firstly, there began a substantial decrease in effective demand embracing all the branches except for the electric power industry and the timber industry complex. The most intensive decrease in sales was registered in the construction industry and in the chemical, petrochemical and food branches. As a result, during November-January, the intensity of the changes in effective demand have fallen from +18 to -9 points. Such a sharp change from a relatively intensive growth (a higher increase rate had been registered only once - in April, 2000) has never been experienced. On the other hand, there also had never been such a long (the years 1999-2000) period of an absolute growth of effective demand. Hopefully, after January (the month traditionally "calm" for Russian industry) the situation will improve.

Secondly, both in December 2000 and in January 2001 the surveys registered a slow-down of the decrease in barter operations. The absolute change of the decrease rate is still rather small (5 points), but (bearing in mind the forecasts of this index) the whole picture looks alarming. The share of barter in the products realization volume amounts to 16% at the present time, with no changes

having been registered since September, 2000 when the previous measurement of this index was performed. In January, 2001 the enterprises realized for money 67% of their products, while in September 2000 - only 58%.

Thirdly, the appraisals of finished stocks underwent sharp changes in January, 2001. The share of the responses "above the standard" increased by 9 points and became equal to the share of the responses "below the standard". The deficiency of stocks that had been registered since September 1998 now disappeared. Such abrupt changes in the appraisals of finished stocks had previously been noted only in the distant past - in the years 1993-1994, when the enterprises for the first time had faced a profound decrease in the demand for their products. An absolute surplus of stocks is still registered only in the metallurgical, chemical and petrochemical industries. In other industries, the deficiency of stocks has diminished. As there were no cardinal changes in the volume of stocks, the main reason for their "reappraisal" are the misgivings lest the shrinking of demand should continue.

Fourthly, an almost complete halt of the rise in production was registered. The intensity of the changes in output fell during one month from +23 to +2 points. This was one of the sharpest drops in the rate of the output changes in the whole history of the surveys. An absolute increase in output was preserved only in electric power engineering, machine building and the timber industry complex.

At the same time, the appraisals of the finished stocks and output volumes so far have not been changing. Approximately one third of the enterprises consider the existing production and sales volumes to be normal. No important changes in the enterprises' appraisals of their financial and economic situation have been registered either. Moreover, the share of the responses "satisfactory" has

reached its absolute peak for all the years of surveying, while the share of the responses "bad" has declined to its lowest point.

The utilization of production capacities in the year 2000 and in early 2001 was stable, at present demonstrating the best level since early 1994. Nevertheless, since July 2000 the appraisals of production capacities have been becoming increasingly negative, in connection with the expected demand level. The share of the enterprises considering their capacities to some extent redundant has increased from 25 to 34%. The greatest number of pessimistic appraisals was received in the construction industry (61%) and machine building (41%).

The predictions of the changes in effective demand after the five months of worsening (alongside with the preservation of the hopes for the expansion of sales) improved in January by 6 points. A growing optimism was registered in all branches except for metallurgy and the light industry. An absolute decrease in sales for money can be possible in the nearest future only in ferrous metallurgy, while the most intensive expansion - in the construction, chemical, petrochemical and machine-building industries.

The forecasts of barter transactions have adequately responded to the shrinking of effective demand. The enterprises are expecting the intensity of the decline in these transactions to decrease abruptly in the nearest future (from -18 to -6 points). Nevertheless, for industry as a whole the growth of barter has not been predicted so far, and its absolute increase is possible only in ferrous metallurgy and the construction industry. The share of the "compensational" forecasts of barter (i.e. the share of the enterprises which are ready to increase the volumes of barter in response to a drop in sales for money) amounted in January to 12%. The minimum of this index (6%) was registered in October 2000.

The evolution of the market behavior of Russian industrial enterprises

The dynamics of the major industrial market indices (demand, output, stocks, plans and expectations of the enterprises) provides sufficient reasons for a suggestion that it is possible that the Russian economy has completed another regular period of its development characterized by a stable and rather intensive growth caused by effective demand. The deceleration of growth followed by an absolute decline in effective demand have been forcing Russian industrial enterprises to resort again to non-monetary schemes of realization of their products. In this connection, a number of urgent questions can be put forth. Are there chances for the return of barter into Russian industry (on a major scale)? Will the Russian enterprises once again base their industrial activity on direct barter operations and will they try to preserve in such a way a necessary minimum of the production volume? Or will they prefer to follow the changes in effective demand for their products so that a significant deceleration of the rise in production and even a decrease in its expansion will become possible? The year 2001 can become a very interesting period for researching the behavior of Russian industrial enterprises. They are entering the new year enriched by their lengthy experience of existence under the conditions of barter and the economy of nonpayments. But during the past two years the enterprises were able "to live in style" due to a normal effective demand, and to settle their accounts with the state and the employees by the monetary means. What compromise will be found by the Russian enterprises this time? The answer can be obtained by investigating the models of the formation of production plans (expectations). These formal and well-known constructions (which under the conditions of the developed market economies are mostly of a

purely academic interest), as far as we know, can provide answers to the above questions.

The expectations of the economy agents are playing an important role in the contemporary theory of economics. But so far there have been too few empirical studies on the features of the expectations at the microlevel in the market economies, and none at all as regards the economies in transition. An analysis of expectations based on the surveys of enterprises was first performed by Theil³. It was followed by other works examining the expectations of manufacturers: Konig, Nerlove and Oudiz⁴, de Leuw and McKelvey⁵, Aiginer (1981), Nerlove⁶, Tompkinson and Common⁷, Kawasaki and Zimmermann⁸, Stalhammar⁹, Bukle, Assendelft and Jakson¹⁰, Marty¹¹. The above-mentioned studies were based mainly on the results of market surveys conducted in different countries. Most frequently researched was the formation of price and output

³ Theil, H., 1966, Applied economic forecasting, North-Holland, Amsterdam.

⁴ Konig, H.M., Nerlove, M. and Oudiz, G., 1981, On the formation of price expectations: An analysis of business test data by log-linear probability models, *European Economic Review*, 16, 103-138.

⁵ de Leuw, F. and McKelvey, M.J., 1981. Price expectations of business firms, *Brookings Papers on Economic Activity*, 299-314.

⁶ Nerlove, M., 1983, Expectations, Plans, and Realisations in Theory and Practice, *Econometrica*, 51, 1251-1279.

⁷ Tompkinson, P. and Common, M., 1983, Evidence on the rationality of expectations in the British manufacturing sector. *Applied Economics*, 15, 425-436.

⁸ Kawasaki, S. and Zimmermann, K. F., 1986, Testing the Rationality of Price Expectations for Manufacturing Firms, *Applied Economics*, 18, 1335-1347.

⁹ Stalhammar, N., 1988, Price and Demand Expectations in the Swedish Manufacturing Industry, *Scandinavian Journal of Economics*, 90, 233-243.

¹⁰ Buckle, R.A., Assendelft, E.W. and Jackson, L.,F., 1990, Manufacturers' expectations of price and quantities: New Zealand experience, 1964-87, *Applied Economics*, 22, 579-598.

¹¹ Marty, R., 1995, Survey evidence of the rationality of expectations.- Paper presented at the 22 CIRET Conference, Singapore.

forecasts; the hypothesis most frequently tested was the one of rational expectations. The testing of this hypothesis through the use of the results provided by market surveys requires special statistical methods because the data are qualitative and not quantitative. They have been proposed by Kawasaki and Zimmermann (see op. cit.).

Less frequently tested are other hypotheses such as the adaptive, the extrapolative and the "learning from mistakes". These models are represented in the most detailed way in the works of Nerlove¹². He used in the models not only the variables clearly represented by the results of market surveys (expectations and their subsequent realizations) but also the derivative indicators: deviation (coincidence) of realizations and forecasts; change of indicators (forecasts and realizations) in neighboring surveys. With the use of these variables, the potential of the analysis of expectations becomes significantly richer.

An analysis of the models of the formation of expectations in their classical (basic) formulations has demonstrated that they represent a solid basis for examining the specific features of the behavior of enterprises in economies in transition. First of all it regards the extrapolative models which surmise that the output forecasts are determined by the previous changes in output. Such a model can be considered as the least appropriate for the economies in transition, and it is typical for enterprises operating in conditions of a planned economy. In the days of plan, it was called "planning from the achieved level", and no demand for products was taken into account. We are suggesting to examine the extrapolative model of formation of production plans where the production plans at the

¹² Nerlove, M., 1956, Estimates of the elasticities of supply of selected agricultural commodities. *Journal of Farm Economics* 38, 496-509. Nerlove, M., 1958, *The Dynamics of supply: Estimation of farmers' response to price*, Baltimore, The Johns Hopkins Press, 1958.

moment t (Q^*t) are determined by the actual change in output at the moments t and $t-1$ (Qt and $Qt-1$).

From this point of view, it is more appropriate for the enterprises operating in economies in transition to use the adaptive model of the formation of production plans in which the plans (Q^*t) are determined by the accuracy of the realization of the preceding plans ($F(Qt, Q^*t-1)$). The accuracy of forecast $F(Qt, Q^*t-1)$ is determined according to the matrix of conjugation of the forecast of the indicator at the moment $t-1$ (Q^*t-1) and the actual realization of this indicator at the moment t (Qt). This variable is also trichotomous and thus can acquire the following values: (+) - the realization has turned out more optimistic than the forecast; (=) - the forecast has coincided with the subsequent realization; (-) - the realization has proved to be more pessimistic than the forecast. In this case, one can suggest that the accounting of the correspondence of output to demand is done indirectly through a new derivative variable - the accuracy of the previous forecasts.

In the same way, it is also possible to evaluate the model of learning from mistakes which suggests that there exists an interdependence between the change in forecasts in two neighboring surveys, on the one hand, and the accuracy of the realization of the first (earliest) of them, on the other: $((Q^*t, Q^*t-1) | F(Qt, Q^*t-1))$. The change undergone by the indicator in the course of two neighboring surveys ($Qt, Qt-1$) is determined according to the matrix of conjugation of the values of the indicator at the moments $t-1$ and t . This variable is also trichotomous; it can acquire the following values: (+) - the indicator has changed in a positive direction; (=) - the indicator has not changed; (-) - the indicator has changed in a negative direction. In this case, the demand for output can also be accounted, but again it will happen indirectly.

Of a particular interest for the researcher of the evolution of the behavior of enterprises operating in economies in transition are the models clearly involving the demand for output, especially the effective and barter demands. Such schemes are not topical under the conditions of developed market economies which suggest a sufficiently strict compliance of the manufacturers with the demand for their products, as well as the absence of its nonmonetary surrogates.

Proceeding from the analysis of the models pertaining to the formation of expectations, we have put forward some new schemes of such models which have included the variables describing actual and expected changes in the two types of demand as well as the deviations of the output from the demand. This permits to substantially increase the list of the models. In case of the extrapolative models, we offer the relationships where the formation of production plans is determined by the preceding actual changes in effective or barter demand. Such principles of the formation of production plans are apparently more progressive than the classical extrapolative model. Nevertheless, any simple extrapolation of the dynamics of demand must be admitted to be relatively primitive; it can take place at the initial stage of the transition from a planned economy to a market one. At the same time, an orientation towards effective demand must be considered as a more pro-market attitude of the manufacturers than the orientation towards barter transactions. In order to test which type of demand is more preferable for the manufacturers, we have examined the combined extrapolative model wherein the role of independent variables was played by the changes in both effective and barter demand used simultaneously.

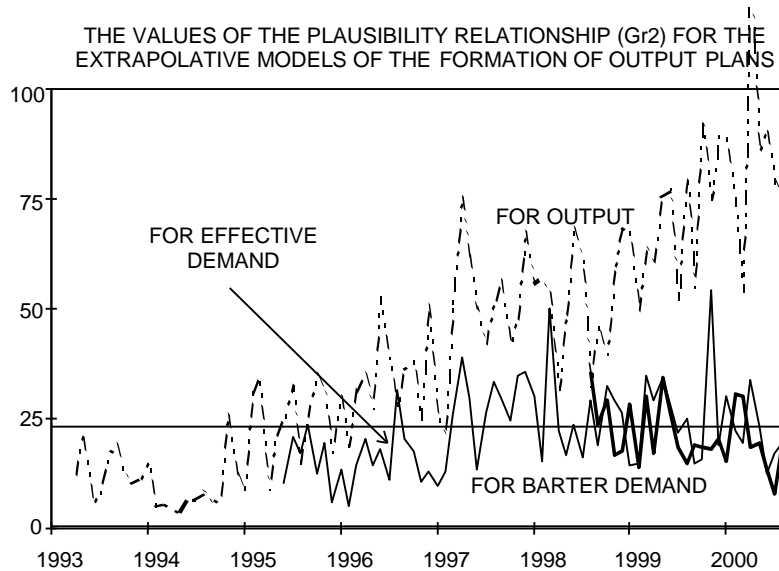
Using the classical adaptive model of the formation of production forecasts as the base, we have also formulated some new models wherein the expected changes in output were determined by the accuracy of realization of the previous forecasts concerning

effective or barter demand in relation to actual changes in output. We presume that in comparison with the basic models such adaptive models should be considered as another step towards market behaviour in case of enterprises operating in economies in transition. From our point of view, the most market-oriented type of adaptive models is the models based on the comparison of production forecasts with the subsequent actual changes of demand.

The basic formulation of the model of learning from mistakes makes it possible to offer new variants of the model including the demand variables similar to the new variants of the adaptive model. In this case, the change in production forecasts which has taken place in the interval between two neighboring surveys can be determined not only by the accuracy of the realization of the first of them, but also by the accuracy of the realization of demand forecasts and output forecasts in relation to the actual changes in demand.

As indicated by the calculations, the extrapolative model explaining the production forecasts at the points t and $t-1$ offers a sufficiently accurate description of the empirical results obtained during the period of 1993-1994. For the year 1995, the forecasts provided by the enterprises can be described by such a model only during five months out of the twelve. Since 1996, the discrepancy between the empirical and model values has been constantly increasing: Russian industrial enterprises are progressively distancing their output planning from the principle of planning "from the achieved level" (see Fig. 2.20).

FIG.2.20



The extrapolative model wherein the production forecasts are determined by the actual changes in effective demand is more "progressive" for the enterprises operating in economies in transition. In this case, the enterprises plan their output by extrapolating the previous tendencies observed in the changes of the demand level. The afore-mentioned model has been tested for the period starting from July, 1995. The quality of the adaptation of this model was the highest for the time prior to early 1997. In 1997 the discrepancies became intolerably large; the model turned out to be acceptable only in 3 cases out of 12. Later the quality of adjustment improved but it was not stable. Only in the year 2000 the extrapolative model began to better describe the formation of production plans in Russian industry.

The extrapolative model, with the actual changes in barter demand playing the role of independent variables, complements the

preceding model. An orientation toward barter demand in the formation of production plans is indicative of the nonmonetary attitudes of the manufacturers. As demonstrated by the calculations, the quality of the adaptation of the model to barter demand is at the same level as the model including the changes in effective demand. This circumstance has necessitated the use of a model that could simultaneously include the changes in both barter and effective demand. Insofar as the questions regarding barter demand have been introduced into the questionnaires only since August 1998, the model has been tested for a total of 28 months. The quality of the adaptation of this combined model turned out to be very high. As demonstrated by the coefficients of the model, the most essential influence on the output plans is exerted by the actual changes in effective demand directly preceding the moment of the formation of the forecasts. The values of these coefficients are always statistically significant. The influence exerted by the preceding actual changes in effective demand is always smaller and sometimes is not statistically significant. The influence of the actual changes in barter demand is by several times lower than the influence of effective demand, and in the past period of one and a half years it became insignificant.

Thus, the extrapolative models illustrated the evolution of the behavior typical of those Russian industrial enterprises which by the year 2000 had definitely abandoned the principle of "planning from the achieved level" traditional for a planned economy. Nowadays, the enterprises prefer to give consideration first of all to the dynamics of effective demand. As for the formation of production plans in industry, the influence of barter here has become substantially smaller.

The adaptive models of the formation of expectations suggest that the predicted changes of the indicator are determined by the

accuracy of the realization of the preceding expectations. These models include a new trichotomous variable based on the forecasts and their subsequent realizations. It can acquire the following values: 1 - if the actual values have turned out better than the forecasts; 2 - if the forecast has coincided with the fact; 3 - if the actual values have turned out to be worse than the forecasts. As in all other models, in this case the object of research is the relation between the forecasts of the changes in production and the accuracy of the preceding production forecasts (the basic model) as well as the accuracy of the forecasts of effective and barter demands. Besides, as the independent variable there has also been used the value of the accuracy of production forecasts in relation to the realizations of effective and barter demands.

The basic adaptive model has demonstrated a relative uniformity and sufficient accuracy throughout all the period of monitoring in the description of the formation of the production forecasts based on the accuracy of realization of the preceding forecasts involving the indicator in question. In the course of the years 1993-2000, no evolution was ever detected. Nevertheless, the coefficients of the model were always negative, i.e. when the actual changes were better than the preceding forecasts, the Russian industrial enterprises were not inclined to believe that these facts were true and to correct accordingly their forecasts by making them more optimistic.

This situation is repeated in the evaluation of those adaptive models where the role of the independent variable is played by the accuracy of effective or barter demands. The quality of the adaptation of these two models is comparable with the quality of adaptation of the basic model; it did not change throughout all the period of monitoring. The coefficients of the model are also negative which is also indicative of a lower trust in the actual changes in comparison with the preceding forecasts. At the same time, the

number of significant coefficients obtained is substantially smaller than in case of the basic model.

The next step in the analysis was the testing of the combined adaptive model examining the dependence of the forecasted changes in output on the accuracy of the preceding forecasts of the changes in effective demand. The quality of adaptation turned out to be relatively worse than that of the preceding ones: it was less suitable for the description of formation of industrial expectations in the years 1997-1998 and 2000. In those cases when the quality was satisfactory the coefficients were also negative. It means that the enterprises were again demonstrating their distrust in the actual changes of the indicators if the former contradicted to the previous forecasts. The number of significant coefficients for the variable describing the accuracy of the forecasts of effective demand turned out to be much smaller than of those for the accuracy of the forecasts concerning the output forecasts. The latest instance when they were significant dates back to September-October, 1998, and only once in the 60 months of monitoring they had a positive value. Then (immediately after the 1998 default) the enterprises for the first and the last time expressed more trust in the better actual changes in effective demand than in their preceding forecasts of this indicator.

The combined adaptive model wherein the role of independent variables is played by the accuracy of output forecasts, effective demand and barter demand has been sufficiently precise in describing the formation of the output forecasts since August, 1998 (when the follow-up of the dynamics of barter demand was initiated). The only exception was the end of 1999-early 2000. At the same time, the coefficients of the model point to the difference in the influence exerted by the accuracy of the applied indicators on the formation of output plans. The accuracy of the preceding forecasts continues

to exert a negative influence on the subsequent forecasts; after all, the enterprises are more inclined to trust their production forecasts than the realizations differing from the latter. The accuracy of the forecasts of effective and barter demands in case of this model is positively related to the output forecasts: while the actual changes in sales or barter transactions differed from their preceding forecasts, the enterprises persisted in forming the forecasts on the basis of realizations and thus corrected their earlier plans. The influence of effective demand on the output forecasts in this model exceeded the influence of barter transactions. Thus, the combined adaptive model points to the fact that the enterprises are reasonable enough to take into account the latest actual changes in demand when mapping their output plans.

The models of learning from mistakes suggest that the changes in forecasting during the period of time between two neighboring surveys depend on the accuracy of the realization of the forecast in the first of the surveys. Two derivative variables are used in these models: the accuracy of the forecast and the change in the forecast between two neighboring surveys. The variable characterizing the accuracy of the forecast can acquire the following values: 1 - if the actual values have turned out to be better than the forecasts; 2 - if the forecast has coincided with the fact; 3 - if the actual values have turned out to be worse than the forecasts. The second variable describing the change in the forecasts between two neighboring surveys is also trichotomous; 1 - if the forecast has become more optimistic; 2 - if the forecast has not changed; 3 - if the forecast has become more pessimistic. Apart from the basic model of the formation of production plans which suggests that the change in the output forecasts between two surveys would depend on the accuracy of the realization of the production forecasts, the research was also focused on the combined models wherein the role of independ-

ent variables was played by the accuracy of forecasts concerning various types of demand.

The basic model of learning from mistakes was sufficiently precise and stable in describing the changes in output during the years 1993-1996. Then the quality of the adaptation of the model began to worsen; the permissible values of the relationship of plausibility were becoming increasingly rare, and since the year 1999 this model has been considered unacceptable. Thus, during the past two years the enterprises have been displaying a tendency not to take into account the accuracy of production forecasts when correcting their further plans. The coefficients of the model were always positive and statistically significant which is indicative of the correction of the plans by the enterprises proceeding from the realization of the previous forecasts. If the actual changes in output turned out to be better than the forecasts, the subsequent forecasts became more optimistic. On the other hand, if the actual changes turned out to be worse than the forecasts, the subsequent forecasts were corrected so as to become more pessimistic.

The role of the independent variable was also played in the basic model of learning from mistakes by the accuracy of the forecasts of effective, barter and other types of nonmonetary demand. Throughout the period of monitoring, the Russian enterprises were taking into account the accuracy of the forecasts of effective demand in order to correct their production plans. The only lengthy period when this model was not working covered several months in the autumn of 1998 and in the winter of 1999* Apparently, the abrupt and unexpected changes in the dynamics of sales did cause a certain confusion in the principles of the formation of production plans in Russian. Then the situation normalized, and the accuracy of the forecasts as regards the sales of products for money was again being taken into account in the process of the correction of

output forecasts. The coefficients of this model were always positive and statistically significant. As far as the accuracy of the forecasts of barter demand is concerned, the model also demonstrated sufficiently precise characteristics of the quality of adaptation. Nevertheless, in half the cases the coefficients of the model have turned out to be negative, and only in three cases they have been statistically significant. Thus, the accuracy of the realization of barter forecasts does not influence properly the correction of production plans. A similar situation is also observed in case of the accuracy of the forecasts of other nonmonetary types of demand. Though the latest model has relatively good characteristics, the coefficients in most cases, again, were negative and always statistically insignificant. The testing of the combined model where the role of independent variables is played simultaneously by the values of the accuracy of all the three types of demand has confirmed the previous results. The accuracy of the forecasts concerning effective demand always exerts a positive and statistically significant influence on the correction of output forecasts. The other types of demand are not taken into account by the enterprises.

Nevertheless, as regards the combined model where the role of independent variables was played by the accuracy of the forecasts concerning output and all the types of demand, only the coefficients of the accuracy of production forecasts turned out to be statistically significant throughout all the period of monitoring. In two cases out of seven, the coefficients for the accuracy of effective demand were significant, while the coefficients for the nonmonetary types of demand were never significant. Similar results were also obtained with the model where the accuracy of forecasts was used together with the values of the accuracy of effective and barter demands. The strongest influence on the correction of forecasts was always exerted by the accuracy of the proceeding output forecasts, and

much more seldom by the accuracy of the forecasts of effective demand, while the accuracy of the forecasts concerning barter demand has never played any role. Thus, the correction of the output forecasts in case of the combined model of learning from mistakes is determined first of all by the accuracy of the proceeding forecasts of this very index. In the second place is the influence of effective demand. The accuracy of the forecasts of nonmonetary types of demand does not influence the correction of the output forecasts.

The problems of monitoring the competitive environment in Russian industry

In 2000 the state policy as regards competition was characterized by the same general features as in the preceding years. The Ministry of antimonopoly policy and support for entrepreneurship (MAP of the RF) was solving its traditional set of tasks. The control over competition and monopoly activity was based on monitoring the observance of the antimonopoly legislation and was essentially limited to the follow-up of the cases of a misused dominance on the markets; of competition-limiting agreements; of the decrees and activities of the power structures aimed at limiting competition, etc. The basic changes in the competitive environment within Russian industry after August 1998 were left beyond the MAP's field of vision and had little influence on the priorities of the state policy as regards competition. The reason for this, in our opinion, lies in the limited set of approaches to and the indices of measuring competition, as well as in the lack of the mechanisms for determining these priorities. In fact in Russia there is no system for monitoring the competition levels on the sales markets which could have served as a means to efficiently follow-up the changes as regards competition in a dynamically developing economy in transition. At the same time, the approach to measuring competition by the re-

sults of surveys involving managers of enterprises that have been for a few recent years developed by the IET allows to make a considerable step forward in the study of these phenomena and to provide a better grounding for the state policy as regards competition¹³.

The traditional methods for measuring competition and the suggested directions for their development have a number of serious drawbacks. Firstly, they utilize only one of the possible characteristics of competition and are not able to encompass the multidimensional scope of the phenomenon under study. Secondly, the ways available for improving the currently employed methods are deficient because of the existing serious limitations in methodology and information techniques that are either unlikely to be overcome or their elimination will require considerable material resources and time. Thirdly, the currently applied methods for estimating competition cannot account for the role of the competition with the imports, the latter being very interesting under the conditions of the Russian economy, with the existing possibilities for import substitution. Fourthly, the methods for estimating competition actually employed by the MAP of Russia and the new proposals of the State Statistics Committee of the RF are not efficient enough and could not reflect the consequences of the 1998 financial crisis. Fifthly, the possible improvement of competition monitoring techniques does not solve the problem of obtaining the aggregate competition estimates at the levels of sub-industries, industries and Russian industry as a whole. Sixthly, the development of competition monitoring techniques within the framework of the traditional statistical approach has a number of serious limitations and cannot provide

¹³ Tzykhlo S.V. Evaluation of Competition in Russian Industry. The Advantages Offered Surveys Targeting the Managers of Enterprises // *Voprosy Statistiki*. - 2000. - N 11.

comprehensive and reliable data on the competitive environment within Russian industry.

The competition monitoring based on regular surveys conducted by the IET and involving the largest and the most representative panel of managers has a number of obvious advantages. Firstly, surveys provide the opportunity to collect the data on a very wide range of parameters dealing with competition but not expressible in quantitative measures. Secondly, the collection and analysis of a large volume of detailed technical and economic data thus becomes unnecessary - this problem is solved individually by each of the enterprises participating in a survey. Thirdly, this is the only possible way for obtaining aggregate estimates of the competition levels on the real sales markets of industrial enterprises. Fourthly, this is the only possible way to obtain comparable estimates of the competition inside the Russian economy and the competition with the imports. Thus, competition monitoring based on regularly conducted surveys provides essentially new statistical data on competition, in a timely fashion and at any aggregation level.

The competition level monitoring on the sales markets of Russian industrial enterprises that has been carried out by the IET since 1995 has provided the evidence that Russian enterprises, on the whole, experience the greatest competition on the part of other Russian enterprises (see Fig. 2.21). The competition with the manufacturers from the far abroad is in fact much weaker than the competition inside Russia. And the last place in this line is occupied by the goods supplied from the near abroad. The absolute average competition level in industry remains low. The estimates of the competition inside Russia are staying somewhere between the “moderate” and “weak” levels. The competition with the goods from the far abroad does not differ greatly from the “weak” level, and that with the near abroad does not exceed this level. During the

year 2000 the competition level inside Russia did not demonstrate any great fluctuations. The most marked changes of the competitive environment in industry took place in the sphere of the competition with the imports: the general competition level here went down almost to an absolute minimum.

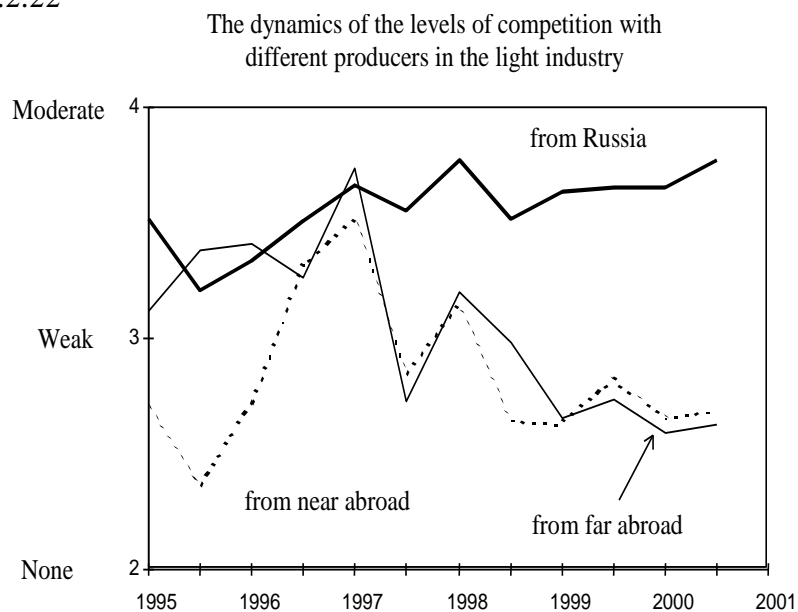
FIG.2.21



The competition inside Russia on the whole during the 5.5 years of monitoring (this question is asked twice a year) has remained the strongest for the enterprises in all branches. Even the enterprises in the light industry which are traditionally regarded as those most strongly suffering from imports only in three cases out of eleven placed the competition with the manufacturers from the far abroad at a higher level than that inside Russia. For the last time such a ratio was registered in the first half of the year 1997 (see Fig.

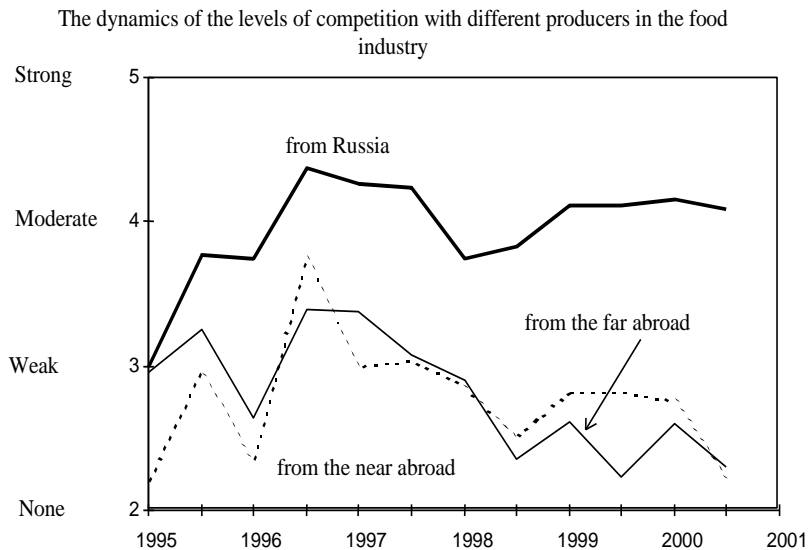
2.22). But even then the absolute value of the competition index was 3.74, i.e. did not even reach the “moderate” level. Since then, the index went down to 2.59 and was demonstrating almost no changes throughout the year 2000.

FIG.2.22



The average excess of the branch-by-branch competition index inside Russia over the index of the competition with the far abroad in the light industry for a 5-year period is 0.53. This is the minimum excess value among all the branches. The maximum average difference was obtained for the food industry (1.15). In this branch the estimates of internal Russian competition have lately been fluctuating around the "moderate" level, and the competition with the far abroad is gradually approaching the "none" level. In the second half of the year 1999 the gap between the indices was 1.88 which represents a maximum value.

FIG. 2.23



The most stable competition level is seen on the sales markets of machine-building enterprises. During the 5 years under study, the competition estimates inside Russia were fluctuating within the interval of 3.25 to 3.75, and those of the competition with the manufacturers from the far abroad - 2.28 to 3.08. The mean excess value of the domestic competition index was 0.51. The 1998 crisis produced a negligible influence over the competition on the sales markets of machine-building plants (see Fig. 2.24). The level of the competition with the imports has been demonstrating a stable enough fluctuation around the "weak" level. Since April 1999 the machine-building industry has experienced a growth of the competition inside Russia, by April 2000 its index had reached an absolute maximum and then showed a negligible decrease. However even in this case it has been just approaching the "moderate" level from below.

FIG.2.24

The dynamics of the levels of competition with different producers in the machine-building industry

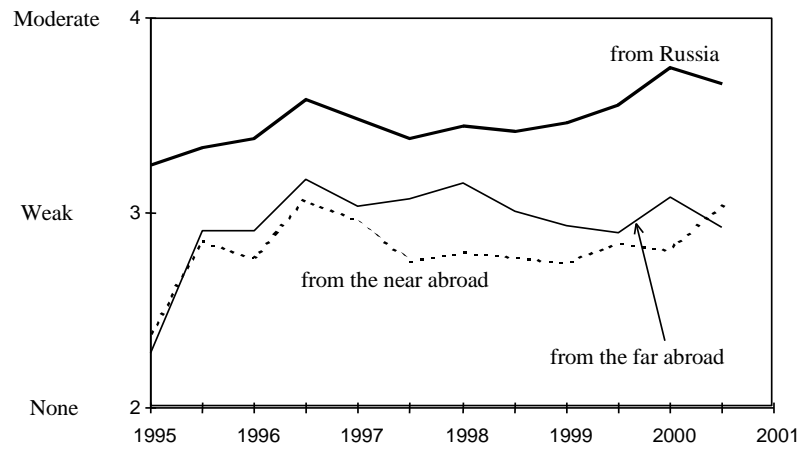
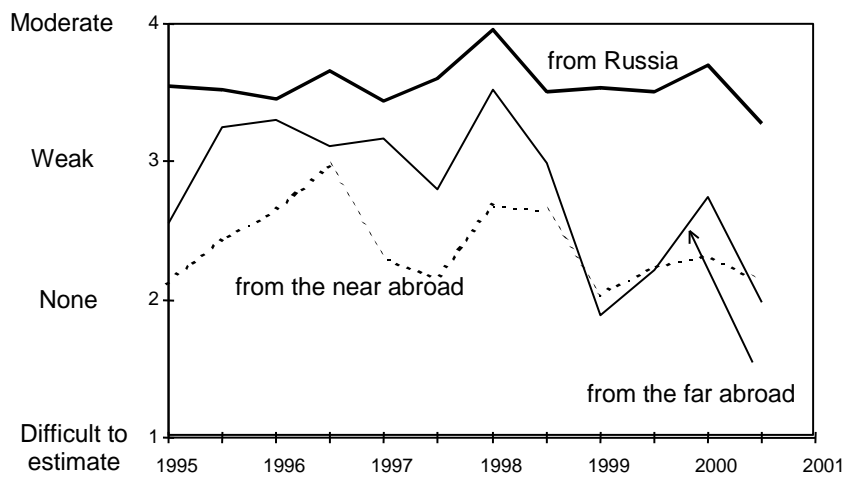


FIG. 2.25

The dynamics of the levels of competition with different producers in the timber and w/w industry



The most noticeable fluctuations of the competition indices were observed on the sales markets of the enterprises in the timber, woodwork, and pulp and paper industries. Between April 1998 and April 1999 the estimates of the competition with the manufacturers from the far abroad fell from 3.52 to 1.89 and are now at the "none" level. After that, during two successive half-years the surveys were demonstrating a rise in competition. The peak value of the post-crisis competition was registered in April 2000. In the second half of the past year the competition with the imports in this branch again disappeared: the producers believed that it could be estimated as "none".

The calculations on which the diagrams 5-9 are based involved all the competition estimates obtained during the surveys, including the responses "difficult to estimate" and "none". The analysis of the share of these responses, in our opinion, has an independent value because it represents the share of those enterprises on whose sales markets there exists no competition. The section on the competition inside Russia contains the smallest number of the responses "difficult to estimate", a maximum of 12%. On the average, the share of the estimated sales markets where some domestic competition can be registered constitutes 93% (see Fig. 2.26). Thus, 7% of the enterprises offered no estimates as regards the competition inside Russia. The leading values of this estimate are represented by the electric power and fuel industry where the share of the responses "difficult to estimate" in a total of 12 surveys was 18% and 13%, respectively. The minimum numbers of uncertain estimates were obtained from metallurgical enterprises: 4% in ferrous and 5% in non-ferrous metallurgy. Possibly, the limited number of large enterprises and the highly organized markets minimize the information uncertainty in these branches.

FIG. 2.26

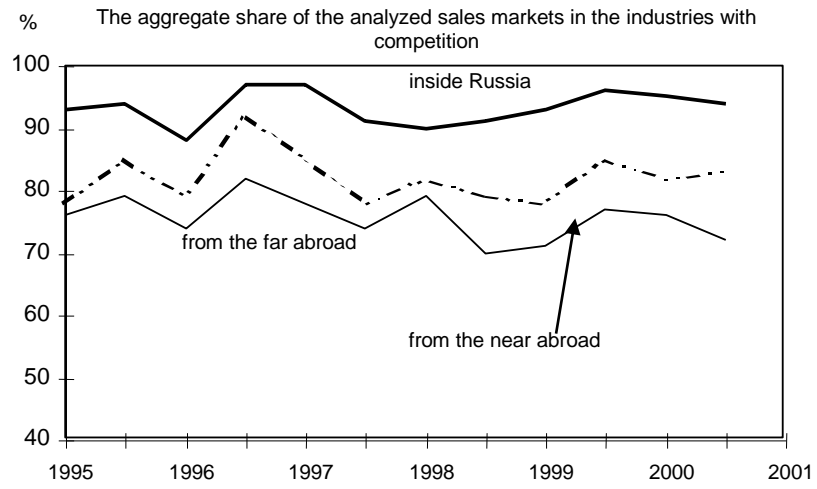


FIG. 2.27



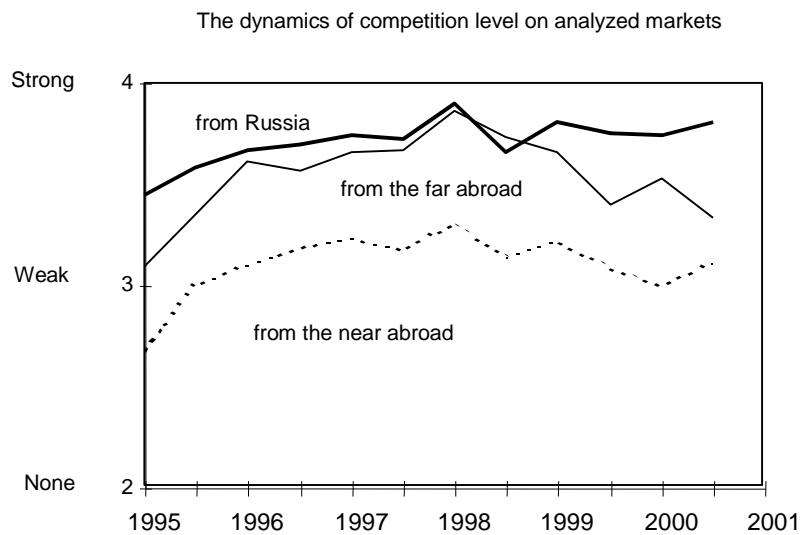
The greatest number of problems is associated with the estimates offered by Russian enterprises as regards the competition with the far abroad. On the average, 24% of the enterprises could not estimate their competition with the imports. In October 1998 the share of such responses was as high as 30%. This type of competition is most rarely encountered by the enterprises in the construction materials producing industry where the share of the responses "difficult to estimate" constitutes 45%.

The share of the competitive markets in Russian industry is considerably smaller than that of the analyzed ones (see Fig. 2.27). When estimating the competition inside Russia, the fact of entering the competitive markets "withdraws" another 13% of enterprises out of the estimates, when estimating the competition with the far abroad - 21%. As a result, an average of 20% enterprises in industry as a whole never encounter any domestic competition, 45% - the competition with the manufacturers from the far abroad. The same branches remain the leaders in terms of lack of competition: in the electric power industry 69% of enterprises feel that they have no competition inside Russia, and 96% - no competition with the far abroad, in the fuel industry - 47% and 82%, respectively. The definite lack of competition inside Russia has helped non-ferrous metallurgy to become the third on this list, as 35% of enterprises in that branch experience no competition or never even think of it. Absence of any competition with the far abroad was reported by 86% of enterprises in the construction materials producing industry.

Now we are going to consider the aggregate competition indices for the analyzed markets, i.e. the markets where the competition could be definitely estimated by Russian enterprises. In this case only four possible answers will be utilized for the calculation: "strong", "moderate", "weak", "none". The dynamics of the competition levels on the analyzed markets has also demonstrated a preva-

lence of the competition inside Russia (see Fig. 2.28). Besides, the values of the aggregate index have shown a slight upward shift, though still remaining below the “moderate” level. The values of the aggregate index of the competition with the far abroad have increased to a much greater degree and as a result are now obviously approaching those of the level of the competition inside Russia, in October 1998 rising even above this level. It should be noted however that the cumulative estimates of the competition with the imports went down at the end of the year 1999 and in the year 2000 they declined almost to the absolute minimum. The considerable upward shift of the aggregate index of the competition with the goods from the far abroad can be explained by the fact that when estimating this area of competition the greatest majority of Russian enterprises choose the response “difficult to estimate” (20-30% of the responses). In the estimates of the competition inside Russia the share of such responses constitutes 4-7%.

FIG. 2.28

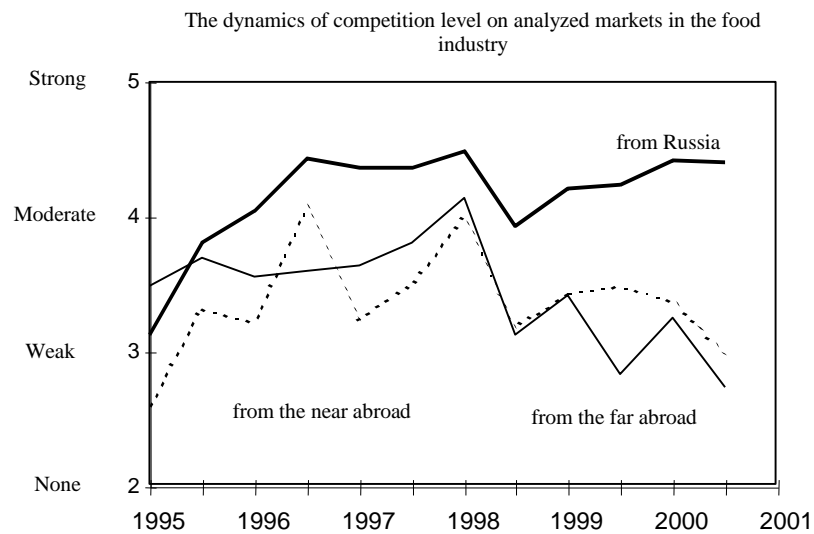


The branch-by-branch competitions estimated have shown similar changes in the machine-building, chemical, petrochemical, timber, woodwork, and pulp and paper industries. Certain peculiarities characterize the results obtained in the light and food industries. In the former, the competition with the far abroad was found to exceed that inside Russia in the period of 1995-1998 and was staying at the level of that inside Russia only during the year 1999. In the first half of the year 2000 the cumulative estimates of the domestic competition and the competition with the far abroad in the light industry closely converged at the "moderate" level. Later surveys demonstrated a growth in the level of the competition inside Russia which by the end of the year 2000 reached an absolute maximum. As for the level of the competition with the imports, it became noticeably lower - almost to the point of an absolute minimum. In the food industry, the competition inside Russia on the estimated markets remained at a higher level almost during the whole monitoring period. The only exception was represented by the survey in April 1995 when the question concerning the competition level was for the first time included in the IET questionnaire. Beginning with the second half of the year 1998, the difference of the domestic competition became quite dramatic, mostly due to the absolute lowering of the level of the competition with the goods from the far abroad. At the end of 2000 the gap reached a maximum (see Fig. 2.29).

Thus, on the analyzed markets the levels of the competition inside Russia and the competition with the imports have demonstrated a far smaller difference than on all the markets of the Russian enterprises. The peculiarity of the analyzed markets in our case is represented by the fact that Russian producers have a definite knowledge of the presence or absence of the goods supplied by other producers, and when such products are present on the market, are

able to estimate the degree of competition. These markets have been sufficiently investigated by the producers, as well as the positions of the producers from the far abroad on these markets.

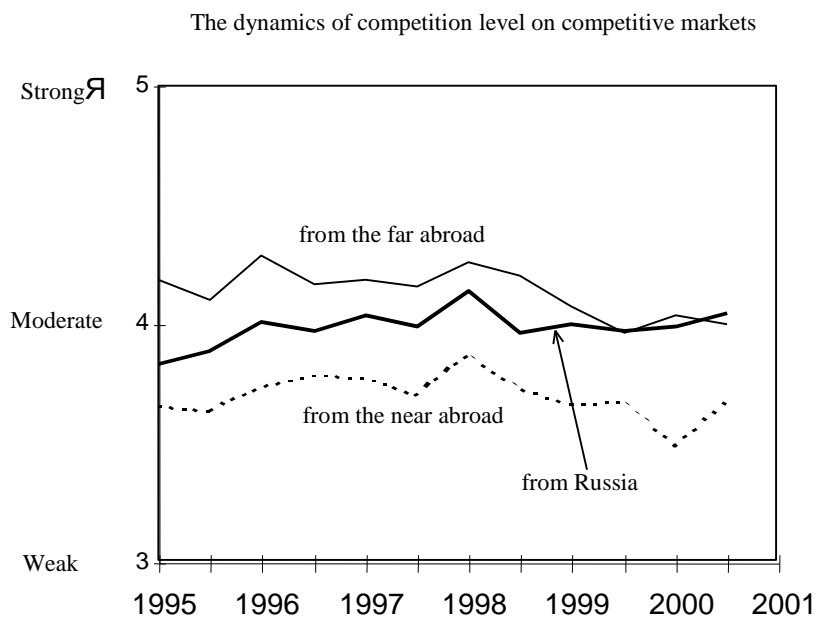
FIG.2.29



The next category of markets is the competitive markets. These are the markets where the producers not only have the knowledge of one another's absence or presence, but also quite obviously compete among themselves. From the point of view of the government, it is these markets that must be investigated in terms of protecting the domestic producers, and the task of creating a competitive environment there is less important. However the situation on such markets must also be under the state control, for the means applied in the competitive struggle to remain within the limits of the law or other regulations. The selection of those markets where the means applied in the competitive struggle have gone beyond the authorized scope and begun to destroy both the industrial potential and the competitive environment itself is also possible, through the

surveys involving the managers of enterprises and conducted by an independent (non-government) body.

FIG. 2.30



The estimated aggregate indices of competition on the competitive markets have demonstrated that the competition inside Russia was lower than the competition with the imports until the second half of 1998, when the estimates became close (see Fig. 2.30). The higher level of the competition with the imports until August 1998 was noted by the enterprises in all branches except for the food industry where the competition inside Russia since 1996 had always been higher than that with the producers from the far abroad. The financial crisis lowered the level of the competition with the imports in all branches. However the competition inside Russia at the level of a single branch remained in fact unchanged. As a result, the post-

crisis competition ratios have depended on the estimated reduction of the competition with the far abroad.

In machine-building and in the light industry the cumulative estimates of the competition with the far abroad did not go below the estimates of the competition inside Russia. At the same time it should be specified that in the light industry the decrease in the competition with the imports had its onset in the second half of the year 1997 and continued until early 1999 when for the only time since the beginning of monitoring it reached a level slightly below that of the competition inside Russia. Then it began to grow, and in the first half of the year 2000 the competition with the far abroad became noticeably higher than that inside Russia (see Fig. 2.31). At the end of the year the competition levels became equal.

The strongest impact of the 1998 financial crisis on the level of the competition with the imports was felt in the timber, woodwork, and pulp and paper industries. The cumulative estimates level fell from 4.70 to 3.72. Until the second half of 1998, the competition with the far abroad had always, and considerably, been higher than that inside Russia. By April 1998 the accumulated difference in the estimated had reached the value of 3.14 which became an absolute record; the value next in magnitude was obtained for the light industry (2.63). The minimum estimates of the competition with the enterprises from the far abroad were registered in early 1999, after which this index began to grow; in the first half of 2000 it became equal to that of the competition inside Russia and then again went below the latter (see Fig. 2.32)

As of the beginning of the year 2000, the highest level of domestic competition on the competitive markets was registered in the food industry, its cumulative values being somewhere mid-way between the “strong” and “moderate” estimates. The level of the competition with the far abroad in this branch was, on the contrary, the lowest among the branches (see Fig. 2.33).

FIG. 2.31

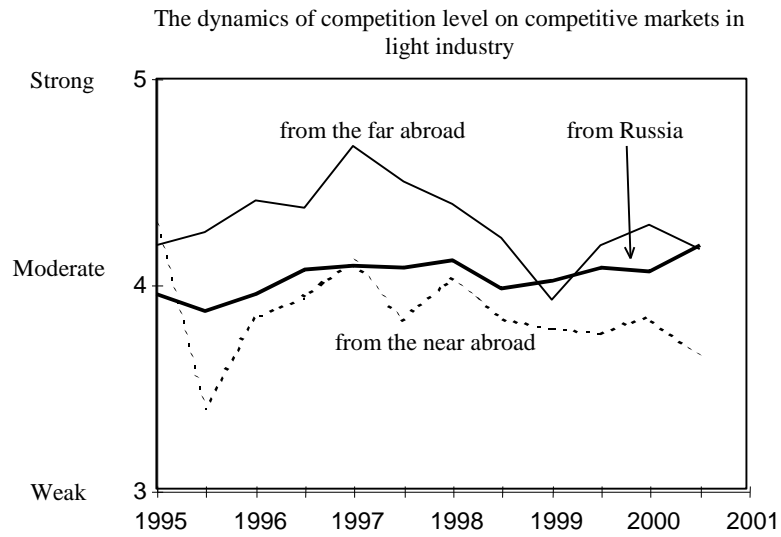
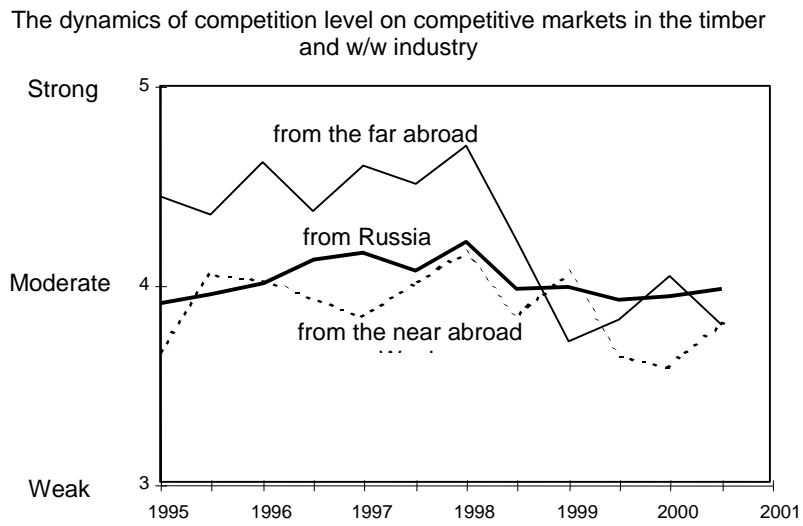
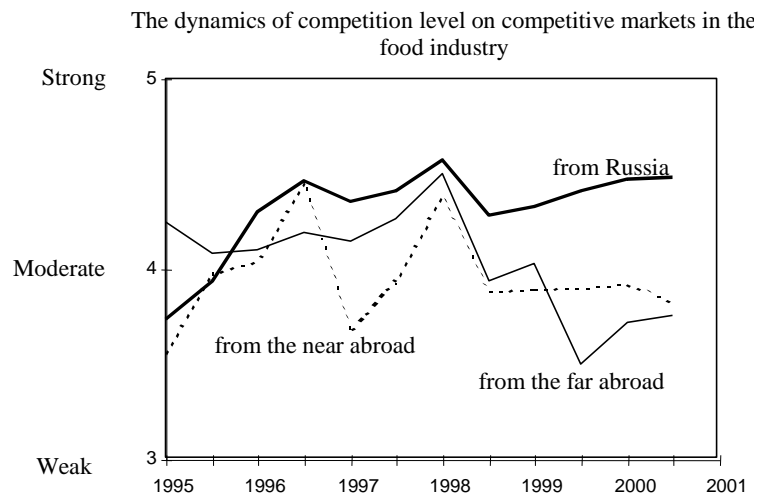


FIG. 2.32



Thus, on the markets penetrated by the producers from the far abroad the Russian enterprises have been experiencing the strongest competition. Its level in most cases is higher than that of the competition inside Russia. The exceptions have been represented by the food industry and - after August 1998 - the chemical and petrochemical industries. The 1998 financial crisis brought down the heat of the competitive struggle with the producers from the far abroad only for a short time. By 2000, the level of the competition with the imports again became higher than that of the domestic one. At the same time, according to the enterprises in all branches, the presence of competitive imports on the sales markets of Russian industrial enterprises was reduced to a negligible degree. In April 1998, the domestic producers were facing (competing with) the producers from the far abroad on 65% of their markets, in October 1998 this figure went down to 55% and remained practically unchanged until early 2000.

FIG. 2.33



The priorities of the state policy as regards competition

The implementation of the state policy as regards competition under the conditions of an economy in transition has been associated with objective difficulties conditioned by the relatively short history of the formation of the competitive environment, the rapid rate of the economic processes and the weakness of the traditional system for competition monitoring. The price of a possible error in the development of the priorities for the state policy in the field of competition might turn out to be too high for the emerging market economy in Russia. Under these conditions, the investigation of the real situation in the sphere of the generating competitive environment in Russian industry can become an important empirical aid for the development of the instruments of the economic policy.

The question pinpointing among the factors regarded by the theory of economics those that are responsible for the formation of the real competitive environment has been in fact ignored by the researchers. The reason for this is the lack of the statistical data needed for the description of both the competition level and the factors on which this level might depend. Besides, it should be borne in mind that it is difficult in principle to offer any adequate statistical measures for some of those factors, and they can be described only at a qualitative level. However the issue of the eventual influence which the agreements between producers on pricing policy or market sharing arrangements exert on the competition level still remains important for the economic analysis.

In order to investigate the impacts of various factors on the formation of the cumulative (generalized) competition level in Russian industry in December 2000, the managers of industrial enterprises participating in the regular surveys of the current situation conducted by the IET were offered a number of questions on the trend and the strength of the influence exerted by the main factors, as specified by the theory of

economics and utilized in the official documents issued by the MAP of the RF¹⁴, on competition. The list of factors included: a) the level of production concentration; b) the level of demand satisfaction and the scope of redundant production capacities; c) pricing policy and market sharing arrangements; d) the volume of transportation costs; e) the problem of the search for suppliers and consumers for a new producer; f) the administrative protection of markets; g) the problem of exit from markets; h) the presence of potential competitors. Most of the factors examined have either no adequate statistical indices or no reliable statistical base. The enterprises were requested to evaluate the influence of each of the factors on the aggregate competition level by its trend (strengthens or weakens) and the strength of influence (considerably, moderately, negligibly, none, difficult to estimate). Here it was presumed that each factor may both strengthen and weaken the competition on particular sales markets. For example, administrative protection can be present on a small number of a producer's markets, and its influence is relatively low. But on the majority of the markets entered by the same producer there are no such barriers; it results in an unlimited movement of goods and services and, naturally, strengthens the competition. In the final analysis, we have the ultimate influence of every particular factor on the aggregate competition level. The statistical processing of survey results is rather simple and essentially consists in ranging the responses obtained and subsequent arithmetic manipulations with the latter. The responses were received from more than 900 enterprises.

The questions on both the strengthening and the weakening influence of each factor make it possible to obtain the resulting estimates of the influence of these factors on the aggregate competition level. This

¹⁴ The schedule for conducting the analysis and the evaluation of the state of the competitive environment on commodity markets (the ed. of the Order of the MAP of the RF, March 11, 1999, N 71). Approved by the Order of the MAP of the RF of December 20, 1996, N 169.

estimate is calculated by subtracting the mean negative influence value from the mean positive influence value. The resulting positive values of this derivative index represent those factors that positively influence, in the final analysis, the competition level, and the negative values represent the negative influence.

TABLE 2.14

The resulting influence of various factors on competition level, with different estimation intervals utilized

Factors	[1,5]	[1,4]	[1,3]
The concentration of production level	-0.12	-0.17	-0.17
Degree of satisfaction of demand	0.03	0.13	0.18
Pricing policy and market sharing arrangements	0.40	0.21	0.21
Transportation costs	-0.26	-0.33	-0.21
Search for suppliers and consumers	-0.65	-0.44	-0.20
Administrative protection of markets	0.29	0.26	0.08
Exit from markets	0.24	0.26	0.19
Potential competitors	0.19	0.15	0.03

Note. The estimation interval [1,5] means that the calculations were based on all categories of responses (considerably, moderately, negligibly, none, difficult to estimate). The interval [1,4] means that only four responses were utilized (considerably, moderately, negligibly, none). The interval [1,3] means that only three responses were utilized (considerably, moderately, negligibly).

The factors included in the questionnaire demonstrated a distinct and persistent division into two such groups. The first group (positive influence on competition) contains five factors: the degree of the satisfaction of demand and the availability of redundant capacities, pricing policy and market sharing arrangements, administrative protection of markets, the problem of exit from markets, the presence of potential competitors. The second group (negative influence) included three factors: the concentration of production level, the volume of transportation costs, the problem of the search of suppliers and consumers for a new producer. The degrees of the positive and negative influences of all the investigated factors on the competition in Russian industry are shown in Table 2.14.

The results obtained have outlined the priorities of the policy as regards competition in Russian industry. Firstly, the main obstacle to the de-

velopment of competition as specified by the producers is the problem of the search for new suppliers and consumers on new sales markets. This cause exerts a negative influence on competition in all branches of industry. The inhibiting effect of this factor is especially great in metallurgy and the construction materials producing industry. The smallest number of such problems is encountered in chemical and petrochemical industries, but even there the influence of the factor in question is negative, when the whole spectrum of estimates is taken into account. For this there can be several reasons. On the one hand, during the relatively short period of market economy formation it is objectively impossible to create a well-developed information infrastructure which could allow the producers to investigate their potential sales markets, to find and make contacts with new contractors. On the other, Russian enterprises probably still prefer to deal with time-tested suppliers and consumers because the habitually low standards of contract relations and the long experience of operating within a non-payments economy make them avoid new partners, however promising. The goals of the state in this field obviously should be concerned with the creation of high-quality market-information infrastructure and promotion of high standards of business relations (primarily those regarding the execution of personal obligations).

Secondly, high transportation costs are regarded by the enterprises as a serious obstacle to competition. The strongest negative influence exerted on the competition by the transportation component in the enterprises' total costs is observed in the construction materials producing industry, timber, woodwork, pulp and paper industries and in metallurgy. As transportation tariffs are set by the state, the diminution of the negative influence of this factor to a considerable degree depends on the activity of the government not only regarding tariff-setting but also in the restructuring of the transport infrastructure.

The most moderate negative influence on the competition level is exerted by the degree of concentration of production. At the branch level, this

factor does not inhibit competition in every branch. In the light and food industries, as well as in the construction industry the degree of concentration of production exerts a positive rather than a negative influence. An excessively high concentration of production has a definitely negative influence only in the metallurgical, chemical, petrochemical and machine-building industries. This fact proves that despite the MAP's attention traditionally paid to this problem there still exists a vast potential for its activity, and the problem of monopolism has not lost its importance.

The strongest positive influence on the competition level, in the final analysis, is exerted by the numerical weakness or low efficiency of producers' agreements on pricing policy and market sharing arrangements. This factor is perhaps the most delicate one among those dealing with the problem under study. However, considering the trustful character of the relations with the respondents and the sufficiently neutral wording of the question, it can be presumed that the respondents' answers to the IET's questionnaire are closest to the truth. The transition period and the stage of primary capital accumulation have left their imprint on the behavior of domestic producers: so far they have preferred to oust a competitor rather than to make a deal with him. The leaders in competition intensification caused by the hostility to compromises were the metallurgical, chemical and petrochemical industries. Most probably, the influence of the "lack of agreements" factor in these branches will be decreasing over time (i.e. as the relations become more civilized). At the branch level the considerable positive influence of the lack of agreements has been registered in all the branches except the light industry. In this latter case the negative value is small, therefore we can speak rather of a zero influence of this factor on the competition inside every branch.

The absence (or low effect) of the administrative protection of the sales markets holds the second place as regards the strength of the positive influence on the competition level. This factor has a positive influence on competition in all branches. It can be supposed that the active struggle

against market regionalization and the traditionally Russian disregard of the law have borne their fruit: the producers now have a united national sales market where the movement of goods can be limited only by the transportation costs and not by administrative barriers.

The difficulties associated with exit from markets (withdrawal of assets) in order to build up production in a more attractive sector are in the third place as regards the strength of the positive influence on competition and are only slightly less important than the former factor. However this circumstance hardly deserves a positive estimate. It is true that enterprises believe that in the present situation it is difficult to liquidate a non-competitive production. They are forced to continue to produce non-competitive goods thus "littering" the market with unsaleable and uncompetitive products and wasting resources, whereas on other markets these same resources could have been used for normal production. This situation has two negative consequences. On those markets wherefrom the assets cannot be withdrawn the producers have to solve the sales problem by means of dumping prices, barter and non-payments. As a result, the "normal" producers encounter problems. They partly lose their market and profits, as well as the assets that could be used for the development of production and the expansion of the output of competitive goods. On the markets where this capital has no access, the consumers suffer because they have a more limited choice of goods and brands, and are forced to pay higher prices than they would have paid in a situation of free capital flow. However the last circumstance is not so important in the present situation in Russia because the existence of a large volume of idle capacities (redundant as regards the current effective demand) compensated for the obstacles on the way of capital flow.

The high satisfaction of demand, the existence of excess capacities and potential competitors who are able to rapidly enter attractive markets, are in the last place on the list of the factors that have a positive influence on the competition in Russian industry. It is understandable that the appearance

and importance of these closely related factors are associated with the decreasing production during the post-Soviet period, low-scale utilization of production capacities and the existence of a large number of enterprises looking for the sales markets. It can be presumed that over time the volume of idle competitive capacities will be reducing, and the competition-strengthening influence of this factor will decrease. In a branch-by-branch analysis, the high satisfaction of demand increases the competition most of all in the chemical and petrochemical industries. The presence of potential competitors matters in the light and food industries.

In the final analysis, in the real economic situation of 2000-2001 the factors studied have been producing a positive influence on the competition level in Russian industry as a whole. However there are still no sufficient grounds for classifying the policy implemented by the state as effective. The real competitive environment is mostly evolving under the influence of the factors that are beyond the competence (the scope of responsibilities) of the antimonopoly body. Neither the high satisfaction of demand, nor the problems associated with exiting the markets, nor the presence of potential competitors are the results of the activity of the MAP of the RF. Also, the lack of agreements among producers can hardly be regarded as a consequence of the Ministry's activity because it is very difficult and time-consuming to reveal those instances when such arrangements have been achieved. So far the MAP of the RF has probably had neither the time nor the experience necessary for investigating such agreements, except those that are very simple and crude and are presumably no more employed by the ingenious Russian business. The only merited achievement of the Ministry confirmed also by producers is the absence of administrative protection on the regional markets. As for the negative influence on competition exerted by the concentration of production and by transportation costs, it should undoubtedly become the main concern of the MAP of the RF in the nearest future.

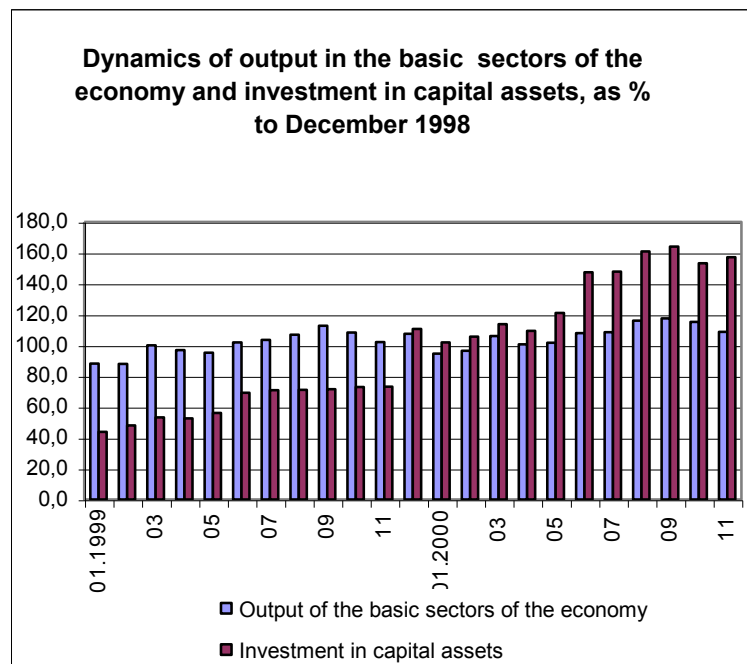
2.3. Investment processes in the industrial sector

In 2000 the volume of investment from all the sources of funding amounted to Rb. 1,165.2 bln. and grew by 17.4% compared with its respective period of the prior year. During the year there was a stable trend to the advanced growth in investment in capital assets against the dynamics of GDP and output in the basic sectors of the economy. The proportion of investment in capital assets in GDP rose from 16.8% vs. 14.6% in 1999. The raise in investment activity in 2000 was accompanied by the growth in demand for construction services and capital goods. While comparing with 1999, the volume of works completed by construction companies grew by 11.5% and accounted for Rb. 530.3 bln., the gross output in the machine-building sector rose by 15.5%, and that of the industry of construction materials – by 7.6%

The raise in investment activity was accompanied by a change in the structure of financing of investments. With the growth in effective demand, practically all the sectors of the economy have improved financial indices of their performance. Since 1999 the structure of financing of investments has demonstrated the trend to a systematic raise in accumulation. The proportion of the accumulation fund in enterprises' own investment resources rose by 20.5 percent points compared with 1999. With the growth in the production profitability rate, the correlation between enterprises' own and attracted funds experiences changes. Let us note that in 2000 the raise of demand for investments found itself under a positive influence of the change in the structure of settlements between enterprises. With the growth in the share of monetary means in settlements for the produce and services delivered and enterprises accumulating their funds in liquid form, there is the emergence of investing in a form of mutual credits in place. In 2000, the share of

borrowed funds in the structure of sources of financing of investment in capital assets rose at 1.6 percent points against its respective period of 1999.

FIGURE 2.33



Source: Goskomstat of RF

The inflow of external funds is closely correlated with the profitability dynamics. Whilst comparing with 1999, the share of attracted funds increased by over 6.3 percent points, however, with the share of banking credits in the structure of investment sources declining continuously. The latter is attributed to the remaining high risks, the absence of transparent schemes of the respective recipients' operations and collateral mechanisms, an insufficient legal

protection of operations on the investment market, and the absence of investment financial institutions.

TABLE 2.15

**Structure of investment in capital assets
by their sources, as % to result**

	1997	1998	1999	2000
Investments in capital assets	100	100	100	100
Including by sources of funding:				
Own funds	60,8	53,2	52,4	46,1
Of which				
Accumulation fund	13,2	13,2	15,9	23,4
Attracted funds	39,2	48,8	47,6	53,9
Of which				
Banking credits	4,5	4,8	4,2	2,9
Capital borrowed from other organizations	2,6	4,3	5,6	7,2
Budget fundsa	20,7	19,1	17,0	21,2
From the federal budget	10,2	6,5	6,4	5,8
From the budgets of the Subjects of the Federation	10,5	12,6	9,6	14,8
Extrabudgetary funds' resources		10,8		3,8
Others		7,2	12,2	17,8
Of which the funds from stock issuance		0,4	0,7	0,5

Source: Goskomstat of RF

Whilst evaluating the investment dynamics in the real sector between 1999 to 2000, it should be noted that the raise of business activity in the national economy to a significant extent was generated by an intensive development of the industrial sector. Over the last two years the investment structure across industrial and production complexes underwent substantial changes. Given that between 1997 to 1999 the investment structure in the sector was changing

thanks to the raise in the proportion of the consumer and metallurgical complexes, and chemicals and forestry, the growth in investment activity in the fuel sector between 1999 to 2000 became a crucial factor determining the change in investment flows across the sectors of the economy.

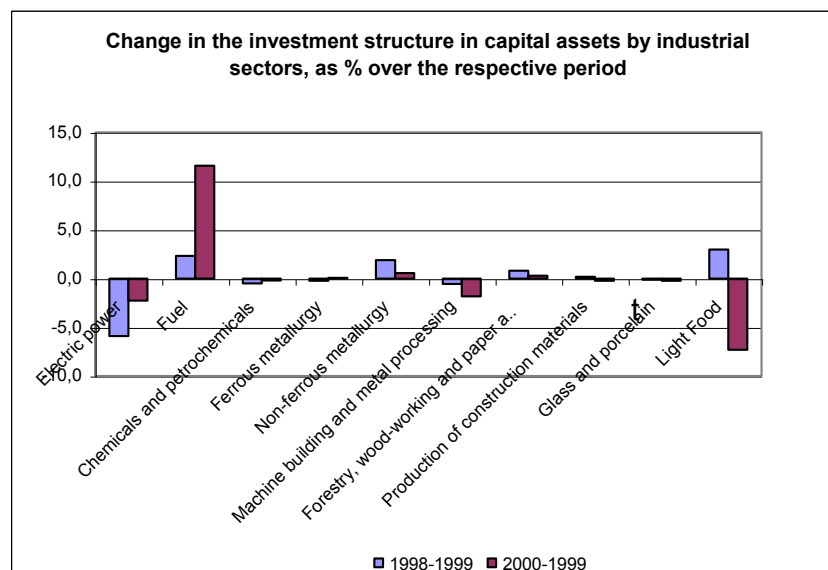
It was the fuel sector that in 2000 became a leader among other industry branches and in the economy on the whole in terms of the investment magnitude. The investing in mining industries has generated a string multiplying effect of renewal of demand for capital and intermediary goods. Whereas the production capacity of the mining industries is oriented primarily to the market for domestic capital goods, that initiated an accelerated raise in output in the respective sectors of the machine-building and metallurgical complexes.

The changes in the structure of machine-building output were determined chiefly by the growth in demand on the part of the industry branches of the oil sector, transport, and communication. It was these sectors that in 2000 reported the highest growth rates in investments in production.

The oil sector reported the placement into operation of over 3,000 new oil wells in 2000, while, however, 68.3% of the aggregate increment in oil output nationwide was ensured by the placement into operation of earlier idle wells. While comparing to 1999, the oil companies' volume of operative drilling rose at 67.5%, while the volume of prospecting drilling- at 27.8%. The raising investment demand on the part of oil companies induced the acceleration of the rate of output of the equipment for extraction of hydrocarbon minerals. Despite an intensive raising of output of equipment for the national oil sector, its insufficient volume and a non-rational structure of its output did not allow a complete satisfaction of the increased demand on the part of operative drilling. At

the same time, on the other hand, it is also insufficient investment that appeared the factor inhibiting the output growth rate.

FIGURE 2.34



As concerns the machine- building complex, its investment activity remained at a low level. Comparing with 1999, the share of investment in machine building and metal processing in the overall volume of capital investments in the industrial sector slid by 1.8 percent points.

Lacking a modern domestic machine-engineering base, the enterprises increase their costs for purchasing import second-hand machinery and equipment as a component of their overall investment costs. In 1999 the respective volume of investing in capital assets by this particular item were raised 2.7 times. In 2000, investments in import equipment of enterprises and organizations (exclusive of small entrepreneurs) accounted for Rb. 48.7 bln., or 22.9% of the total amount of investment in machinery, equipment,

devices and instruments. At the same time the demand for second-hand equipment also grew on the part of enterprises of consumer sector that traditionally are oriented to the market for import equipment and enterprises of the sector for non-ferrous metal, wood-working and forestry sectors whose investment programs usually were based on the domestic production of capital goods.

The import of second-hand equipment, introduction in production of morally obsolete production capacities and expansion of the sphere of capital repair of the currently operating domestic and import equipment, along with limited capacity of the machine-building complex to produce modern equipment has become an obstacle to economic growth.

It is the processes of production restructuring aimed at increasing enterprises' competitiveness that play an important part in changing the investment environment. In connection with that, the problems of diversification of investment flows and enhancement of the efficiency of the use of investment and accumulated capital assets become especially pressing. The analysis of the dynamics of investment activity over last decade shows that currently investments in capital assets roughly account for $\frac{1}{4}$ of the pre-reform (1990) level, while the volume of capital assets in the economy remained practically at the level of 1990. That can be attributed both to the specifics of capital assets re-valuation and a sharp deterioration of reproduction characteristics. The capital assets renewal rate in the industrial sector slid from 6.9% in 1990 to 1.0 in 1998, while the average age of production equipment grew from 10.8 up to 16.1 years, respectively. The high level of the physical and moral depletion of capital assets, the unfavorable age structure of the machinery and equipment stock forms rather a rigid constraint to economic growth. With a long-lasting trend to the decrease in the share of gross accumulation in capital assets in GDP, the normal capital

assets reproduction cycle has been broken. The calculations of the structure of gross accumulation in capital assets show an absolute decline in the net accumulation volume in place since 1995. In such a situation the enterprises' investment activity has been reduced to maintenance of the accumulated capacity. The comparison between dynamics of output and changes in the structure of employment in the economy's sectors and in the industrial sector demonstrates that with the trend to decline in technical and economic characteristics of the production apparatus and investment activity in capital-intensive industries, some "exchange" with labor and capital occurred. The maintenance of a high level of employment along with a traditionally high level of manual labor to a certain extent allowed compensation for the lack of investment resources, but at the same time that led to technological stagnation. When compared with 1995, the manufacturing industries and infrastructure sectors have shown a trend to an absolute contraction in the physical volume of capital assets.

TABLE 2.16

Indices of physical volume of capital assets across the sectors of the economy, as % to 1995

	1996	1997	1998
All capital assets (including cattle)	99,9	99,5	99,0
Capital assets of industries producing goods	99,2	97,8	96,4
industrial sector	100,0	99,5	99,0
agriculture	96,8	92,1	87,7
Construction	97,9	96,5	95,1
Capital assets of industries delivering market and non-market services	100,6	101,0	101,4
Transport and communication	100,1	99,6	99,1
Trade and public catering, wholesale trade with production and technical merchandise	98,9	98,0	97,1

Source: Goskomstat of RF

The reproduction of capital assets also finds itself under the impact of the trend to raise in costs for capital repair. The calculations covering the period between 1995 through 1999 showed that the costs for capital repair roughly accounted for 20% of the volume of investment in capital assets. Such a high share of repair proves the thesis on the focus of the investment process on cheap and short-term methods of production apparatus renewal. As a result, there is investment demand for the components of technological equipment that can be replaced without long-term investment in capital assets, i.e. using liquid assets, which forms a specific feature of the investment process in the national economy. However, from a longer-term perspective such a practice leads to technological and economic stagnation. The production apparatus created over the previous decades has been focused on production in the conditions of a closed economy that did not imply any competition, while at present there is an urgent need in renewal of an active part of capital assets, qualitative changes in technological level of production and raising its efficiency.

The technological structure of investments in capital assets experiences changes: during the initial stages of reform one could note a rise in the share of costs for construction and assembly works, while since 1995 there has been noted a gradual growth in the share of expenses on purchasing machinery and equipment in the overall volume of investment in capital assets. The growth in spending on machinery and equipment was determined by the shifts in the investment reproduction structure. The period between 1995 through 2000 was characterized with the expansion of the work on enterprises modernization and reconstruction. In 2000, the spending on machinery and equipment in the overall of investment rose up to 35.7% vs. 30.8% reported in 1998.

Whilst estimating the current state and prospects of the national economy's development one should take into account that the surge of investment activity in 2000 to a significant extent should be attributed to the market situation. With a 20.4% increase in investment in the industrial sector relative to 1999, the investment in the oil sector showed a 65.0% growth. In fact, the investment demand in 2000 practically fully was generated by the oil sector whose share in the total amount of investment in industrial sector accounted for over 30%. Comparing with 1999, the fuel sector reported a 2.2-fold rise in its profits and a 3.4-growth in income denominated in foreign exchange. Though the national exporters have raised their investment spending on development of their profile production, they are not going to invest their free resources in the economy. Hence, the gap between producers (exporters) of energy resources and the other part of the economy tends to widen.

From a long-term perspective, the current "heavy" structure of the national economy would not be able to ensure high steady growth rates. In addition, the economy's excessive dependence on external conditions poses a serious threat. Because of that, the industrial policy should be focused on changing the sectoral structure of the economy, its modernization, and raise of the share of industries with a high level of value – added. The effective changes in the economy and its sustainable growth necessitate an inflow of long-term investments based upon the system of credit and financial institutions.

Foreign investment

The national economy showed more favorable conditions for attraction of foreign investment in 2000 relative to 1999. Russia's

climbing to the 32nd from the 49th the position¹⁵ worldwide in terms of attractiveness to investors testifies to the improvement of its investment climate.

As of 1 January 2001, the foreign capital accumulated in the non-financial sector of the national economy accounted roughly for USD 32 bln. In 2000 the total volume of foreign investment inflow made up almost USD 11 bln., or at 15% more than in 1999.

TABLE 2.17

Structure of foreign investments in Russian economy

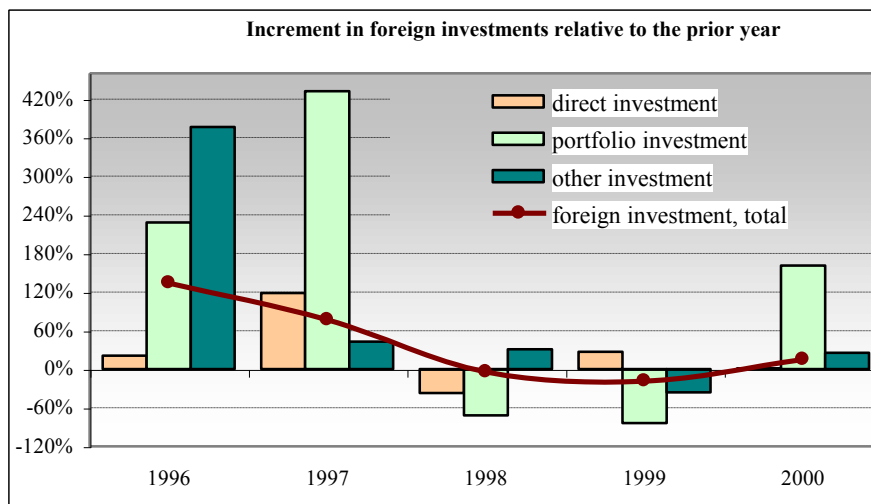
	Total, USD mln..	Direct		Portfolio		Others	
		USD mln.	As % to result	USD mln.	As % to result	USD mln.	As % to result
1996	6970	2440	35,01	128	1,84	4402	63,16
1997	12295	5333	43,38	681	5,54	6281	51,09
1998	11773	3361	28,55	191	1,62	8221	69,83
1999	9560	4260	44,56	31	0,32	5269	55,12
2000	10958	4429	40,4	145	1,3	6384	58,3

Source: Goskomstat of RF.

¹⁵ According to the annual survey of AT Kearney of heads of 1,000 largest international companies published in FT

The volume of FDI in 2000 practically remained unchanged (+1%) relative to 1999.

FIGURE. 2.35



The major part of foreign investment in Russian economy (60%) comprises other investments that are formed mainly from trade credits, credits of foreign governments issued under guarantees of the RF Government, and credits disbursed by international financial organizations – The World Bank, the IMF, and EBRD. In January 2001 the World Bank announced the raise of Russia’s credit rating. Between 2001 to 2002 the country would receive a. USD 600 mln. worth credits (instead of 150 mln., as announced previously in 2000). Should Russia succeed in promoting economic reforms, the credit amount may be increased up to USD 1 bln.

Between 1994 through 2000 the Fund for Crediting the Russian Small Businesses run by EBRD disbursed over 32,000 loans worth a total USD 400 mln.

TABLE 2.18

**Foreign investments in Russian economy between
1998 through 2000, as USD mln.**

	1998	1999	2000
Investment accumulated as of the beginning of the year	33 942	35 338	29 253
Investment inflow over the year	11 773	9 560	10 958
Investment withdrawn (redeemed) over the year	10 377	15 645	8206
Investment accumulated as of end-year	35 338	29 253	32 005

Source: Goskomstat of RF

The sectoral structure of foreign investment in 2000 testifies to the largest volume of foreign investment forwarded to the industrial sector (USD 4,721 mln., or 43.1% of the aggregate volume of foreign investment). Given an insignificant change in absolute indices of the foreign investment inflow in industrial sector in 2000 relative to 1999, in terms of investment sectoral structure, the proportional weight of industrial sector slid from 51.5% in 1999 to 43.1% in 2000. That can be attributed to the growth in investment in other spheres of the national economy over the period in question. Thus, in 2000 foreign investment in the communication sector showed a 3-fold rise, while that in the sphere of credit, finance, insurance and pension provision- 2.3-fold growth.

TABLE 2.19

**Sectoral structure of foreign investment
in Russian economy**

	As USD mln.				Change relative to the prior year, as %			
	1997	1998	1999	2000	1997	1998	1999	2000
Industrial sector	3610	4698	4876	4721	58,5	30,1	3,8	-3,2
Transport and communication	194	589	907	1947	-27,9	203,6	54,0	114,6
Trade and public catering	733	1201	1622	1924	95,5	63,8	35,1	18,6
General commercial operations on ensuring the market's functioning	2299	1426	190	271	41,1	-38,0	-86,7	42,6
Finance, credit, insurance, pension provision	4763	900	114	274	135,3	-81,1	-87,3	140,3
Other sectors	696	2959	1851	1821	76,2	325,1	-37,4	-1,7

Source: Goskomstat of Russia

In 2000, FDI mainly were forwarded in transport (21.4% of the overall volume of FDI), the food-processing sector (18.5%), trade and public catering (18.9%), and fuel sector (10%), machine building, and metal processing (4.4%).

A significant part of investment in the industrial sector comprises credits from international financial institutions. Traditionally, the major part of such investments was forwarded to the industries orienting to the domestic consumer market and ensuring the access to natural resources. As far as the volume of attracted investment is concerned, among the basic sectors the leaders still were the food-processing and fuel industries, and metallurgy, with their aggregate share accounted for 74% (37.8%, 3.2%, and 13.1%, respectively) of the total amount of foreign investments in the industrial sector.

FIGURE 2.36

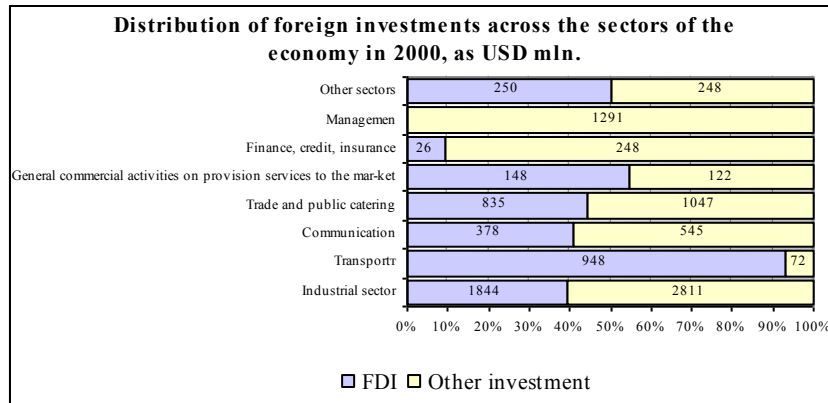
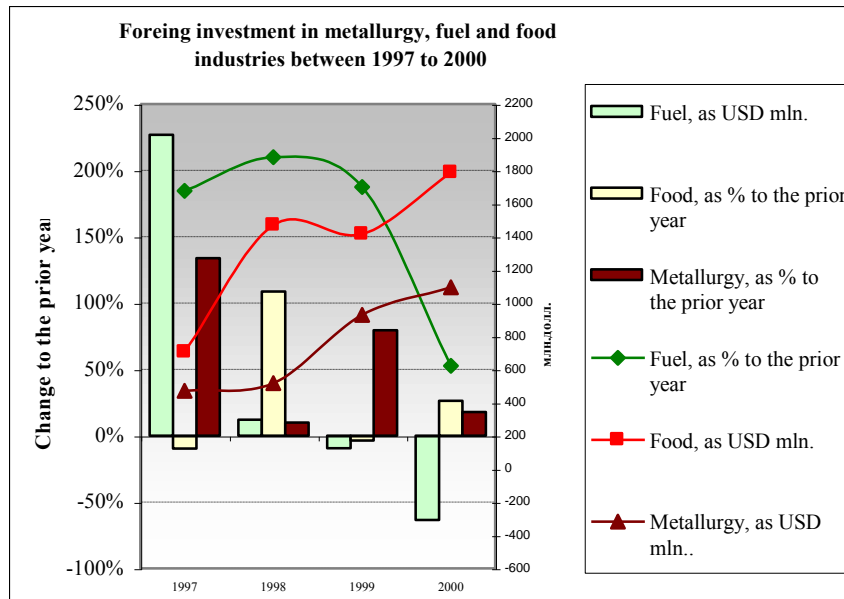


FIGURE 2.37



The focus of foreign companies investing to Russia on the local market is proved by a low proportion of export in the overall volume

of goods and services they delivered. At present the foreign companies' daughter firms export on average not more than 12% of the total volume of goods and services.

In 2000, the structure of foreign investment in the industrial sector did not differ from the structure of their total volume and was characterized with the contraction in the proportion of FDI against the growth in other investments. Thus, given that in 1999 the proportion of direct investment in industrial sector in their overall volume in this sector was 53.4%, while portfolio- 0.5%, and others- 46.1%, in 2000 the proportion of the former slid to 39.4%, while the proportions of portfolio and other investments grew up to 1.5% and 59.1%, respectively.

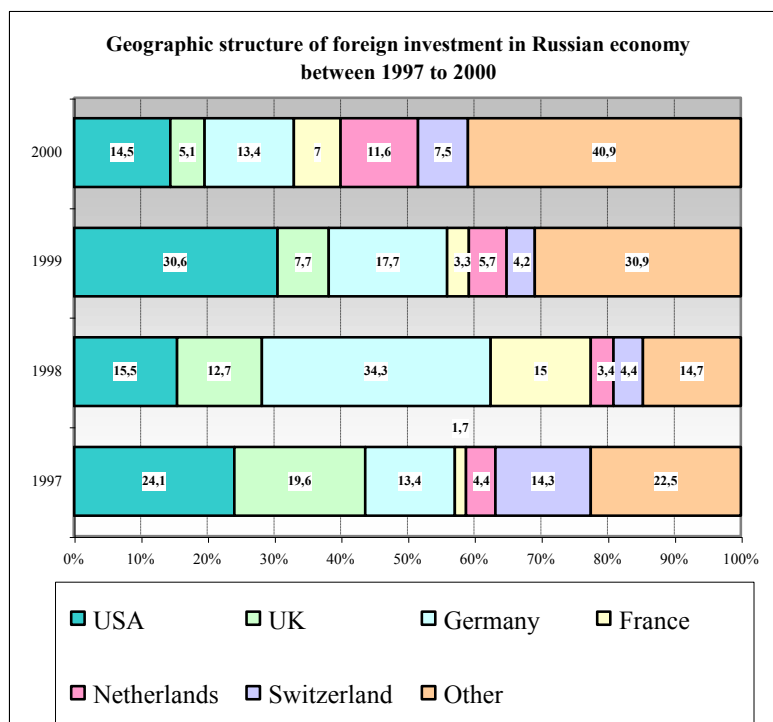
In terms of territories, in 2000 the main characteristics of foreign investments appeared the decline in differentiation between Russian regions by their volumes of foreign capital inflow.

In order to support Russian companies, the formation of investment funds will be continued in 2001. Thus, for example in Nizhny Novgorod the US company SEF supported by EBRD intends to create an investment fund to finance small - and medium-size businesses (in a form of credits or by contributing to their authorized capital). The volume of investment planned to be forwarded to support national enterprises is estimated at the level of USD 30 to 35 mln.

The authorities of the North - West supra-region plan to establish in 2001 a Commission for Protection of Investors' Rights. One of the major functions of the Commission should be preventing crisis situation at enterprises, for the recent practice has shown that potential investors are stopped by an insufficiently efficient management, especially at the enterprises whose control block is owned by the state.

In 2000 Russia receive investments from 108 countries (in 1999-96 countries), with the US being an undisputable leader (14.5% of the total volume of foreign investment received over 2000), followed by Germany(13.4%) and, consequently by UK, Netherlands, Switzerland, and France.

FIGURE 2.38



While considering the overall volume of accumulated foreign investment, according to results of 2000, it is US, Germany, Cyprus, France and UK that were the leaders with their proportion in the respective total volume accounted for 73.1% (in 1999- 80.7%). This top five exporters of capital to Russia also hold 63.9% of direct investment, 48.4% of portfolio, and 76.1% of other ones. Their

respective indices of 1999 were: 72.%, 49.5%, and 88%, respectively.

TABLE 2.20

Country	Accumulated, as of end 2000	Invested over 2000	
		Main spheres of investment	USD mln.
Total	32005		10958
Including:			
USA	7030	Total	1594
		Including: industrial sector	690
		transport and communication	647
Germany	6529	Total	1468
		Including: food	195
		Communication	383
		Finance, credit, insurance, pension provision	102
		управление	297
Cyprus	4230	Total	1448
		Including: food	257
		transport	171
		management	381
France	3353	Total	743
		including: machine uilding and non-ferrous metallurgy	235
		management	250
		agriculture	10
UK	2275	Total	599
		Including: construction	15
Netherlands	1436	Total	1231
		Including: food	636508
		transport	276
		finance, credit, insurance, pension provision	82

Source: Goskomstat of RF

The structure of investment that the largest countries-investors accumulated by late 2000 is dominated by 'other' investments

formed mostly at the expense of credits. Thus, the proportional weight of this kind of investment received from Germany accounted for 80% of the overall volume of German investment accumulated in Russian economy, while the respective indices for France, UK, and Italy were 92.2%, 55.3%, and 90.8%, respectively, providing that the proportion of 'other' investment in the overall volume of investment accumulated by late 2000 accounted for 48.0%.

In late January 2001, Barings Vostok Capital Partners announced the establishment of the first since 1998 fund for direct investment for Russia, Ukraine, and CIS countries with the starting capital of over USD 100 mln. The fund will be investing in the oil and gas sector, telecommunication, forestry, output of consumer goods, and information technologies.

The inflow of the PSA- based foreign investments in the national mineral sector still remains low. Despite the enactment of the federal Law "On production sharing agreements" yet in 1996, by now there have been only four such agreements concluded: Sakhalin-1, and 2 (in Sakhalin Oblast), Kharyaginskoye (Nenetsky AO) and Samotlorskoye (Khanty-Mansy AO). The subject of all of them became hydrocarbon deposits. De-facto in 2000 only the first three of the a.m. four agreements were operating: notably, they were concluded prior to the enactment of the respective Law on PSA. The attraction of investment by the concluded PSA=s proceeds at a very slow pace compared with projected timing and volumes, while negotiations on conclusion of new agreements drag on very slowly.

In the forthcoming period, however, one may expect a certain improvement of the situation in this area. Thus, in particular it is intended to introduce deadline practices with respect to conclusion of agreements. If the agreement has not been concluded over a pre-set period of time, the deposit would be subject to withdrawal from

the list of deposits whose development is allowed under PSA conditions. That would ensure the availability of new, more attractive deposits in the said list. In addition, it is intended to complement the current three-stage production sharing system with a simpler two-stage one, which is also used worldwide. It is also intended to pass a special Chapter of the Tax Code that should deal with regulation of taxation of investors in the course of carrying out PSA.

One of the crucial challenges with regard to prospects of PSA=s' development in Russia is the problem of a quantitative restriction of employment of the PSA regime. At present the law reads that no more than 30% of the prospected stock of minerals may be developed under the terms of production sharing. According to the data of the RF Ministry for Natural Resources, on the whole throughout the country it is intended to provide 38 objects for concluding PSA=s on them, including 27 oil deposits, 2- of natural gas, 5 -gold, 2- iron ore, 1- oil shales, and 1-tin. The proportions of the prospected stock of main kinds of minerals comprised by the objects that were included in the lists of deposits designated for their development under PSA terms or arranged for such an inclusion, as per the current law, are as follows: oil- 26.5%, natural gas- 11.2%, gold- 13.4%, iron ore- 9.5%, tin- 6.2% , and oil shales- 22.1%.

Hence, in the oil sector (which is the most attractive for the domestic and foreign investors) the level of the use of the set quota should reach its ultimate value in a not-so-distant future. That sharply reactivated the efforts of proponents of a prompt expansion of the PSA regime's sphere in terms of cancellation of the earlier set quantitative restrictions. However one cannot help but take into account certain defects of the PSA system that are related primarily to the individualization of conditions and terms of agreements on concrete projects. Lacking the necessary experience and corrupt

civil servants may help the investor to get excessively beneficial terms for the project implementation and, consequently, the government losing a certain part of revenues from the development of the national natural resources.

It is also principally important that the respective agreements have not been concluded as yet on the overwhelming majority of the objects included in the legislatively approved lists or arranged for such an inclusion. That is why at its special meeting on PSA held in August 2000 the RF Government took a decision to keep the stock quotas on PSA unchanged. One should envisage that in the forthcoming future the government would focus its attention on improving the state regulation system and completion of the ongoing preparatory work on the deposits already allocated for the PSA-based development. Nonetheless, some raise in the given quotas may become possible in the future.

It is the formation of a broad spectrum of normative acts ensuring the existence of conditions for investment activity and guarantees of stability of investors' rights that appear a crucial factor determining the steady functioning of the investment sphere.

In the meantime the government practically has completed a package of bills aimed at reducing administrative barriers. If passed, it should help improve the investment climate in the country.

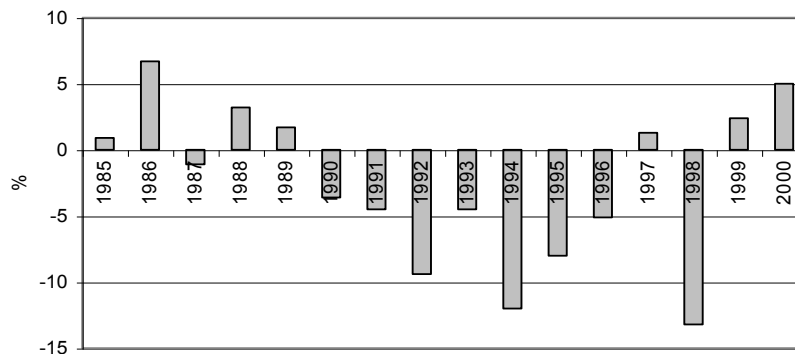
2.4. Russian agrifood sector

General performance

2000 was the second year round of growth in the Russian agrarian sector. Agricultural output expanded at the rate of 5% which is outstandingly high for the recent 15-year period (Picture 2.39). Still, it didn't reach the level of relatively favourable 1997. The growth of gross output was provided by crop production which expanded by 8,9% while livestock production was only slightly over the 1999 level.

PICTURE 2.39

Change in the Russian agricultural output (1985-2000)



Source: State Committee for Statistics of the Russian Federation.

All other components of the Russian agrifood sector show growth as well. The food industry output followed the trend of 1999 and increased by 7,1%. Tractor and agricultural machinery production also retained unprecedented growth rates of the previous year: 48,4% in 2000. The output of mineral fertilizers expanded by

6,3%. Only the microbiological industry and flour milling experienced decline.

The persisting since 1998 crisis undervaluation of ruble still favours economic performance of the agrifood sector which remains quite profitable and attractive for investors. In mid-2000 the Concept of agrifood policies for 2001-2010 was adopted and the first efforts were made to implement it. The developments of late 2000 - early 2001 evidence the strengthening of government regulation of agrifood markets. As different from the preceding attempts, these efforts bring real results positively influencing market situation. The humanitarian aid supplies discontinued, and thus Russian exporters of agrifood commodities were released from constraints. All this together with favourable weather conditions fostered a notable growth in agriculture and the agrifood sector in general.

Production

Agriculture

The bulk of gross output growth was provided by crop production, and first of all by grains production (Table 2.21).

TABLE 2.21.

Gross production of basic agricultural crops, million tons

	1986-90 (aver- age)	1992	1997	1998	1999	2000	2000 as % of 1999	2000 as % of 1986-90
Grain (weight after processing)	104,3	106,9	88,6	47,8	54,7	65,4	119,6	62,7
including	43,5	46,2	44,3	27,0	31,0	34,4	111,0	79,1
wheat								
Sugar beets	33,2	25,5	13,9	10,8	15,2	13,9	91,45	41,9
Sunflower seeds	3,1	3,1	2,8	3,0	4,2	3,8	90,48	122,6
Potatoes	35,9	38,3	37	31,3	31,2	32,6	104,5	90,8
Vegetables	11,2	10,0	11,1	10,5	12,3	12,1	98,37	108,0

Source: State Committee for Statistics of the Russian Federation.

The latter again demonstrated the trend towards bigger share of feed grains (barley, oats, corn) thus evidencing progress in domestic livestock production. Meanwhile, the growth of food grains crop in absolute terms didn't prevent the shrinkage of their share in the total grains output (Table 2.22).

TABLE 2.22

Gross production of grains: dynamics and structure, %

	2000 as % of 1999	Structure of gross grains production		
		1995-1999	1999	2000
Grains, total	119,6	100	100	100
incl. wheat	111,1	52,6	56,7	51,6
barley	132,1	21,4	19,4	22,5
rye	114,0	8,3	8,8	7,9
oats	136,7	9,2	8,0	10,9
corn	141,7	2,3	2,0	2,3
grain legumes	136,4	n.a.	1,6	1,8

Source: Own calculations based on Grain Association Herald, № 01(68), January 19, 2000 and data of the State Committee for Statistics of the Russian Federation.

TABLE 2.23

Gross production of basic livestock products, million tons

	1995-99	1998	1999	2000	
				Jan. - June	Jan. - Dec.
Meat (slaughter weight)	5,0	4,7	4,3	2,8	4,4
Milk	34,9	33,2	32,1	16,6	31,9
Eggs (billion pieces)	33,3	32,6	33,3	17,4	33,9

Source: State Committee for Statistics of the Russian Federation.

The production of basic livestock products except milk is also growing. Yet the rate of this growth in the second half of the year noticeably fell (Table 2.23). Output is increasing despite continuing

decline in the livestock numbers, evidencing higher productivity of animals.

Output of livestock products continues to grow faster than their sales meaning that the process of eliminating shadow turnover is not yet completed.

Production of agricultural inputs

Bigger receipts from marketing enable agricultural producers to buy more farm machinery. In 2000 the growth in tractor and agricultural machinery production continued averaging almost 150% by November (e.g. the production of grain harvesters increased nearly 2,5 times) (Table 2.24). The industry has restored its performance at approximately the 1995 level. It should be noted, that the increase in production provides for larger sales on both domestic and foreign markets, the CIS countries being the major importers of Russian agricultural machinery. In 1999 Russia became a net exporter of tractors. Yet, the bulk of produced agricultural machines is acquired by domestic farms. In the situation when agricultural production is growing the domestic demand for Russian agricultural machinery will depend on the “price/quality” correlation and, accordingly, on the exchange rate of national currency.

More mineral fertilizers were sold on the domestic market evidencing their wider application in agriculture (Table 2.25). Stocks that accumulated in 1999 helped to increase the 2000 domestic use and export by 7% while production grew by only 6%. The bulk of fertilizer output (almost 80%) is exported conditioning very non-elastic supply on the domestic market. Policy tools intended to stimulate greater application of mineral fertilizers by Russian agricultural producers should be different from the price regulation efforts made until now.

TABLE 2.24

Production of agricultural inputs

	1990	1995	1996	1997	1998	1999	2000	2000 as % of 1999	2000 as % of 1990
Tractors, thousand	214	21,2	14,0	12,4	9,8	15,4	19,2	124,8	8,97
Tractor ploughs, thousand	85,7	4,0	1,6	1,3	1,4	1,8	2,5	137,7	2,9
Tractor seed drills, thousand	51,1	1,6	1,9	1,5	1,3	3,3	5,1	156,9	10,0
Tractor cultivators, thousand	101	2,0	2,9	3,0	3,2	3,2	4,5	141,8	4,4
Grain harvesters, thousand	65,7	6,2	2,5	2,3	1,0	2,0	5,1	2,5 fold	7,8
Tractor mowers, thousand	22,6	5,1	3,3	4,2	6,1	6,7	6,4	96,1	28,55
Feed grinders, thousand	0,4	1,1	1,1	1,1	1,5	1,5	0,9	64,2	2,3 fold
Mineral fertilizers, thousand tons	15979	9639	9076	9546	9380	11496	12221	106,3	76,5

Source: Russian Statistical Yearbook 2000, p. 333; Social and Economic Situation of Russia, January - December 2000.

TABLE 2.25

Supply and utilization of mineral fertilizers in January - September 2000, thousand tons

	2000	1999	2000 as % of 1999	Share, %
Supply, including	9427,2	8801,7	107,1	100,0
Production	9258,5	8643,0	107,1	98,2
Import	98,4	169,7	58,0	1,0
Change of stocks (+,-)	-70,3	+11,0		+0,8
Utilization	9427,2	8801,7	107,1	100,0
Sale on domestic market	1898,1	1774,4	107,0	20,1
Export	7529,1	7027,3	107,1	79,9

Source: Social and Economic Situation of Russia, January - December 2000, State Committee for Statistics of the Russian Federation.

Food industry

Food industry also continues to grow (except for flour milling that was affected by poor domestic grain crop in the previous agricultural year) (Table 2.26). The output of some food products (sugar, vegetable oil) exceeded the pre-reform level. The production of other commodities is still constrained by low domestic demand and non-developed export. Thus, despite two years of growth in the meat and milk industries, their output still accounts for only 17% and 30% of the 1990 level, respectively. The output of milk industry is increasing due to larger supplies to the external markets. In 2000 the export of milk products sharply grew (see below).

The decline in sugar production is caused by large increase of stocks, primarily due to imports.

TABLE 2.26

Production of basic food products, thousand tons

	1990	1998	1999	2000	2000 as % of 1999	2000 as % of 1990
Meat	6629	1336	1129	1153	102,1	17,4
Sausage	2283	1113	948	1061	111,9	46,5
Butter	833	276	262	265	101,1	31,8
Milk products	20,8	5,6	5,7	6,16	108,0	29,6
Vegetable oils	1159	782	881	1354	153,7	116,8
Sugar powder	3758	4745	6808	6058	89,0	161,2
Flour, million tons	20,7	12,0	12,7	11,9	93,7	57,5
Groats	2900	1089	868	919	105,9	31,7
Macaroni	1038	554	679	691	101,8	66,6
Margarine products	808	185	377	455	120,7	56,3
Canned meat, million standard cases	8202	344	490	437	89,2	5,3

Source: Russian Statistical Yearbook 2000; Social and Economic Situation of Russia, January - December 2000.

Financial performance of agriculture

According to preliminary estimates, agriculture's profit in 2000 amounted to 24 billion rubles (as of October 1, 2000) which is 30% over the 1999 level. The sector makes profit for the second year round (in 1998 it made loss of 34 billion rubles). The number of farms making loss dropped from 54% in 1999 to 48% in 2000¹⁶.

As different from the previous year, in 2000 the ratio of agricultural and input prices was not in favour of agriculture: from December 1999 prices for industrial inputs rose by 33,9% while prices for agricultural products - by only 22,2% (in 1999 - 67,3% and 91,4%, respectively). Besides, prices for goods and services most frequently used in agriculture lifted even more substantially: for diesel fuel - by 56%, for fuel oil - by 88%, for electricity - by 39%, for gas - by 62%, for railroad transportation - by 69%. Given the apparent deterioration of price parity, improvement of the sector's financial performance is all the more notable.

As of November 1, 2000 federal budget outlays for agriculture equalled 10,3 billion rubles which is only 66% of the planned amount (industry, energy production and construction received even smaller percentage of planned funds - 47%). After a relatively full financing of the agrifood sector in 1998, the practice of sequestering expenses thereon is being restored. Nevertheless, in real terms the federal budget outlays for the sector grew by 8% (index of agricultural prices taken as a deflator).

¹⁶ Non-official data of the RF Ministry of Agriculture.

Investments in agricultural production are growing partially due to an outburst of direct foreign investments in primary farming (Table 2.27).

TABLE 2.27

Fixed capital investments in agriculture

1997		1998		1999	2000	
6 months	year	6 months	year	6 months	year	6 months
<i>Total investments, billion rubles*</i>						
2,3	10,3	2,8	10,4	5,2	18,2	9,5
<i>foreign direct investments, million dollars</i>						
3,7	5,5	1,5	4,2	8,6	45**	16

* - rubles after devaluation; ** - including ruble investments converted into dollars.

Source: Economic Journal of the Highest School of Economics. Vol. 4, № 4, 2000, p. 569.

At the same time, the sector's higher profitability doesn't solve the problem of agricultural producers' accumulated debts, in November 2000 amounting to nearly 180 billion rubles (of which 143 billion rubles are outstanding debts). Almost 65% of the outstanding debts are liabilities before various budgets and non-budget funds. Agricultural growth necessitates a rational restructuring of these debts that notably hinder the sector's development. The 4-fold gap between annual profits and accumulated debts leaves no hope that agriculture will solve this problem by itself. On the eve of a new farming season producers' debts and blocked accounts prevent them from using normal seasonal credits, thus supporting shadow turnover, barter, commodity credits and associated with them inter-regional trade barriers. This, in turn, aggravates the terms of trade for agriculture.

Agricultural and food markets

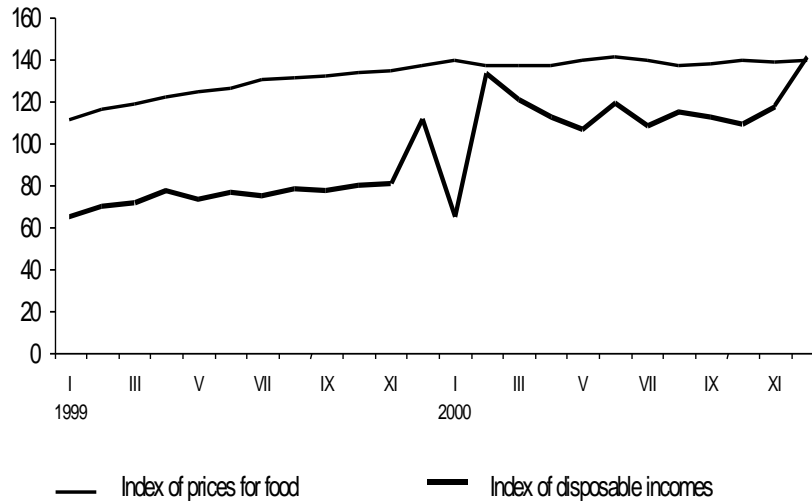
In 2000 the progress in situation on the food markets, which started in 1999, continued. It was primarily due to the growth and

restructuring of demand for food as real incomes of population were rising.

Russians' incomes were up 9,1% but their pre-crisis level hadn't been as yet restored. The average per capita incomes of richer 10% population groups rose conditioning changes in food demand structure. Besides, in 2000 the trend of incomes' change as compared to that of food prices improved. During the year the gap between them (in constant prices) shrank and by the end of 2000 incomes left food prices behind by the rate of growth (Picture 2.40). So, higher population incomes became a factor of expanding demand for food products.

PICTURE 2.40

Change of food prices and disposable incomes (as % of December 1998)



Source: Social and Economic Situation of Russia, corresponding periods 1999 and 2000.

In 2000 the retail trade in food revived: its turnover was up 7,3% as compared to the corresponding period 1999 when it dropped by 8,4% from the 1998 level. Food service receipts also grew by 8,6%. All this evidences an upward trend in food commodities' consumption.

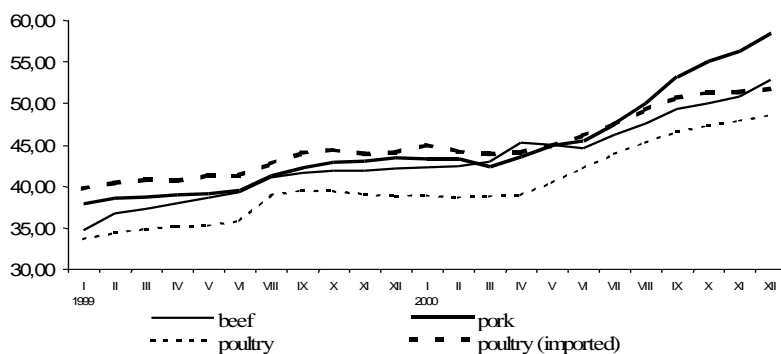
The bigger food consumption potentially widens opportunities for growth of domestic agricultural and food production. During two years after the 1998 crisis the gap between average retail prices for some basic domestic and imported food products persists: domestic beef is cheaper by 13%, macaroni - by 44%, poultry - by 11%, semi-smoked sausage - by 33%, butter - by 25%, sunflower oil - by 30%.

The meat sub-sector is a good example of how the growing demand for meat products is transmitted through the food chain to primary producers. Higher real incomes entailed higher prices for meat products (Picture 2.41) the demand for which is very income elastic. The meat industry responded by larger output. The above mentioned gap in prices on domestic and foreign markets and the growing meat processing led to higher purchase prices for raw meat. As a result purchase prices for livestock also rose (Picture 2.42) and the volumes of marketing livestock and poultry by all agricultural producers increased.

However, the difference between retail prices for domestic and imported poultry and beef is gradually shortening as prices for imported products rise at a slower pace. Beginning from the second part of 2000 prices for imported poultry are lower than those for domestic pork and by the end of the year - than those for domestic beef as well. This is a sign that domestic products-substitutes are losing their apparent advantages over competitors and the demand for them may fall.

PICTURE 2.41

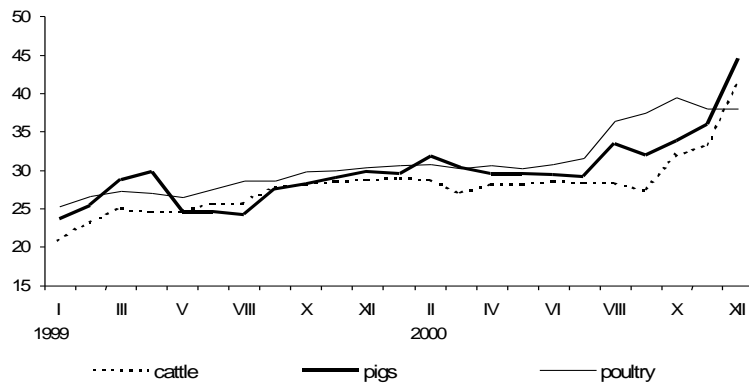
Retail prices for selected kinds of meat, rubles per kilogram



Source: Informational materials for RF territories. Ministry of Agriculture of the Russian Federation, corresponding months.

PICTURE 2.42

Change of prices received by agricultural producers for selected kinds of livestock (slaughter weight)

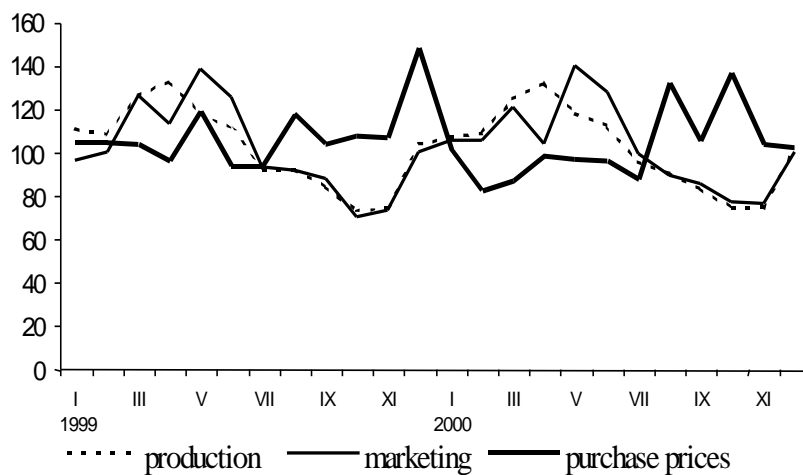


Source: Informational materials for RF territories. Ministry of Agriculture of the Russian Federation, corresponding months.

The dynamics of purchase prices for milk reflect a clearly seasonal nature of production in this sub-sector. For the second year in turn marketing of milk grows faster than its gross output in all months except the spring ones which may mean that milk is wastefully used for feeding calves (Picture 2.43).

PICTURE 2.43

**Change of production, marketing and purchase prices for milk
(as % of the preceding month)**



Source: Social and Economic Situation of Russia, RF State Committee for Statistics, corresponding months.

*Foreign trade in agricultural and food commodities*¹⁷

A downward trend in Russia's foreign trade in agricultural commodities that started in 1998 was not overcome in the following year. 1999 was marked by the lowest volumes of agrifood exports and imports since the beginning of reforms (Picture 2.44). Russia's import of agricultural and food products was 25,4% below the 1998 level. Its volume didn't even reach the 1990-1993 average when the newly initiated economic reforms and the dissolution of the USSR and the Council for Mutual Economic Assistance caused the decline in Russia's trade with other countries. The decline in export was even steeper - 35,4% as compared to 1998 level. Export sales of agricultural and food products almost reached the bottom of 1993 when they were restricted¹⁸. The share of agrifood commodities in Russia's total imports grew from 26,3% in 1998 to 28,4% in 1999. Their share in the total exports, on the contrary, fell from 1,8% to 1,1%. This means that agrifood trade is less elastic to ruble exchange rate than the foreign trade in general. One can conclude that the growth in agrifood sector after the 1998 crisis was to a lesser degree conditioned by the national currency devaluation as compared to other sectors of the economy.

Meat still remains the basic item of the Russia's agrifood imports. Beginning from 1994 it accounts for 10-13% of the imported food supplies.

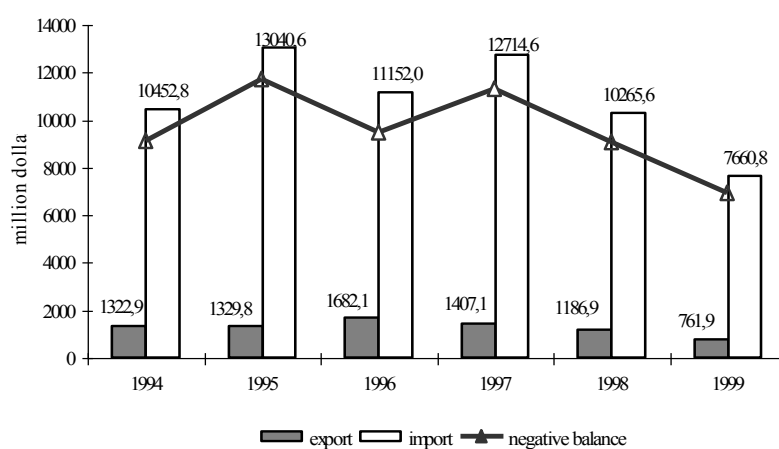
¹⁷ This chapter primarily bases on the materials of Customs statistics of foreign trade of the Russian Federation that may differ from the data of the State Committee for Statistics.

¹⁸ According to FAO data the Russia's agrifood export in 1993 equalled 756,9 million dollars.

In recent years purchases of raw sugar steadily grow while those of white sugar decline. Import supplies satisfy the bulk of domestic sugar plants' requirements in raw sugar.

PICTURE 2.44

Russia's agrifood imports and exports in 1994-1999



Source: Customs statistics of foreign trade of the Russian Federation.

TABLE 2.28

Import of basic agricultural and food products in 1996-1999, thousand tons*

	1996	1997	1998	1999
Beef	448,9	618,1	419,5	531,4
Pork	303,9	308,9	282,0	444,4
Poultry meat	754,4	1146,6	814,5	236,0
Butter	112,8	169,7	79,6	34,3
Sunflower oil**	174,2	322,1	232,0	300,0
Wheat and meslin	2058,8	2143,0	1095,2	4547,1
Wheat flour	720,4	386,9	216,1	124,2
Raw sugar	1696,1	2519,2	4060,2	5773,9

TABLE 2.28 CONTINUED

White sugar	1436,0	949,9	385,1	125,7
Citrus fruits	443,8	570,1	541,9	379,6
Coffee	25,1	27,8	4,9	9,1
Tea	118,5	158,2	150,2	161,1

* - less import from Belarus.

** - together with cotton and safflower oil.

Source: Customs statistics of foreign trade of the Russian Federation.

The drop of export in 1999 was due to the introduction of agri-food export restrictions. Export sales of sunflower seeds were constrained by the imposed export duties on this commodity (Table 2.29). The sales of grain declined due to the government ban on export of commodities supplied to the country under food aid programs.

TABLE 2.29

**Export of basic agricultural and food products in 1996-1999,
thousand tons***

	1996	1997	1998	1999
Fish, frozen	893,0	186,7	301,3	229,6
Wheat and meslin	359,9	543,3	1523,7	650,8
Sunflower seeds	1779,0	1049,2	1107,2	312,1
Vodka, thous. dal of 100% alcohol	2952,5	1317,1	475,7	667,7

* - less import from Belarus.

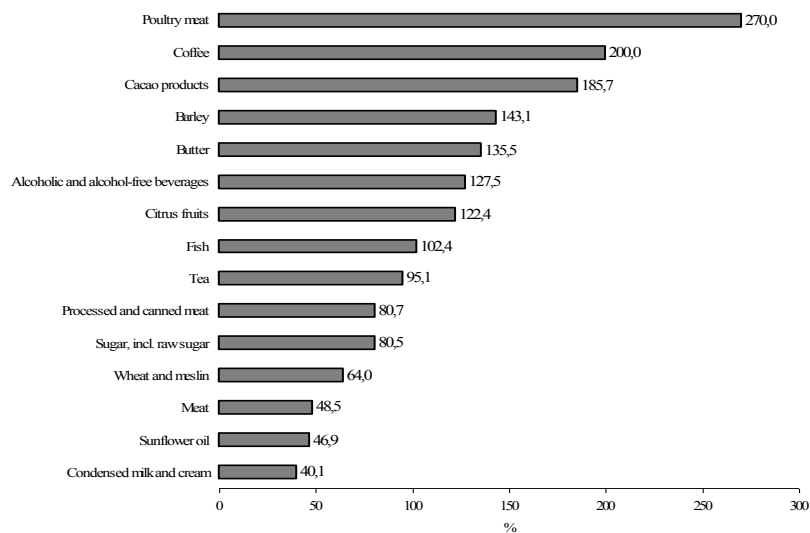
Source: Customs statistics of foreign trade of the Russian Federation.

Beginning from 1998 the negative balance of foreign trade in agricultural and food commodities is reducing. The trend continued into 2000. The gap between exports and imports shrank due to smaller food supplies into the country and bigger (for the first time since 1996) sales of Russian agrifood commodities on external markets.

In January-September 2000 the Russian agrifood import was 11,6% below the corresponding 1999 level. The decline was due to smaller purchases in the non-CIS countries (19% down the 1999 level) while the value of supplies from the CIS countries increased by 27,9%. The principal contributors to reduction of imports from the non-CIS countries were shorter supplies of meat, grain and sunflower oil (Picture 2.45).

PICTURE 2.45

Russia's import of selected food products in January-November 2000 as compared to January-November 1999



Source: State Committee for Statistics of the Russian Federation.

One should note the steepest ever decline of meat (except poultry) supplies. They didn't fall so much even after the recent financial crisis causing the dramatic crash of Russia's import. The reason for that is, first, the curtailment of meat supplies from the EU and the US under humanitarian aid programs. In 1999 the commercial

import accounted for 70% of meat and meat products supplies while 30% thereof were provided by humanitarian deliveries. Another factor of meat imports drop is the outbreak of bovine spongiform encephalopathy in some European countries. Due to that Russia banned import of beef, cattle and feed additives from Great Britain, Portugal, Switzerland, some districts of France, Germany and Ireland. Ukraine remains the major supplier of beef to Russia accounting for over half of corresponding imports (Table 2.30). Despite a notable reduction of beef imports from Germany due to veterinary bans, the country is the second principal supplier of this product to the Russian market. While supplies from many European countries, where cases of bovine spongiform encephalopathy have been reported, shortened, the beef imports from Lithuania and the US noticeably grew.

TABLE 2.30

**Geographic structure of beef imports in
January-September 2000**

	Share, %	2000 as % of 1999
Ukraine	50,7	82,9
Germany	15,7	30,0
Lithuania	6,5	552,1
USA	6,3	207,7
Italy	3,3	40,7
Mongolia	3,3	46,0
France	2,0	9,6
Ireland	1,8	5,8
<i>Other countries</i>	<i>10,4</i>	

Source: Own calculations based on data of RF Customs statistics of foreign trade.

In January-November 2000 Russia imported 26,7% less grains than within the corresponding period 1999. Due to the discontinued grain supplies under humanitarian aid programs, the imports of wheat from the non-CIS countries sharply fell. In January-September 2000 Russia bought there only 9,3% of all the imported wheat. An additional factor of smaller grain purchases in foreign countries may be the increase of domestic basic grains output in the last season.

A record high domestic output of sunflower oil in 2000 permitted to cut its import.

Similar to meat, white and raw sugar were the principal items of the Russian agrifood import in 1999 (15% of its total amount). The introduction of customs tariffs and temporary special duties on their import in 2000 and large accumulated ending stocks of 1999 contributed to the decrease of corresponding supplies to the country¹⁹ (Picture 2.45). Due to poor crop of sugar beets in Ukraine the import of sugar from this country fell. In January-September 2000 Russia made the bulk of purchases in Poland and Argentine accounting for 43,9% and 51,5% of the total sugar imports respectively.

The reduction of poultry meat imports in 1998 as well as the inflow of foreign and domestic investments in the Russian poultry production inspired hope for the sub-sector's growth. The United States attempted to restore their former share of the Russian market of imported poultry (80% before the crisis) through the means of humanitarian aid programs. In 2000 the US poultry supplies to the country grew at a record high rate. In January-November they accounted for about 70% of the respective imports' increase. During those months Russia imported 2,7 times more poultry than in the

¹⁹ The expiration of 45% seasonal duty on December 16 was followed by an unprecedented growth of sugar imports to Russia in the last two weeks of 2000.

same period last year. The lowering of import duties envisaged by the government can result in larger supplies from abroad. Given that Russia will hardly attain sustainable growth in domestic poultry production.

The gradual rehabilitation of population's real incomes after their crisis-induced dramatic drop stabilized the demand on commodity markets. As a result import supplies of butter, cacao products, coffee, citrus fruits, strong and soft drinks began to grow.

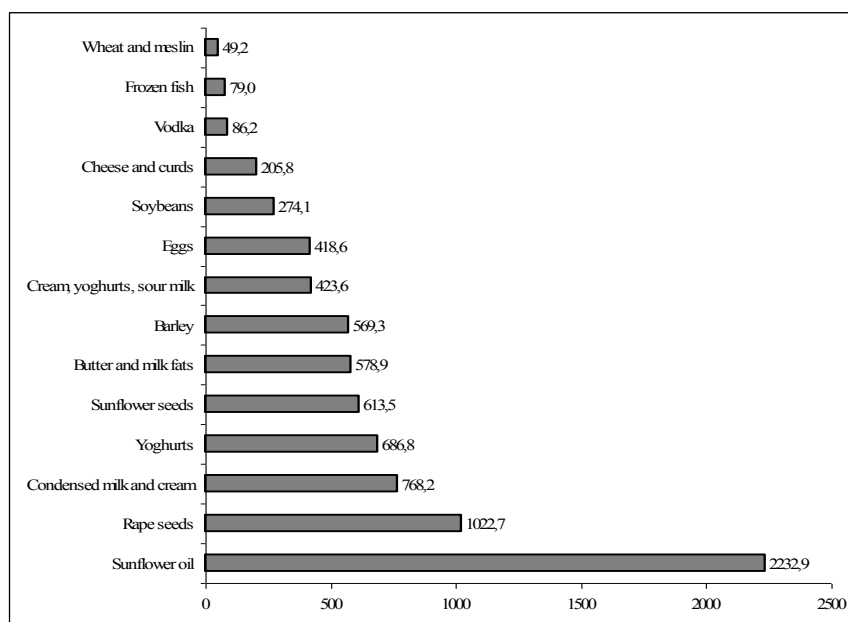
A positive development in Russia's foreign trade in agricultural and food products in 2000 was the growth of export. In January-September 2000 the country exported 84,5% more food than in the same period last year. Several products enriched the list of traditionally exported food items: vegetable oil, milk and margarine products, macaroni and dried milk.

The export duty on oilseeds introduced in 1999 initially limited their sales to foreign countries. However, already in January-September 2000 they grew despite restrictions. In 1999 the purchase price for sunflower seeds on the domestic market was about US\$ 112 per ton while an average export contract price exceeded US\$ 180 per ton. This difference in prices made export of sunflower seeds beneficial for exporters. The world price reaching US\$ 240 fully covered their expenses on paying export tariffs. Still, export duties did make the sale of sunflower seeds to domestic processors more attractive. The output of sunflower oil sharply increased inducing its larger export. For the first time since many years the growth was so impressive - 22 fold (Picture 2.46). At present Russia has a positive balance of foreign trade in both oilseeds and sunflower oil. The major importers of Russian sunflower oil are non-CIS countries such as Algeria, Egypt and Turkey accounting for 32,7%, 23,3% and 12,1% of its total export respectively. Among

the CIS countries the principal buyer is Kazakhstan (19,2% of the total export sales).

PICTURE 2.46

Russia's export of selected food products in January-September 2000 as compared to January-September 1999



Source: State Committee for Statistics of the Russian Federation.

Due to the over 5-fold growth of barley exports in January-September 2000, the balance of foreign trade in this item became positive. The principal importers were non-CIS countries accounting for 99,5% of the respective Russian export. According to the Grain Association data feed barley constituted the bulk of export sales.

The export of milk products, especially of condensed milk and cream and yoghurts, noticeably grew. The major importers of Russian yoghurts and butter were the CIS countries, while condensed

milk and cream, cheese and curds were primarily supplied to the non-CIS countries. Given no growth in domestic output of butter and its larger imports, an essential increase in butter exports is most probably due to re-exports.

According to the data of the State Committee for Statistics the growth of domestic production of macaroni and margarine products helped to expand their export in January-September 2000 by 37,5% and 7,4 fold respectively.

Thus, the dynamics of agrifood foreign trade reflect the curtailment of imports and the expansion of exports. It's worth noting, that the principal contributors to export growth are mass food products rather than traditional items of Russia's food sales to foreign countries. The growing domestic production, limited by population's purchasing power, searches for markets outside Russia.

Agrifood policies

Similar to all other sectors of the domestic economy, the government policies in agrifood sector in the first 6 months 2000 were shaped by the process of elaborating a new strategy of the country's social and economic development. A new concept of the Russia's agrarian policies was approved only at the end of July 2000. However, the first steps towards its implementations were made already in August.

From our point of view, the new concept differs radically from all the preceding ones. First of all, its emphasis is decisively shifted from the institutional transformations (such as land reform, restructuring of agricultural enterprises, privatization, etc.) to the regulation of agrifood markets. The fact is acknowledged that nowadays in order to support agricultural producers the government cannot administratively set basic market parameters but has to influence markets with certain policy tools. Markets of agricultural produce as well as

markets of inputs, capital and land are subject to such regulation. It is the cornerstone of the whole concept presenting an absolutely new approach to the agrarian policies as compared to the traditional one.

One of the concept's central elements is the involvement of producer associations into the regulating mechanism. The process of founding associations and unions of certain agrifood products' producers is currently rather active in Russia. Some of them formed quite skilful lobbying institutions that are successful enough in defending their interests when the government policies are being elaborated. They form analytical divisions, finance some activities that are of crucial importance for them but not affordable for the state (e.g. Milk association pays for the development of relevant standards). As state budget becomes tighter, the concept proposes to involve such associations in regulating the sector. This idea is productive in many respects. First, it allows the state to explicitly control the balance between different groups of interests. At present the struggle between them is latent and thus not always efficient. Second, the financial potential of associations can be engaged for fulfilling many state functions such as the mentioned above elaboration of standards, product quality control, antitrust regulation, market information dissemination, carrying out or financing of applied research, etc. Third, the activation of such associations definitely strengthens the positions of civil society in the country since it's one of the forms of society members' self-organization.

Finally, the concept attempts to specify the tasks fulfilled by federal and regional authorities. The federal government is to be responsible for: the maintenance of common market space and food security of the country; carrying out of structural and foreign trade policies; unification of land, credit, discount and technological policies; informational support of agrifood sector; general state control functions in the sector; control over observation of pertaining federal legisla-

tion. All the rest remains under the jurisdiction of regional authorities. Given that, the concept strives to define only the federal government's functions and doesn't examine all the agrifood issues which was usually the case in such documents.

The first radical step in the concept's framework is a new mechanism of crediting agriculture for harvesting works. It's known that during all the reform years and irrespective of credit mechanisms used the major source of agricultural loans was the state budget. We wrote not once about the shortcomings of such an approach to crediting the sector and thus will skip repetition. At the same time, the developments of 1999-2000 illustrate the willingness of commercial banks to credit the so called "real sector" and agriculture in particular. However, agricultural producers are not yet ready (either due to economic or psychological considerations) to take loans at average commercial interests. In similar situation most countries of the Central and Eastern Europe applied the mechanism of subsidizing the interest rates on commercial banks' credits. No doubt, any subsidized credit leads to lower efficiency of the sector as compared to other ones and is undesirable from the pure economic theory's point of view. Still, the already rich experience of transitional economies evidences that during transformation the agrarian production cannot do without soft credits.

At the same time, the system of subsidizing interest rate has some advantages as compared to the distribution of budget funds through any mechanisms (the state agricultural bank, commercial banks, commodity credit). First, it brings about the multiplication effect when one budget ruble attracts to agriculture several (depending on the price elasticity of demand for money which in Russia cannot even be appraised) rubles from commercial banks. Second, commercial banks get engaged in crediting agriculture, form corresponding institutions, acquire customers, establish contacts in the

sector. Even if credit subsidies are later lifted, it won't be easy for them to quit. Thus, the agricultural credit system, so much spoken about but not actually progressing (in case one doesn't seriously regard the creation of a state agricultural bank as a step forward), is being formed. Third, the above scheme is free of all the shortcomings of distribution system, inherent to bureaucratic schemes of crediting agrifood sector and empowering officials to select final borrowers.

We regard the introduced scheme of soft credits to agriculture as an experimental one: it was to be effective only during 2000 harvesting campaign and only for producers of grain and oilseeds. According to it, grain and oilseed producers get a subsidy equalling 20% of the interest rate on credits received by them for financing harvesting works. In order to avoid abuse (in particular, a collusion between a borrower and a bank), only credits at or under the current average 28% per annum are liable for subsidies. Not less than 5% are to be paid by the borrower himself, meaning that if a bank sets an interest below 25%, the subsidy will be less than 20%. It is granted directly to a borrower on the condition that he'll pay his debt back completely by December 15. A positive distinction of this credit scheme is the naming of funds' source (the fund for managing, studying, preservation and reproduction of water biological resources) which earlier was not necessarily included in resolutions changing the allocation of budget money.

As a result of the scheme's implementation 60 commercial banks in 48 regions of Russia credited 1154 producers to the total amount of 1,7 billion rubles. Only 54 million rubles were allocated from the budget. In case the program of agricultural credit support is continued and the ratio remains the same, 1,4 billion rubles that the government plans to spend on subsidizing seasonal credits to agriculture in 2001 will bring additional 765 billion credit rubles to the sector.

On June 13, 2000 the Bank of Russia issued a licence to the Russian Agricultural Bank whose authorized capital (375 million rubles) was funded by ARCO (the Agency for Restructuring Credit Organizations). Over half a year has passed since then but the role of this bank in financing the agrifood sector, especially in the framework of soft credits' mechanism described above, is not yet clear.

Starting from the mid-year subsidies paid to producers of agricultural chemicals were cut from 40% to 25% of the producer price. However, as mentioned above, given the large share of export in the total sale of mineral fertilizers such subsidies fail to be an incentive: the price elasticity of supply on domestic market is not high. Accordingly, changes in the subsidy mechanism are not important for agriculture.

The government also examined a concept of regulating grain market. According to it, purchase interventions on the grain market are to be carried out in order to smooth down price fluctuations. Agricultural producers are usually not able to store grain till spring "high" prices and have to sell it right after harvesting thus pushing the price down. Traders are the principal beneficiaries from price fluctuations. In this situation purchase interventions could be useful for the sector. However, we have reasons to think that this year they won't bring results due to the lack of appropriate institutional back-up.

In 2000 the foreign trade policies developed in two directions: (1) more flexible regulation protecting domestic producers from unfair competition and (2) rigid control of agrifood exports.

In order to compete on the Russian market many foreign suppliers often use such unfair practices as counterfeit labelling, dumping prices, disregard of sanitary requirements. Violations are most frequent in the import of poultry and other kinds of meat. In order to strengthen the control over poultry imports at the end of 1999 the government approved a list of ports through which poultry can be

imported from countries having no land communication with Russia. The limitation didn't apply to poultry imported from the US and the EU under humanitarian aid programs. Beginning from June 2000 border cross points have also been defined for countries exporting poultry to Russia by trucks. The effect of non-tariff limitations was mitigated by lower import duties. Beginning from August 2000 they were reduced from 30% (but not less than 0,3 euros per kilogram) to 25% (but not less than 0,2 euros per kilogram) and unified for all kinds of poultry. Such a reduction was supposed to drag importers out of the shadow sector and to induce them to declare actual names of imported items.

In 2000 the import of raw and white sugar was regulated with the same tools as in 1999: import tariffs, seasonal and temporary special duties. However, import tariffs were raised and the term of seasonal duties was extended (Table 2.31). In 2001 the import duty on raw sugar will be 30% but not less than 0,09 euros per kilogram, on white sugar - 30% but not less than 0,12 euros per kilogram. The duty on 3,65 million tons of raw sugar imported under the quota will be only 5%.

TABLE 2.31

Import duties on white and raw sugar in 2000

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
White sugar												
Import tariff		30%, but not less than 0,12 euros per 1 kg										
Seasonal duty	45%					45%, but not less than 0,15 euros per 1 kg						
Raw sugar												
Import tariff		5%										
Temporary special duty					10%							
Seasonal duty	45%					40%						

Source: Customs legislation of the Russian Federation.

In compliance with the Government Resolution of July 28, 2000 "On tariff regulation of raw sugar import" (№ 572), on No-

vember 27, 2000 the Europe-Asia Exchange held a tender for tariff quota on import to Russia from December 16, 2000 to December 31, 2001 of raw sugar originating from developing countries - beneficiaries of the Russian Federation's preferences. The volume of marketed tariff quota totalled 3,65 million tons (146 lots of 25000 tons). 48 companies were admitted to participate but 16 of them didn't buy any lots.

This was the first experience of defining and marketing tariff quotas in Russia. Both participants and administrators noted a high level of trade sessions' organization and the lack of procedure violations.

As a result of the tender the government earned about 209 million US dollars.

The volume of quota sold (3,65 million tons) accounts for nearly 90% of raw sugar imports in 1998²⁰. Last season the output of sugar beets in Russia dropped by 8% as compared to the preceding year. Thus, the volume of quota sold generally covers the Russia's demand for imported raw sugar and potentially fosters domestic production of sugar beets.

The tender dispelled fears of sugar market operators warning against the sector's monopolization: lots distributed quite evenly between large companies.

The major problem in the course of the tender was an unexpectedly high purchase price for quotas. According to the government Resolution, the minimum rate had to be set at 3 euros per ton (about 2,6 US dollars). But the price actually rose to an average 57 dollars per ton (varying from 43 to 69 dollars). This is a natural extreme reaction of market operators in the transition environment. It potentially entails a set of problems on the domestic sugar market.

²⁰ In 1999 seasonal tariffs on raw sugar import were introduced. That's why it won't be correct to compare its volume with the quota.

According to the RF government decisions the customs duty on raw sugar imported under the quota is set at 5%. The import duty on raw sugar in excess of the quota is 30% but not less than 0,09 euros per kilogram. Calculations show that in the port of destination the price for raw sugar imported under the quota and in excess of it will differ only by 3-7%. Given that all the tender participants took credits for buying quotas, their expenses per ton of raw sugar may even be higher than those of importers that supply sugar in excess of quotas and pay 30% customs duties.

Moreover, the current ratio of ad valorem import tariffs on white sugar and raw sugar again makes the import of white sugar more beneficial (which already was the case several years ago).

One should also take into account that companies-buyers of quotas won't be able to compete with a large number of small importers of white and raw sugar sometimes using different schemes of evading taxes and understating the customs value.

In April 2000 the fixed customs duty on imported wine (0,5 euros per litre) was replaced with an ad valorem one (25% of the customs value). Beginning from June 2000 the import duty on juices was reduced from 15% (but not less than 0,07 euros per litre) to 5%. The policy of export restrictions, initiated in 1999, was continued in 2000. It envisaged the imposition of export tariffs on fish and canned fish products (5%), oilseeds (10% but not less than 20 euros per ton of soybeans and rape and not less than 15 euros per ton of sunflower seeds) and ethyl alcohol (6,5%).

In general the trends in agrifood policies in late 2000-early 2001 let us suppose that in the near future we'll witness a more rigid and targeted regulation of agrifood markets developing in the two major directions:

- protection of domestic producers, first of all processors and traders and only then - of agricultural producers;

- elaboration of land legislation favouring transferability of agricultural land.

Outlook for agrifood sector development in 2001

The major factor of food production growth are higher real incomes of population. In 2000 0,75 rubles of real incomes' increase resulted in 1 ruble increase of food retail sales. The income elasticity of food demand is still very high. Accordingly, in the near future growing real incomes will continue to raise demand for agrifood products. The Russian agricultural production and food industry still demonstrate relatively high elasticity of supply and the current investments in these sectors support the belief that they will retain it in the years to come.

On the other hand, the foreign trade balance for agrifood commodities remains very negative. According to preliminary estimates the situation improved for grains, flour, vegetable oil. Some more milk products were exported. However, export still fails to stimulate domestic production. The lack of bulky export sales prevents from estimating the competitiveness of Russian commodities protected on the domestic market by relatively weak ruble.

In this situation the demand for domestic agrifood products in the near future will be determined by comparative rates of strengthening ruble and improving the competitiveness of Russian produce. The government's protectionist policy which is likely to tighten in 2001 will certainly play here an important role.

2.5. The Sphere of Research and Development

In the previous year 2000 the restructuring of the state bodies supervising science was started. This was one of the first steps on the way of implementing a new policy in the sphere of science and technology.

In May the Ministry of Science and Technologies was liquidated, and the new Ministry of Industry, Science and Technologies was established instead. A little later began the discussion on the issue of creating a special Council on Science and High Technologies under the President of the RF. One of the tasks of the Council must be to define and to correct the priority directions for the development of science and technologies in Russia. There are going to be 10-12 such directions at most - similar to the common practice in the developed countries of the world. The creation of the Council can really help to properly organize the activity of developing and implementing true priorities: until now, the declared priorities and the actual priorities have often been something entirely different.

The new Ministry of Industry, Science and Technologies became one of the largest federal bodies. Some 1,400 enterprises were transferred into the sphere of its authority, mainly those belonging to the MIC. However the "share" of science within the new ministry turned out to be modest. The experts from the Ministry of Science and Technologies estimate this situation as threatening because in this way science may become a "servicing" sector that works for the provision of raw-material base and the needs of the MIC. At the same time, there is some hope that the new ministry will be able at last to coordinate the formerly disintegrated policies in the spheres of science and industry and thus contribute to inno-

vation development of the economy. At the present moment it is difficult to predict what kind of policy the Ministry is going to pursue in reality because the period of its formation has been prolonged: six months passed between the moment of its creation and the approval of the Regulation where its goals, tasks, functions and rights are defined. The corresponding Decree of the government came out only in November 2000, so during those six months the Ministry was not active, though the new Minister A. Dondukov did point out the key direction for the activity of the new body. A key priority, in the Minister's opinion, is the development of new information technologies in general and of a supercomputer in particular, as well as preservation of the already existing potential in the sphere of science and consequently codification of knowledge and experience. If the meaning of the first direction is more or less clear, the second one has given rise to many questions. To achieve this goal, within the Ministry a special department for the codification of knowledge and experience was set up which is going to play a coordinating role in listing, within a single cadastre, all the technologies currently existing in Russia. This work promises to be very time- and labor-consuming while its efficacy as a measure for preserving the scientific potential appears questionable. On the whole, to divert resources for implementing such an ambitious project seems untimely, especially in the situation of steadily diminishing importance of science among other consumers of budget resources.

The budget allocation on science, under the budget item "Fundamental research and assistance to the progress of science and technology", was 0.25% of the GDP which is slightly less than the same figure for the year 1999 (0.26% of the GDP)²¹. In 2001, judg-

²¹ Nauka Rossii v tzifrakh - 2000 (Russia's science in figures - 2000). M., CISN, 2000, p. 45.

ing by the approved indices, the situation will remain as before. On this item of the federal budget 22 billion 93 million roubles is allocated as compared to 15 billion 926 million in 2000. However, for the Law "On Science and the State Policy in the Sphere of Science and Technology" to be properly implemented, the federal budget allocation should have been 47.7 billion roubles.

Even with the present level of funding a much more efficient use of the budget resources could be possible. Today it is far from ideal. The budget expenditures on the civil science are subdivided into two different in principle subsections: 1) fundamental research; 2) development of promising technologies and priority directions for the progress in science and technology. Formally, this subdivision is absolutely correct, but the actual content of these two subsections does not correspond to what is declared in their titles. The fact is that in the first subdivision the distribution of resources is carried out by government departments and funds. And, while within the funds mostly fundamental research is actually financed, in the organizations belonging to the Academy sector all kinds of projects are under way including those that involve development and engineering work. This discrepancy between the title and the essence, regrettably, often leads to many unforeseen consequences.

For example, the leadership of the RAS and some officials at the Ministry of Industry, Science and Technologies often declare that it is necessary to provide priority funding for fundamental science, in actuality understanding this as the growth of budget allocations for the RAS. The strong pro-Academy lobby using this statement to its own advantage has increased the share of the allocations for the RAS to over 30% of all budget allocations for the civil science. In addition, these resources represent base financing, i.e. are distributed in the least efficient out of all the possible ways. Besides, the obligations of financing the RAS were fulfilled by the

State to the greatest degree, and in 2000 more resources than initially planned were granted. The implementation of the budget for the RAS was 103.3%, while, for instance, the MSU received only 30% of its assigned funding.

At the same time, total expenditures of the state budget on science have been demonstrating a noticeable shift in the “balance” from the civil sector toward the defense sector. This is the evidence of the beginning of support and exploitation of the vast resources of science, technology and labor that can be available within the MIC for the benefit of the economic growth and national security of the country. The attention to this sphere was very timely. The crisis affected the military science to a greater extent than it did the civil science. The implementation of the defense budget as far as research and development were concerned was disastrous, in 1997 having gone down to 14% of the budget assignment. According to the surveys that were conducted last year among the scientists employed in the defense sectors, over 50% of Russian military scientists are inclined to leave the country and seek employment abroad. Moreover, 80% of them are ready to accept job offers from any country if a respectable reward for their work is guaranteed.²² The government settled on a complex approach to solving the problem of developing the defense sector because the suggested measures are concerned about not only supporting research, but also educating future employees for defense-oriented institutes. It is planned to provide special aid to higher educational establishments that prepare the personnel for “the defense”, including up-to-date research and laboratory equipment, computers, educational and methodolog-

²² E. Vladimirova. Podarit li Rossiya stranam tretiego mira oruzhie massovogo unichtozheniya? (Will Russia provide the Third World countries with mass destruction weapons?) //www.utro. ru, March 21, 2000.

ical materials and information in the field of science and technology.

Another major item of the state expenditures in the sphere of science and technology is financing of the outer space research. Although state financing for this sector in 2000 was decreasing, nevertheless it is still represented by a significant figure: the state budget expenditures for the programme "Research-and-Development Activities in the Area of Outer Space Exploration" were 1.6 times as large as the total financing for all the subprogrammes within the federal target programme "Research and Development of the Priority Directions for Science and Technology for the Civil Purposes".²³

In the area of extrabudgetary financing the year 2000 can be characterized as a period of further increase in the number of the sources of finance for science. Firstly, support at the regional level is acquiring an increasing importance. Secondly, the number of foreign programmes of cooperation and support has again started to grow.

The local authorities, as a rule, provide funding for the research in the interests of the region in question, for innovation activity, as well as for the support of the young and of those higher educational establishments that are most successful in combining education and research. The numbers of the participants in the programmes and the volumes of allocated resources are not very large: thus, in Tomsk Province, some 30 million roubles is allocated for the development of innovation activity, in Irkutsk Province - 17,5 million roubles for the support of research in the interests of the region. Within the budget of the city of Moscow, in 2000 345,8 million roubles, or 0.23%, was allocated. On the whole, total fi-

²³ Nauka Rossii v tzifrakh - 2000 (Russia's science in figures - 2000). M., CISN, 2000, p. 43, 47.

nancing from the regional sources was about 13% of the State budget financing for science. The focus of attention of the local authorities is directed at supporting high-quality education, on the one hand, and rehabilitating regional industry, on the other. However it would be impossible to achieve these two goals without supporting also the sphere of science, and local administrations are getting increasingly aware of this need. Therefore one can predict further growth of financing for science from regional sources.

As for foreign programmes and funds, a certain evolution can also be noticed here, primarily through the recent correction of priorities and forms of financing. With increasing frequency one can observe the following approaches: the grants grow smaller in number and bigger in size (the Ford Foundation, the McArthurs' Fund); institutional support is provided to research and academic educational establishments (the American Fund of Civil Research and Development for the Independent States of the Former Soviet Union, the Open Society Institute, the Moscow Social Science Fund); targeted support for young researchers and students within separate programmes or complex initiatives (INTAS, the Open Society Institute, the Ford Foundation, the McArthurs' Fund, the American Fund of Civil Research and Development, the Spenser Foundation).

A special place is now occupied by the programmes of institutional support in the area of both natural and social and humanitarian sciences. In 2000, with the financial support provided by the McArthurs' Fund, the Carnegie Corporation in New York and the Ministry of Education of the RF, the American Fund of Civil Research and Development for the Independent States of the Former Soviet Union was carrying on the implementation of the program of establishing Regional Research and Educational Centers. Four new centers were opened, in Ekaterinburg, Saratov, Kazan' and Novosi-

birsk, specializing in research in the fields of studies on materials, chemistry biology. Each of the centers receives over \$ 1 million for the period of 3 years and is obliged to direct the resources primarily for the support of the material base and equipment and the development of new educational programs where latest achievements of science are incorporated in the education process. At least 10% of the grant should be spent on supporting students, aspirants and young researchers - in the form of contests for individual research grants, training programs, participation in scientific conferences. Now in Russia there are eight such centers - the first four were created in 1998-1999²⁴.

The same three organizations, the McArthurs's Fund, the Carnegie Corporation in New York and the Ministry of Education of the RF, supported the creation of research centers in accordance with the program "Creation of Interregional Centers for Promising Research in the Field of Social and Humanitarian Studies". The winners in this contest were three higher educational establishments - the Ural, Tomsk and Voronezh State Universities. Each is going to receive a grant of \$ 224,000 for the term of 1.5 years with possible prolongation of the financing for several more years. In 2001 it is planned to open another 5 such centers. This program takes into account the specific features of the humanities research, and therefore a special emphasis is given to the development of libraries, electronic ones including, publishing activity, organization of conferences and seminars. And here, too, support of the young is an important priority.

At the same time, the conditions for the activity of foreign funds have become less clearly defined because a discussion was

²⁴ For more details about this program see: Rossiiskaya ekonomika v 1999 godu. Tendentsii i perspektivy. Vypusk 21 ("The Russian Economy in 1999. Trends and Prospects." Issue 21). M., IET, April 2000. P. 622-623.

started concerning a new registration regime for both the funds and organizations engaged in providing humanitarian aid to Russian science and the recipients of such financing. The idea is that those grant recipients who want to be allowed exemption from taxes must undergo registration at new recently established interdepartmental Committee. One component of the registration procedure is going to be an examination of projects both at the initial stage of their implementation and at the stage of completion, in order to rule out any duplication of technologies and to protect the right of intellectual property. All information will be collected within a joint information system. Many details here are yet unclear, however it obvious that the management pattern is being built with orientation to the new priority - codification of knowledge on the basis of creating databases and data banks.

It is true that today the State does not even possess reliable information about the main trends of the research that is under way within the framework of international cooperation. At most, only 15-20% of all international projects are implemented in coordination with the Ministries of Education and Science. Improved coordination might be not only in the interests of the State but also for the benefit of the international organizations who often duplicate their programs.

In addition to internal, there are also external factors that might influence the volume, orientation and the mechanisms of the foreign aid provided to Russian science. After the new President took office in the USA, a more strict approach to providing financial aid to Russia, the sphere of science included, was declared. Primarily this concerns American programs and organizations. In particular, it is intended to cancel the Nann-Lugar program which has been one of the main sources for implementing conversion initiatives through different funds and organizations. It is planned to shift the

emphasis from the State level to the level of non-government organizations, including private ones.

Science and education so far have not been popular with the domestic philanthropists. One of the inhibiting factors here is the existing system of taxation. The domestic humanitarian aid is subject to taxation, as well as the research equipment and literature that are purchased abroad and imported into Russia for the purpose of scientific research. At the same time, financial and industrial groups (FIG) are beginning to focus their attention on the sphere of education and to a certain extent on young researchers. "Rossiiskii Kredit", the Charity Fund of the "INTERROS" Holding (the V. Potanin scholarships), and the oil company "Ukos" were the first to offer support to students.. As a rule, support in the form of scholarship is granted to the best students who study either at institutions oriented at specific industries or on those territories where the main enterprises of the FIGs in question are located. Some programs also include support of the development of material and technical base of those departments and chairs within higher educational establishments where the majority of the students are receiving scholarships from the FIGs study. Private entrepreneurs who are not members of FIGs also provide some aid to students and young scientists. They sponsor the programme "The Polzunov Grants", create jobs for students at small-scale innovation companies, and so on.

Thus, support of young scientists and students is a priority both for the local authorities and foreign and domestic benefactors. Besides, it coincides also with the government priorities. This attention to the "problem of the young" is not accidental: during the recent 5 years the number of young people under 30 years of age engaged in science fell by 30% while the total number of research-

ers - only by 20%.²⁵ An outflow of the young people can be seen not only in the sphere of science but also in small-scale innovation enterprising. Judging by the results of selective surveys, the share of young people aged under 35 years in small-scale innovation enterprises is 12% of total staff at most while in 1996 it was 26%.²⁶ In 2000, the urgency of "the problem of the young" was still growing, and the situation with staff continuity was officially estimated as disastrous. In July the draft of "The Concept of the State Support for the Talented Young in Science and the Development of Manpower Potential of the Russian Science" was offered for public discussion. The concept has given rise to lot of criticism. Firstly, it contains quite a few ungrounded indices which were applied as a basis for developing the goals and tasks formulated in "The Concept". Secondly, the suggested measures are mostly declarative in nature and do not take it into account that the issues of supporting the young must be dealt with within a more complex problem - that of preserving continuity in science. Thirdly, "The Concept" offers no answer to the question of how many resources the State is prepared to invest with the purpose of attracting and keeping the young in the sphere of science. Supplementary individual financial support of young people without adequate renovation of the equipment needed for research, without investments in the development of information support, will result only in another waste of budget money because in this case only enthusiasts will stay on in science. And the renovation of the

²⁵ Calculated on the basis of: *Nauka Rossii v 1996 godu*. (Russia's Science in the year 1996). M., Goskomstat RF, 1996, p. 18; *Nauka Rossii v tzifrakh - 2000* (Russia's science in figures - 2000). M., CISN, 2000, p. 37.

²⁶ *Otchet o deyatel'nosti Fonda sodeistvia razvitiu malukh form predpriyatii v hauchno-tekhnicheskoi sfere za 1999 god* (Report on the activity of the Fund for encouraging small businesses in the sphere of science and technology in the year 1999). M., Fond Sodeistvia, 2000, p. 28.

material and technical base will require truly large-scale expenditures on the part of the State and, consequently, an unavoidable revision of the current principles of budget allocation.

In practice, all the government agencies functioning in the sphere of science and technology in 2000 continued to develop their programs of exclusive support of the young. As a rule, this support is realized in the form of various bonuses, grants or scholarships distributed on a competitive basis. The RAS has the greatest volume of expenditures for the support of the young: every year some 130 million roubles is allocated for this purpose within its budget.

Considerable support of the young is organized also through the State program for the support of the leading research schools, and within this framework, in 2000 additional funding was provided for 6264 young scientists aged under 33 years.²⁷ This is almost twice as much as the number of those young researchers who were granted support at the very beginning of the implementation of this program in 1996.

In July 2000 the Ministry of Education announced the beginning of the program of allocating grants for young scientists for doing research abroad. This initiative to a certain extent is similar to that which since March 1999 has been implemented within the framework of the project "Young Scientists of Russia". Among its participants are the RFFS [Russian Fund of Fundamental Studies], the Fund for encouraging small-scale businesses in the sphere of science and technology, as well as a number of private companies. The essence of this project is that money is provided for the trips of young scientists to attend foreign scientific conferences. As of the end of July 2000, over 100 such grants were allocated. Last year the "Yandex" company joined the group of the sponsors of this

²⁷ Source: <http://courier.com.ru/cour/0010/1800.htm>.

program. It is intending to support promotion of the developments authored by young scientists on the market. The same goal is being pursued by the new joint initiative of the RAS and the Fund for encouraging small-scale enterprises in the sphere of science and technology - "Young Scientists - For Small-Scale Entrepreneurship in Science and Technology". It is planned that it is the young scientists of the RAS (aged under 35, the winners in the competition, who are going to conduct the research in the interests of those small-scale businesses which have ordered these developments. This research will be financed by the Fund and the small businesses on a parity basis.

Besides, the RFFS at the end of the year announced a contest in accordance with the Program for the support of young scientists and aspirants (aged under 33 years) whose work was already being financed by the initiative grants of the Fund. The implementation of this program became possible due to budget adjustments by which the Fund was allocated an additional 90 million roubles. It is planned to allocate to young scientists 3,000 grants, approximately 30,000 roubles each.

In 2000, the issue of prolonging for another 5 years the Presidential Target Program "State Support of the Integration of Higher Education and Fundamental Science for the Years 1997-2000" ("Integration"). The support of the young, beginning with schoolchildren, and their involvement in the sphere of science is also an important component of this program.

The task of integrating science and education is becoming most vital because the education of highly qualified manpower is being increasingly concentrated at higher educational establishments where in its turn the base for research is becoming progressively

smaller. Today we are witnessing a paradoxical situation when aspirants are being educated by 538 higher educational establishments at their own postgraduate departments whereas small-scale actual research, if any, is carried out only by 384 such establishments.²⁸ As a result, less than a quarter of all resident aspirants and doctorants actually participate in research activity. Noteworthy also the small extent of the involvement of students in research activity - only 8 % of their total number, by the estimates of sociologists. At the same time, the share of the students entering after graduation a postgraduate course is about 7%. Thus, the degree of the involvement of students in research probably depends on the actual number of those who later are going to pursue a career in science.

A selective survey conducted in 2000 among the participants of the "Integration" Program revealed that the involvement of students and aspirants in the activity of the newly created (in accordance with the Program) Centers of education and research (CER) positively influences their intention to work in the sphere of science: 100% of the students expressed their desire to continue research activity, and for 80,5% of the respondents this decision was associated with their work at the CER. At the same time, the wish to continue research activity does not necessarily mean any connection with Russian science: 65.3% are willing to continue their education and later pursue their career abroad. Thus, the "Integration" Program, like any other specialized program, cannot prevent "brain drain". For this, a cardinal alteration of both the conditions in the sphere of science and the attitude to science on the part of society is needed.

²⁸ These figures are taken from the following sources: 1) Vysshee obrazovanie v Rossii - 1999 (The higher education in Russia - 1999). M., CISN, March 9, 2000.

The effect of the Program would have been higher if a different level of financing were provided - the Program received only 44% of the financing allocated by the Government Decree "On the Federal Target Program of the Integration of Higher Education and Fundamental Science for the Years 1997-2000" of September 9, 1996, No 1062. It is not accidental therefore that the main problem threatening the smooth functioning of the CERs established within its framework as pointed out by the respondents was the inadequate funding of the successfully functioning CERs. The resources of the programme were never the sole source of their financing, and this undoubtedly what makes them stable structures. The structure of the sources of financing was as follows: 30% were covered by the resources of the "Integration" Program, 17% by other budget resources, 11% were covered by the resources provided by industry, another 11% by other extrabudgetary sources, 9% - by foreign grants, 8% by local (regional) sources, and, finally, the RSSF grants and foreign contracts covered 7% each.

The program was estimated as one of the most successful government initiatives in the sphere of science and education and therefore was extended to cover the year 2001, with the same level of financing as in the preceding year. Later it is intended to approve its revised version for the next 5 years - until 2006.

In accordance with the new version of the Program entitled "The Integration of Science and Higher Education in Russia" support will be provided not only for fundamental science but also for applied research and even innovation activity. A greater attention than before will be paid to international cooperation because it increases academic mobility and at the same time provides a potentially new source for supporting science and education. The circle of potential participants has also been widened: now any organizations dealing with science and technology can be included in pro-

jects and not only higher educational establishments or academic institutes. Therefore, another consumer was added to the former two (the Ministry of Education and the RAS) the Ministry of Industry, Science and Technologies. It is planned that one fifth of total resources will be obtained from extrabudgetary and local sources and directed primarily for the development of innovation activity.

This expansion of the task spectrum in face of very limited financing seems rather unreasonable. A more efficient way would be to pool the resources in order to deal with a limited number of those tasks which can be most expediently tackled within a programme.

The integration of science and education can be regarded not only as cooperation between higher educational establishments and research organizations but also as integration of research and education within a single institution. This latter way is very important in terms of improving the quality of education and research activity at higher educational establishments. This circumstance was taken into consideration during the development of the Law "On the Higher and Postgraduate Education" which took a whole year to complete. According to the Draft Law, now, when granting accreditation to higher educational establishments, their research activity should be taken in consideration. Besides, there has been an ongoing discussion of the concept of federal research universities. This status will supposedly be granted to those higher educational establishments that act as centers of science for entire regions and are capable of generating scientific schools at other universities. The creation of a system of 25-30 federal research universities is envisaged. The universities aspiring to obtain this status must be innovative also in a wider sense of the word: they should be capable of developing and introducing new specialties and fields of specialization for their students as well as to educate specialists of at least at the Master's Degree level. The essence of one of the proposals un-

der consideration is that the applicant institutions must also develop technological innovations. Therefore it is planned to look for likely candidates among those institutions that have their own technoparks. The draft is still at the stage of discussion because the implementation of the concept of research universities is going to involve a very wide range of participants. Besides, the new structure may not fit very well into the existing legal space. The situation became even more complicated after the new Civil Code was enacted because now it is often problematic to define the legal status of the research institutes existing under the auspices of higher educational establishments. There is a probability that all this will further delay the final decision concerning federal research universities.

The situation described above is not a unique example of a case when a new law further complicates the situation already existing in the sphere of education and research. This also has something to do with the activity of state research funds - the RFFR and the Russian Humanitarian Research Fund (RHRF). These two funds have been long recognized by the academic community, and their high esteem can be illustrated by the fact that the possession of a grant allocated by one of these Russian funds is regarded as one of the criteria of the high level of a particular research team and the research organization it belongs to as a whole. This recognition of the funds is not accidental because when resources are allocated through funds, the following become obvious: the problem chosen for research, the results of its examination and the examining experts, the selection criteria, the time allocated for solving the problem. The results of grant implementation are always available through published reports. However today the total budget of research funds is approximately 4.5 times less than the budget of the Russian Academy of Sciences. Correspondingly, with such a modest budget, the grants these funds can allocate are also small. In

2000, the maximum size of an individual grant allocated by the RHRF was 30,000 roubles, a collective grant - 105,000 roubles.²⁹ In 2000, the Funds' position became less stable, and now they are obliged to revise their statutes in accordance with the existing legislation, which in fact may alter both the ideology and the principles of the Funds' activity. The need to revise the statutes arose because the Funds had been created as early as in 1992-1994 when the Civil Code of the RF, the Budget Code of the RF, and the Law "On the Non-Commercial Organizations" had not yet been enacted. The enactment of new laws has revealed a discrepancy between the actual features characterizing an organization like a fund and their definition contained in the Decree of the President of the RF "On the Urgent Measures for Preserving the Potential of Science and Technology of the RF" (of April 27, 1992) which provided the legal basis for establishing the first of the two Funds - the RFFR. The RHRF emerged by having separated from the RFFR in 1994, and inherited many provisions of the former's statute. It was suggested that the Funds should revise their statutes and in fact choose one of the two available organizational forms - "state institution" or "fund". The problem is that the RFFR and the RHRF have the features of both forms, and so the choice of either one will inevitably lead to a change in the mechanisms and principles of their activity. The Funds were created as independent experts' institutions for allocating grants on a competitive basis for scientific research. At the same time the source of this independent financing is the State budget. If they choose the status of a State institution, their budget source of financing will remain guaranteed, but there is undoubtedly a threat that the system of independent expertise might be destroyed. If the "fund" form is chosen, the State financing is not going to be guaranteed.

²⁹ Vestnik RGNF, No 2, 2000, p. 116.

Finally, the support of innovation activity has remained an important goal of the state policy in the sphere of science and technology. In the first half of the year several noteworthy events occurred in this area that put an end to the many years of discussion and heralded the beginning of practical actions. By this we mean the creation of the first Russian Venture Fund, the introduction of the "Science City" status and the establishment of Federal Centers for Science and High Technologies (FCSHT).

On March 10, 2000 the decree of the government on the creation of the Venture Fund was issued. The approaches to it have been discussed since 1997. The State was directly involved in the establishment of the Fund by providing a material contribution of 100 million roubles from the resources of the Russian Fund for Technological Development (RFTD). The central fund will be located in St. Petersburg. An interest in creating regional branches has already been demonstrated by the leaderships of Saratov, Novgorod, Samara, Nizhnii-Novgorod Provinces and the Republic of Tatarstan. In addition to the State budget, other sources of financing will have to be found, both domestic and foreign. It is expected that the ratio of internal and external investments in the regional funds is going to be 1:2, but the search for extrabudgetary sources is not going to be an easy task.

The implemented approach means that the State is going to be a key participant. However it should be noted that this provision is arguable. The experience of many western countries shows that active involvement of the State can be harmful. For example, there was an episode in the history of the famous Silicone Valley when the State made an attempt to introduce strict regulative measures which resulted in a marked slowdown in the development of venture business. The experience of the Valley's development has demonstrated that the main factors contributing to the success of

venture business were flexible labor and financial markets, the presence of strong universities and only a limited number of obstacles in the way of enterprising. Almost all these factors are absent in the present-day Russia. Besides, the regulative norms for the venture activity are still to be developed. It is necessary to introduce amendments to the existing taxation and customs legislations and to develop the rules for the circulation of venture companies' shares on the market. If this is not done quickly, the activity of the Fund will be paralyzed.

On May 7, after three years of discussion, the President signed the Decree "On Granting the Science City status to the city of Obninsk, Kaluga Province". This status was granted to the city till December 31, 2024, and with this, a number of privileges were granted which will help the region to become a center for the development of high technologies. For instance, the Law on the status of a Science City envisages investment tax credit as one of the measures of support. The tax privilege was to be the principal one: initially it was planned that the Obninsk City Administration will be granted the right, for the term of 5 years, to direct at least half of its tax revenues for the development of the innovation sphere. Later this scheme was rejected because Obninsk is going to be a pilot area for developing mechanisms that could be applicable to the majority of Science Cities. And Science Cities exist under objectively different conditions. In many such cities there is no industry (Dubna, Protvino, Pushchino, Troitzk, Chernogolovka) and consequently no tax revenues that could be spent on innovative development. Finally, it was decided to make use of the inner capacities of research organizations in order to develop high technology products. The present-day version of granting this status envisages additional financing from the State budget directed in a targeted manner for the implementation of innovation projects picked out by the results of a contest. For this purpose, programs' boards of directors are created whose task will be to select projects and to

control their implementation. However there is still no mechanism for directing financial resources specifically for the purposes of research projects, and in reality the local administration can use this centrally allocated funding for any other needs.

In addition to direct State financing, it is planned that the Science Cities are going to make a more efficient use of the existing federal property: there are many free areas that can be turned into innovation infrastructures. The status of a Science City should also contribute to the growth of international prestige and thus attract foreign investors. A promising direction is also the development of venture financing, and besides, the Science Cities can become the centers of natural integration of science, education and industry. Today, in addition to science and technology, they also possess a well-developed educational component: over 70% of Science Cities have their own higher educational establishments where research is a natural integral part of the educational process.

Other forms of organizing innovation activity have also been developed: ITC (innovation technology centers), IIC (innovation industry complexes) and FCSHT (Federal Centers of Science and High Technologies). The work of organizing two ITCs in Krasnodar and Taganrog was started; a new ITC was opened at the Nizhnii-Novgorod State University; a new (the 4th in number) IIC was created in St. Petersburg. In April the draft Decree on the first Federal Center of Science and High Technologies was submitted to the government.³⁰ It was suggested to grant the status of a FCSHT to the All-Russian Research Institute on the Problems of Civil Defense and Emergency Situations of the MES of Russia, and another five organizations have passed the preliminary selection procedure and are applying for the status of a FCSHT.

³⁰ For more details about the FCSHT and their purposes see: Rossiiskaya ekonomika v 1999 godu. Tendentsii i perspektivy. Vypusk 21 ("The Russian Economy in 1999. Trends and Prospects." Issue 21). M., IET, April 2000. P. 626.

As the ITCs at the present time are considered to be the most productive form of implementing innovation activity, an accreditation procedure of the previously created forms, and technoparks in particular, was started in order to confirm the State support only for those among them that are truly engaged in science and technology. The 2000 accreditation was granted to less than one half (30 out of 78) technoparks³¹, of which about ten were assessed by experts as structures meeting the international standards. The low index of the activity of technoparks is probably accounted for by the fact that they were created without applying market approaches. Most of them were organized with the sole purpose of attracting additional budgetary resources. At the same time the State did not conduct any initial selection policy in accordance with target criteria; in particular, no tentative calculation of the recoupment of the projects was made.

An important initiative, from the point of view of involving industry in innovation activity, was put forth by the Russian Fund of Technological Development. The Fund announced a contest for financing innovation projects developed on the basis of a new scheme of returnable financing. Now the contest is conducted in two stages: at the first stage the enterprises that are interested in particular developments submit to the RFTD orders for the development of the technologies they need and thus become the customers of the contest. Then the contest itself is conducted with the participation of developer organizations. The RFTD provides financing on a retrievable basis for the research and developments carried out by the winners of the contest. The customer enterprise pays for the work at the stage of completion, after the contest committee has estimated that the result is in conformity with the technical assignment. This model helps enterprises to avoid investing their own resources for a long period as well as to avoid the risks associated with research and de-

³¹ Just for comparison: in the USA there are about 160 technoparks, and in the world on the whole - over 300.

velopment. The implementation of some selected projects will be started in 2001.

At the same time, despite the measures that are being undertaken, the innovation climate itself has shown no serious changes, and the innovation sphere, as demonstrated by some indices, undergoes little development. Thus, for example, the number of small-scale innovation enterprises in the sphere of science and technology is continually diminishing: if in 1999 there were 37.1 thousand such enterprises, by April 1, 2000 only 31 thousand remained. One of the possible approaches to the development of this sphere consists in delegating some administrative and coordinating functions from the center to the regions.

Inside the small-scale enterprises, primary importance is given to the problem of educating highly qualified managers capable of seeing the developments through to the commercial stage. At the present moment 80% of the developments to be implemented has not been completed and therefore are not ready for commercialization. Another factor that seriously inhibits the development of small-scale high-technology businesses is the extremely undeveloped legislation in this sphere. The Law "On Innovation Activity and the State Innovation Policy" is still being refined, and there are many problems - from controversial definitions to vaguely described mechanisms of supporting innovation activity. No qualitative changes occurred in the sphere of legal regulation of the protection of intellectual property (IP), though this issue is regarded as one of the most important. The situation in the sphere of IP regulation does not look attractive for potential investors, especially foreign ones. The legal conflict between the interests of the State and the interests of developers has not been resolved so far. Now the State had extensive rights and little responsibility. An attempt to settle the conflict was represented by the development of "The Concept of the State Policy of Drawing the Results of the Activity in the Sphere of Science and Technology Achieved at the Expense of the Federal Budget into the Economic Turnover". A key pro-

vision therein sounds as follows: the results achieved at the expense of the State resources become a secure property of the Russian Federation only in case when the State takes full responsibility for bringing the product in question to the market as well as financial obligations to the authors of the project and the participants in the commercialization process (with the exception of the developments intended for military or dual purposes). Besides, it has been suggested that a single federal executive body be nominated as responsible for the development and implementation of the policy concerning the IP. So far, only chaotic collisions of the interests of various departments belonging to the economic, academic, law-enforcing and defense as well as and industrial blocs could be observed there. Today "The Concept" is at the stage of discussion. An additional problem in this sphere is represented by the incompatibility of the existing Russian legislation in the sphere of the IP and the corresponding legislations of other countries. In order to solve this problem, it is planned to sign the Program of Cooperation between Russia and the World Intellectual Property Organization. Besides, the situation might be improved after the enactment of Part III of the Civil Code of the RF containing the legal norms regarding the IP.

Thus, in face of the ongoing changes in the administrative structure in the sphere of science, a number of initiatives that have been discussed during the preceding years had begun to be implemented in practice. This undoubtedly is a positive achievement, as well as the Nobel Prize granted to Academician Zh. Alferov which for some time revived public interest to the sphere of science. Perhaps all these factors and trends taken together will contribute to the growth of the prestige of research activity in Russia which has waned noticeably in the preceding years.

2.6. Foreign trade

In 2000, the foreign trade complex remained one of the most dynamic sectors of the national economy. It experienced a favorable impact of the renewal of economic growth in the global economy. According to the IMF data, in 2000 its growth accounted for 4.7% thus making up the peak value recorded over last decade. That can be attributed to the Asian economies' prompt recovery and a high growth rate demonstrated the US economy. The IMF projects the further growth of the world economy at 4.2% in 2001. It is the forecasted slowdown in the growth in the US industrial output, further rise in oil prices, and the Japanese economy's slow recovery that may affect the state of affairs worldwide.

According to the World Bank, the volume of global trade grew by 12.5% compared with 1999, thus being the highest growth rate of the world trade since the early '70s. The main factors ensuring its acceleration in 2000 became the lifting of trade barriers and the cutting-edge achievements in the communication and transport area that allowed the contraction in commodities and services circulation. Many developing economies have managed to raise their volumes of export considerably over the last decade, and that to a significant extent encouraged the growth in the world trade.

According to WTO data, Russia's share in the world export accounts for 1.3%, and the one in imports- 0.7%. From the perspective of the price situation in the world markets, 2000 became very favorable for Russia, particularly in terms of the average oil prices. The average price for barrel of Light Sweet made up USD 30.4, Brent- 28.5, Urals- 26.8. The oil prices grew by 60% vs. 1999, and by 115% - against 1998.

In an effort to curb such a fast price rise for oil and petroleum derivatives in 2000, OPEC undertook four attempts to raise its quo-

tas for its members for oil output and export, and the cumulative growth in the quotas made up 3.7 mln. barrels a day. However, it was only mid-December 2000 when the price rise returned under control. At that time, the prices dropped by 30% on average, however a new price rise began afterwards, As a result of that, the prices grew by 18% compared with their minimal level registered in December.

The average prices for non-ferrous metals remained fairly close to the level of late 1999.

TABLE 2.32

Average world prices in December of the respective year

	1996	1997	1998	1999	2000
Oil (Brent), USD/t	171,8	128,9	75,8	183,4	186,5
Natural gas, USD/Thos. cub.m.	141,8	87,1	80,4	87,5	311,2
Petrol, USD/t.	180,7	148,0	98,8	188,2	273,2
Copper, USD/t.	2291,1	1768,7	1477,7	1826,3	1914,4
Aluminum, USD/t.	1498,1	1532,4	1252,1	1559,2	1562,5
Nickel, USD/t.	6649,9	5957,4	4125,8	8118,5	7315,4

Source: based on the data of London Metal Exchange and New York Mercantile Exchange.

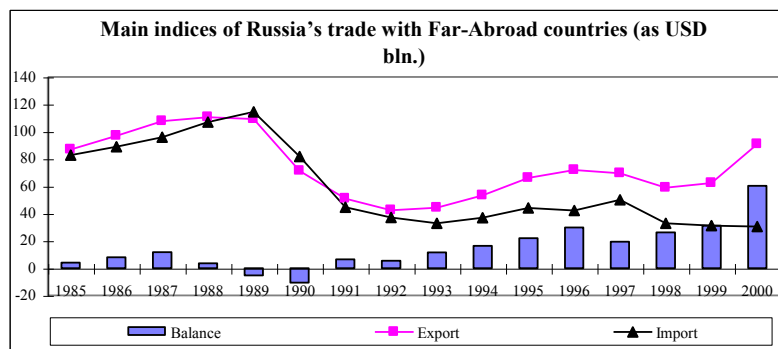
In 2000 Russia's foreign trade turnover peaked USD 149.5 bln. vs. 115.5 bln. reported in 1999. The positive balance of foreign trade accounted USD 60.9 bln., thus showing a 68.6% grow relative to its respective value of 1999 and being a record-breaking index for the last decade.

In addition to the rise in world prices for energy sources, the dynamics of foreign trade indicators was also determined by the downfall in prices for the traditional Russian imports. Thus, in 2000, according to the State Customs Committee, the correlation between the average export price and the average import one at 64% exceeded the respective index of the prior year in the Ist

quarter, at 54%-in the IInd quarter, and at 46%-in the IIIrd quarter. Between January to November 2000 the correlation between the average world prices for Russian exports and the average world prices for Russian imports exceeded its respective rate of the prior year at 43%. At the same time the world prices for Russian exports grew roughly by one-third, while the world price level for Russian imports slid by 6%.

In 2000, the trade turnover between Russia and Far-Abroad countries accounted for USD 121.4 bln., or 130.8% of the level of 1999.

FIG.2.47



Source: Goskomstat of RF

Export. Considering the results of the year on the whole, Russian exports in value equivalent were worth a total of USD 105.4 bln. thus showing a 38.9% growth relative to their respective index of the prior year.

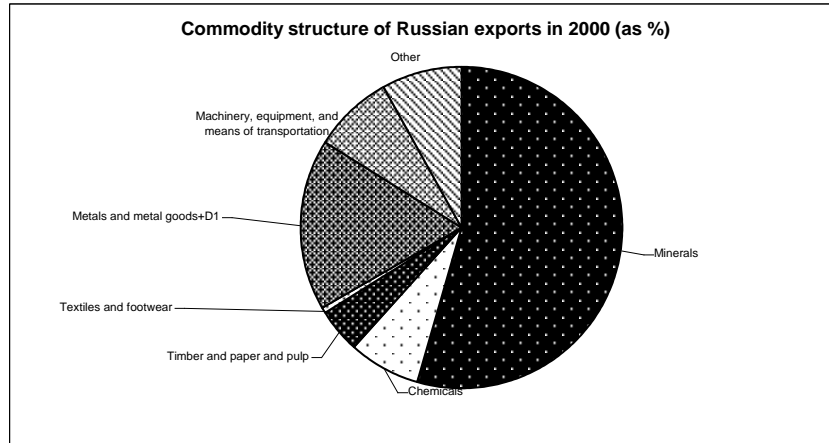
The physical volume of export was growing at much slower rate than the prices. According to results of the first ten months of 2000, the growth in physical volume of export made up 9% compared with its respective index of the prior year, while contract prices rose roughly by 1/3.

As concerns the country structure of Russian export, the Far-Abroad countries increased their proportion in that: given that in 1998 that accounted for 80%, in 1999 it rose up to 84%, and in 2000- to 86.1%.

In 2000, Russia's exports to Far-Abroad Countries were worth a total of USD 90.5 bln., or at 42.4% more than in 1999.

Traditionally it was fuel and energy sources that remained the crucial Russian export item. The high average contract prices for oil and petroleum derivatives generated the 80% growth in the value of the export volume of the national fuel and energy complex, of which 71% can be attributed to the rise in oil prices, while 5% -to the growth in the physical volume of exports. As a result, the proportion of fuel and energy commodities in Russia's overall export to Far-Abroad countries grew by 9.2 per cent points vs. 1999 and accounted for 53.5% of the total amount of Russian export.

FIG.2.48



Source: the RF Ministry of Economic Development

It was crude oil that constituted the major export item to Far-Abroad countries in 2000 (over 1/4 of the total amount of exports to

these countries). When compared with 1999, the physical volume of oil export grew by 10.3%, and its average contract price- by 62%. Thus, given that in the Ist half 2000 the oil price accounted for USD 174/t., in the IIIrd quarter it climbed up to 183, and in the IVth quarter - to USD 187/t. The export price for petroleum derivatives compared with 1999 grew by 81%, including for jet fuel- by 98%, diesel fuel- 92%, gasoline- 70%, black oil - 66%. When compared with 1999, the physical volume of the export of petroleum derivatives grew by 8.8%, natural gas- 2.1%, coal - 69.5%.

TABLE 2.33

**Dynamics of physical volume of Russia's exports to
Far-Abroad countries**

	1994	1995	1996	1997	1998	1999	2000
Crude oil, mln.t.	91,7	96,2	105,4	109,8	117,9	115,7	127,6
Petroleum derivatives, mln.t.	39,1	43,5	55,0	58,4	51,2	53,9	58,4
Natural gas, mln. cub.m.	109,3	121,9	128,0	120,9	125,0	131,1	133,8
Coal, mln.t.	17,7	21	20,3	18,9	18,6	22,0	37,3
Ferrous ore, mln.t.	9,8	11,4	7,8	8,2	10,1	7,6	9,1
Ferrous metals, USD. Mln. (in comparable prices)	4371	5646	6208	6018	4464,1	3885,8 0	4957
Aluminum, Thos.t.	2301	2250	2616	2693	2790,4	3113,5	3173
Copper, Thos.t.	451	467	524	533	550,3	532,9	642,4
Nickel, Thos.t.	124	153	166	220	214,1	211,1	196,8
Machinery and equipment, USD. Mln. (in comparable prices)	32000	5314,5	5554,2	5598,7	5760,5	5953,6	6825
Mineral fertilizers, mln.t.	13,1	16,2	15,1	14,4	15,9	18,8	19,9
Round timber, mln. cub.m	13,5	17,9	15,4	17	19,8	27,5	30,6

Source: Goskomstat of RF

It was metals and related items that followed oil and petroleum derivatives in terms of their significance for the national export, though their proportional weight in the overall export to far-Abroad countries slid from 22.2% in 1999 to 17.9% in 2000. The 16% growth of their export value became possible only thanks to a 22% growth in average contract prices for them. The prices for cast iron rose at 21%, ferroalloys – 14%, intermediary goods made from iron and non-alloyed steel – 34%, rolled iron and carbon steel - 23%, copper – 11%, nickel - 49%, aluminum – 12%, while the physical volume of the export of this group of commodities showed a 5% fall.

The export of machinery and equipment rose by 14.6%, and the share of these goods in the overall export to Far – Abroad countries made up 7.5% vs. 9.6% in 1999.

The share of chemicals in Russia's exports to Far-Abroad countries accounts for 6.7% (in 1999 – 8.2), thus showing a 17% growth in its export value volume relative to 1999. The physical volume of exported mineral fertilizers grew by 6%, ammonia – 14%, methanol – 57%, and synthetic rubber- 13%.

The value of exported timber and paper and pulp commodities grew by 17%, with their proportion in the country's exports to Far-Abroad countries accounting for 4.5% (in 1999- 5.5%). The physical volume of exported round timber grew by 11.3%, sawed timber- by 21%, glued plywood- 6%, and cellulose- by 23%. The average contract prices for cellulose and journal paper grew by 29% and 11%, respectively, while the prices for glued plywood and sawed materials declined, accordingly, by 12% and 4%.

Because of the advanced growth in physical volumes of exports and export prices relative to domestic prices, in 2000 the proportion of export in GDP rose by 2.5 per cent points compared with the prior year.

TABLE 2.34

Average export prices for major commodities (USD/t.)

	1994	1995	1996	1997	1998	1999	2000
Crude oil	100,6	108,2	133,5	118,6	74,2	100,8	175,0
Natural gas, Thos.m ³	72,8	80,1	84,2	88,6	66,3	53,5	87,5
Coal	33	36,2	38,8	35,7	27,3	16,6	26,4
Iron ore	19,6	23,1	26,7	23,9	21,5	15,1	15,8
Nitric fertilizers	80,9	119,8	128	90,3	60,5	38,3	58,3
Potassic fertilizers	69,7	71,9	77,2	79,8	87,4	86,4	87,0
Pound timber, m ³	53	58	59,4	57,5	50,5	43,4	43,5
Journal paper	291,5	591,8	473,7	383,4	398,9	358,3	397,4
Cast iron	112,8	130,4	136,8	124,3	108,5	68,3	85,4
Ferroalloys	832,7	1090	1114	818,9	733,8	560,3	631,0
Copper	2042	2550	2143	2102	1655,0	1429,7	1658,3
Nickel	5973	8057	7272	6733	5148,4	5236	8949,4
Aluminum	1029	1519	1500	1402	1349,4	1145	1343,2
Passenger cars, unit.	3046	3417	3940	3806	4336,2	3223	3203,1
Trucks, unit.	8494	11915	12833	17900	11908,7	10581	12422,2

Source: Goskomstat of RF

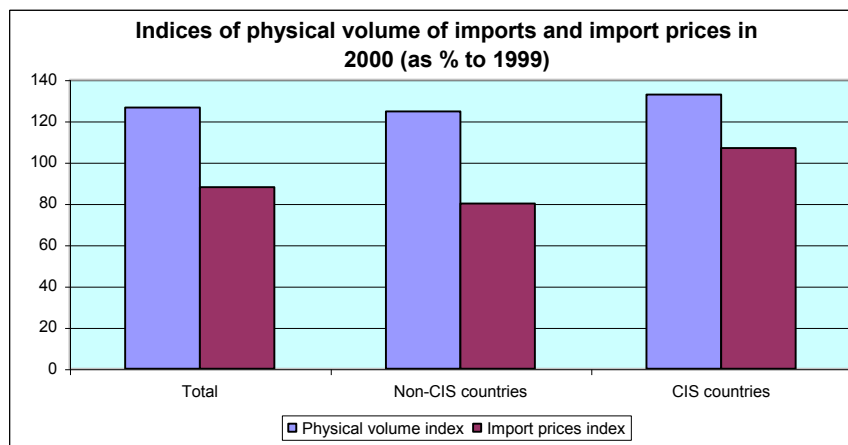
The further dynamics of the national exports to a significant extent depends on the world prices for energy sources. In early 2001 the state of affairs in the market was more favorable to the Russian exporters than it was projected in late 2000. The supply of crude oil was slightly in excess over the respective demand, and the prices remained at rather a high level. In January, the price for Brent was USD 26/barrel. Since January, the prices for natural gas have risen by 9% on average.

The change in the state of affairs in the world economy may lead to a contraction in the demand volume for petroleum derivatives, which would entail a decline in oil prices. At the same time the OPEC members will be anxious to prevent any radical downfall in prices. In March 2001 OPEC made a decision on a regular lower-

ing of oil export quotas which would enable the prices to stabilize at a relatively high level. In such circumstances Russian exports should keep their fairly high rates in 2001, though it is most unlikely they would beat off the rise noted in 2000.

Imports. According to SCS data, in 2000 the average prices for import goods were down compared their respective level of 1999: in the 1st quarter- by 15%, in the IInd quarter – by 13%, in the IIIrd quarter- by 12% compared with the respective indices of the prior year. Nonetheless, in 2000 the value volume of imports grew by 11.9% against 1999 and accounted for USD 44.2 bln. That became possible due to a considerable (roughly at 25%) rise in the physical volume of imports.

FIGURE 2.49



Source: SCS

The proportion of Far-Abroad countries in the total volume of import supplies slid from 73.7% in 1999 to 70% in 2000.

In 2000 Russian imports from far-Abroad countries were developing at a random. It remained practically equal to its respective index of the prior year (with a negligible growth rate of 0.1%)

through the 1st half 2000, which at that time could be attributed mostly to the import substitution processes, low demand for import merchandise, and the contraction of purchases of machinery and equipment, food stuffs and related raw materials from the said countries, along with the re-orientation towards the import supplies of cheaper substitutes for the noted goods from the CIS countries.

In 2000, the real exchange of ruble was strengthening against USD³². Hence, the attractiveness of imports grew by late 2000. In the second half of the year the average monthly volumes of import supplies became worth a total of USD 2.5 to 2.8 bln. and peaked 3.4 bln. by December. In all over the year Russia imported from Far-Abroad countries USD 30.0 bln.- worth merchandise, which became at 6.9% more than in 1999.

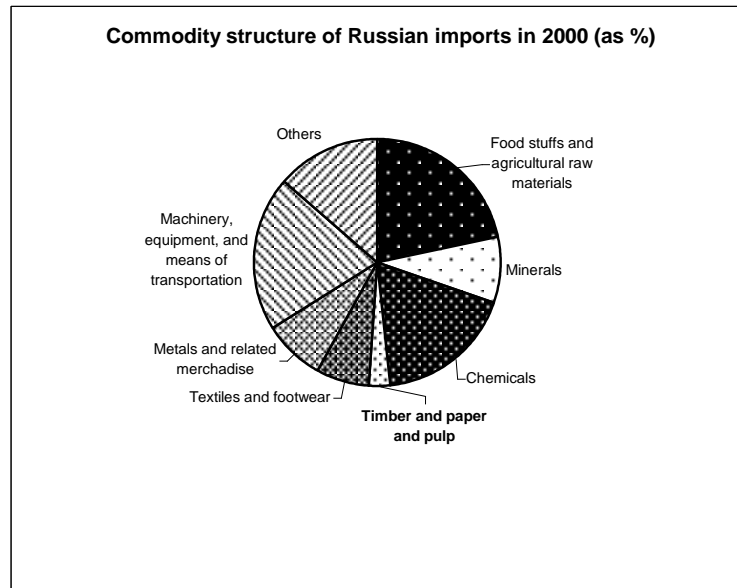
The increment in imports was related to the growth in the purchasing of agricultural raw goods and commodities designated for production. That was determined by the increasing demand on the part of industrial sector. The import supplies of investment-related commodities grew by 6.9% in 2000.

The growth in the population's real disposable incomes encouraged the increase in import of consumer goods, primarily medicines.

With food stuffs, machinery and equipment, and chemicals still being major import items, the commodity structure of Russian imports has not experienced any substantial changes.

³² See the Section on monetary and credit, and exchange rate policy of the present review

FIG2.50



Source: the RF Ministry for Economic Development

It was machinery and equipment that were the major item of Russian import from Far-Abroad countries. Their proportional weight in the overall volume of imports from these countries made up 36.2% and has not changed since 1999. As concerns the structure of the machine - building produce imported from Far-Abroad countries, technological equipment accounted for 2/3 of that, while the share of instrument making produce made up 13%, and another 9% was the share of the means of ground transportation. The purchases of latter demonstrated their growth at 21% against the prior year, while the import supplies of vessels and naval equipment.

In 2000, the proportion of food stuffs and agricultural raw materials in the overall volume of imports fell from 28.8% to 23.9%. When compared with 1999, the import of deep-frozen meat from Far - Abroad countries dropped 2.4-fold, powder and condensed milk-

4.1- fold, animal butter – by 24%, sunflower oil- 3.9-fold, unrefined sugar – by 21%, tobacco goods- by 38%. At the same time the import supply of poultry grew 2.9-fold, deep-frozen fish - by 6%, citrus fruits – by 18%, coffee – 2.2-fold, meat preserves- by 33%, refined sugar- 3.8 times, cacao beans- by 45%, alcoholic and soft drinks – by 17%. The import purchases of tea, maize, and chocolate remained at the level of the prior year.

The import procurement of chemicals showed by 25%, and their share in the overall import from Far-Abroad countries grew by 3.9% compared with 1999 and made up 20.7%. Of the main goods in the group one should note the growth in import supplies of medicines (by 42%), chemicals means of crops protection –by 43%, and rubber- 2-fold.

As concerns other groups of merchandise, the import supplies of timber and paper and pulp goods grew by 16% (with their share in imports accounted for 4.5%), textiles – by 23 (3.9), while the import supplies of metals and related articles slid by 6% (4.7%), and those of minerals- by 14% (1.7%).

TABLE 2.35

Dynamics of physical volumes of main Russian imports

	1994	1995	1996	1997	1998	1999	2000
Pipes, Thos.tr	631	367	385	239	154,1	366,6	269,8
Machinery and equipment, USD mln.	10696	12804	10172	13511	12789,4	7881,7	8028,0
Medicines, USD mln.	1184	969	1083	531	1198,0	763,0	1089,6
Textile clothes, USD mln.	861	511	298	313	211,9	89,0	105,7
Footwear, mln. pairs	41,7	26	45,8	15,4	2,9	1,2	2,8
Deep-frozen meat, Thos.tr	358	506	540	694	595,8	806,8	340,4
Deep-frozen poultry, Thos.t.ыс.	496	824	748	1117	814,1	234,8	677,1
Unrefined sugar, Thos.t.	1081	1166	1680	2511	3002,9	5774,2	4546,6
Alcoholic and soft drinks, USD mln.	695	1017	379	700	390,4	145,6	170,3

Source :Goskomstat of RF

The import supplies ensured the satisfaction of a considerable part of the domestic demand for investment and consumer goods. By late 2000 the proportional weight of import goods in the retail trade sector accounted for 41% compared with 36% reported in 1999.

In the conditions of the strengthening of Rb. real exchange rate, rise in business activity and expansion of the domestic effective demand the import supplies should grow further on in the forthcoming future.

Trade with the CIS countries

In 2000, the volume of mutual trade between Russia and the CIS countries grew by 24.0% compared with the level of the prior year and made up USD 27.9 bln., with exports accounted for 14.6 bln. (a 20.7% growth) and imports – 13.3 bln. (a 27.9% growth).

The proportional weight of the goods turnover between Russia and the CIS countries in the overall volume of the Russian goods turnover in 2000 showed some decline against 1999 and accounted for 18.6%, providing that the proportion of the CIS countries in Russian exports was 13.8%, and imports- 30.1%.

Within the Commonwealth, however, Russian supplies still are focused mostly on three countries: Ukraine, Belarus, and Kazakhstan, whose aggregate share in Russia's goods turnover with the CIS countries roughly accounts for 90%.

The structure of the national goods turnover has remained unchanged since the date of the establishment of the Commonwealth of independent States, with over 50% of exports comprising supplies of energy sources and roughly 25% of import supplies from the neighboring countries to Russia falling on food stuffs.

TABLE 2.36

**Dynamics of Russia's foreign trade with the
CIS countries in 2000 .**

	1999	2000
Goods turnover (USD bln.)	22,5	27,9
Exports (USD bln.)	12,1	14,6
Imports (USD bln.)	10,4	13,3
Balance	1,7	1,3
Increment rate against the prior year (%)	- 21,3	24,0
The proportion of the CIS countries in the overall goods turnover (%)	19,5	18,6

Source: Goskomstat of RF

Exports. As long as the commodity structure of Russian exports to the CIS countries are concerned, almost 55% of them comprise the supplies of energy and fuel resources, and roughly another 20%—metals and related goods, while chemicals, machine-building produce, products of the forestry and paper and pulp sector account for a. 7% each of the overall volume of the national exports to the CIS countries. The main reason for the growth in Russia's goods turnover with the CIS countries last year was the state of affairs in the world market for energy sources, which was very favorable to Russia. The rise in export supplies in value equivalent became possible chiefly due to the growth in contract prices. The latter more than doubled for crude oil, gasoline and jet fuel; grew 1.5-1.8 times for diesel fuel, black oil, and coal. Thus, given that the physical volume of oil supplies to the CIS countries in 2000 fell by 11.1% against 1999, the respective value volumes showed a 84.6% growth.

However, the growth in supplies in natural equivalent was also noted by some export items. The export supplies of gasoline and diesel fuel grew as much as by 78.0% (with the 3.3-fold growth in

the value volume) and by 42.9% (the 2.3-fold growth in the value volume), respectively.

As concerns the export supplies of another major Russian export item- natural gas, - their volume fell by 19.2% compared with the prior year. Last year, the gas supplies showed a negative dynamics, for because of a huge amount of the CIS countries' outstanding debt, GASPROM is increasingly oriented towards European countries that guarantee their payments in foreign exchange.

TABLE 6.

**Export of single kinds of merchandise
to the CIS countries in 2000**

	2000	As % to 1999
Crude oil, mln.t.	16,9	89,9
Petroleum derivatives, Thos.t.	3480,0	115,3
including:		
Gasoline, Thos.t.	817,3	178,0
Diesel fuel, Thos.t.	1122,9	142,9
Black oil, Thos.t.	576,5569,5	53,2
Natural gas, млрд куб.м	60,0	80,8
Coal, Thos.t.	6106,0	102,9
Machinery and equipment, USD mln.	2335,0	123,4
Iron ores and concentrates, Thos.t.	10114,0	3,0 –fold growth
Ferrous metals (except cast iron, ferro-alloys, and scrap) , USD mln	511,7	148,9
Synthetic Rubber , Thos.t.	51,5	56,0
Timber cellulose, Thos.t.	44,6	80,7
Journal paper, Thos.t.	112,9	116,7
Wheat, Thos.t.	457,4	94,5

Source: Goskomstat of RF

The Russian produce found sales markets in the region thanks to low transportation costs, high level of barter deals, and vast opportunities to pay with mutual deliveries, and to employ delays in payments. The existence of significant potential markets for Rus-

sian exports in the CIS countries is proved by the data on the increase in export supplies of the Russian commodities, the average actual prices for export operations by which exceed the analogous prices for the respective operations with Far-Abroad countries. Usually the average export prices for Russian goods exported to the CIS countries is minimum 1.5 times down compared with the respective supplies to any other country, however, in 2000 the export prices for a whole range of goods, on the contrary, were higher than their respective indices in Russia's trade with the West.

For example, the export prices for diesel fuel, gasoline, conversion cast iron, and journal paper supplied to the CIS countries were in excess of the prices for the respective supplies to third countries at 12.9%; 31.3%; almost twice; and 17.9%, respectively. Thus, diesel fuel was sold to the CIS countries at the average weighed price of USD 283.3/t., while to the third countries- USD 250.9/t., while the gasoline prices were USD 289.1/t. and 220.6/t/, respectively.

In 2000 the situation in the market for ferrous metals changed drastically compared with 1999: given that in 1999 the prices for the supplies of these kind of produce to the CIS countries were lower than the average contract prices for supplies to the West, and the average price for ores and ferrous concentrates was USD 11/t., while for the Far-Abroad countries- USD 17/t., in 2000 the said prices grew by almost 20%. Hence, the neighboring countries consequently have become more attractive for the Russian exporters in terms of prices for their exports. Statistical data show that given that in 1999 the supplies of ferrous metals and iron ores experienced, respectively, a 29.2% and a 13.1% fall, in 2000 they grew by 48.9% and almost tripled, respectively.

The value volume of the supplies of machinery and equipment grew by almost 25%. and became USD 2.3 bln. worth (in 1999 these exports accounted for USD 1.65 bln. and were down by

25.9% compared with 1998). Despite the negative world price dynamics for industrial produce and non-fuel minerals that has a compensating effect on the oil prices, the Russian machinery and equipment maintain their competitiveness in the CIS countries' markets mostly thanks to their technological compatibility and significant volumes of barter deals. For instance, in 2000 the supplies of machinery, equipment and transport vehicles to Kazakhstan grew considerably: the volume of these exports accounted for almost 30% of the overall volume of Russian exports to the country.

The CIS countries also consume almost 100% of the non-organized export from Russia. However, in connection with the decision of the Russian authorities to introduce visa regime with the CIS countries made in late summer 2000, the volume of "shuttle" trade carried out by private individuals with the Near-Abroad states may decline considerably.

Imports. In 2000, the import increment rate from the CIS countries was significantly superior to the respective indices of Far-Abroad countries and accounted 27.9%. Given that the proportion of imports from the CIS countries in the overall volume of Russian import supplies was 25% in 1998 and 26.5% in 1999, in 2000 it reached 30.1%. At the same time the growth rate in their value volume were inferior to the growth rate of their physical volume. Such a trend was determined by the lowering of world prices for the main Russian imports and re-orientation of the national importers towards importation of cheaper merchandise.

The imports from the CIS countries demonstrated roughly a 30% rise at the expense of repayment of outstanding debts for Russia's supplies of energy sources; in addition, after the crisis it has become more profitable to import many goods from these countries due to their cheaper prices and, accordingly, lower quality.

The commodity structure of imports from the CIS countries comprises roughly 20% of supplies of food stuffs and agricultural raw materials, and fuel and energy sources each, while the proportion of supplies of metals, machine-building produce, and chemicals was fluctuation between 12 to 15% over the year.

When compared 2000 to 1999, imports grew: food stuffs and related materials- by 28%, fuel and energy commodities- 2.7-fold, chemicals and textiles (by 31%), metals and related finished goods by 75%, machinery and equipment- by 24.8%.

The growth in imports in natural equivalent in 2000 was especially notable in terms of the following goods: cream butter (2.2-fold), fish (at 38.5%), wheat (28.0%), alcoholic and soft drinks (at 23.4%), machinery and equipment (22.8%), steel pipes (62.9%), ferrous metals (62.1%), and coal (59.1%).

TABLE 2.38

Import of single kinds of merchandise from the CIS countries

	2000	As % to 1999
Machinery and equipment, USD mln.	2543,7	122,8
Passenger cars, pcs.	14111	144,7
Bread crops, Thos.t.	2803,1	120,5
Alcoholic and soft drinks, USD mln.	248,7	123,4
Cotton cloth, USD mln.	41,3	139,7
Textile clothes, USD mln.	127,5	151,1
Ferrous metals (except cast iron, ferroalloys, and scrap) USD mln.	573,9	162,1
Pipes, thos.t.	793,7	162,9
Coal, mln.t.	25,4	159,1
Sunflower seeds oil, Thos.t.	94,6	103,6
Fresh and deep-frozen fish, Thos.t.	22,8	164,2
Cream butter, Thos.t.	54,3	порт в 2,2р.
Refined sugar, Thos.t.	196,7	70,0

Source: Goskomstat of RF

Similar to exports, with the general price level for the goods imported from the CIS countries being low, the average prices for single kinds of merchandise, however, exceeded at 30 and more percent their Western analogues: in 2000 the average price for import fish from the CIS countries was USD 572.4/t., with the analogous produce from the Far-Abroad countries USD 381.1/t.; the prices for cream butter were, accordingly USD 562.3 and 357.9 per ton. At the same time in 2000 fish supplies grew by 64.2% and sunflower seeds oil- by 4%. The prices for meat supplied from the CIS countries exceeded the purchasing prices in the West at almost 70%, providing that the decline in the volume of meat import from the neighboring regions was insignificant and accounted just for 4%. However, due to a very complicated epidemiological situation in the Western market for meat, the volumes of meat import from the CIS countries are likely to remain at the previous level or even tend to grow.

Despite an unfavorable correlation between the prices quoted by CIS exporters and those in the West, the rise in the food supplies from the CIS countries finds itself under the impact of the fact that many Russia's trade partners there pay with food for Russian supplies of energy sources.

While comparing with the prior year, the statistical data shows the 22.8% rise in the import supplies of machinery and equipment from the neighboring countries. That has slightly improved the structure of Russian imports and helped move their focus in favor of finished products.

Russia's Mutual Trade with its largest Trade Partners in the Cis

In light of regulation of Russia's mutual trade with other members of the Commonwealth, the agenda comprises the following major issues to be tackled: Ukraine's accession to the Customs Un-

ion of CIS countries, which should allow supplies of energy sources without collection of export duties; customs duties imposed on the goods with the origin in third countries, though imported from the Belorussian territory; legitimacy of introduction by some neighboring countries of restrictions on Russian exports, etc. Last year, the problem of a free trade zone was also a hot issue, for the implementation of the multilateral agreement on free trade has not been ratified by the Russian Parliament as yet, for the legislators are afraid of a sharp contraction in the respective budget revenues. The economic relations between Russia and some of its partners in the Commonwealth experienced a number of changes.

Ukraine

In 2000, the RF Government has to undertake some measures to protect the national producers' interests, because the other CIS countries' produce often proved to be considerably cheaper than its Russian analogues. In autumn 2000 Russia announced its intention to introduce anti-dumping sanctions against the Ukrainian-made steel pipes, whose share in the overall volume of the national pipe import accounted for 80%. The negotiations were held over 6 months, however, fruitless they were. Nonetheless, only in October 2000 alone the import of Ukrainian pipes was over 100 Thos. t. and accounted for 25% of the Russian output. According to the national metal producers, their monthly losses totaled a. USD 15 mln. In addition, a number of largest metal producers announced their readiness to launch an anti-dumping trial against the Ukrainian producers of hot-rolled plates, reinforced steel, and rolling items. In compliance with the current bilateral agreements, VAT is paid according to the "country of origin" principle, while Ukraine grants its exporters with significant benefits. That automatically makes the Ukrainian metals roughly at 10% cheaper than Russian ones. The

agreements on the transition towards the collection of VAT according to the “country of destination” principle concluded in 2000, perhaps, should slightly improve the situation in the Russian market for metal products. The Ministry of Economic Development and Trade proposed a special customs duty of 40% of the customs value of the goods, however, the final decision has not been taken as yet.

Ukraine has also practiced restrictive measures against Russian exports: in March 2000, the Ukrainian Interdepartmental Commission for International Trade ruled the decision to introduce quotas, including on Russian goods, on textiles, electric lamps, chemicals (polyurethane plates). The annual losses of Russian producers may make up USD 14-15 mln.

During the whole year Russia and Ukraine were holding negotiations on such sensitive issue as the restructuring of the Ukrainian 2 bln. USD debt for the Russian gas supplies. Though the countries have agreed upon the establishment of a joint venture to sell gas, Ukraine plans to a significant extent to re-orient its gas procurements to Turkmenistan. It is envisaged that a 2.5- fold increase in the Turkmenian gas supplies would become possible thanks to the intended construction of a new gas pipeline from Turkmenistan bypassing the Russian territory. However, at present the negotiations between Ukraine and Turkmenistan are in the dead end, while Gasprom has taken its chance and plans to buy as much as 10 bln. cub.m. of the Turkmenian gas between 2000 to 2001 to re-sell that to the third countries.

Belarus

In autumn 2000, the Russian-Belorussian Council of Ministers reactivated its work. At that time, at their meeting they discussed such crucial issues as the transition to the single currency and

bringing into line the both countries' customs and tax policies. Nonetheless, despite the respective agreement signed yet in November 2000, which read that as early as in 2005 the Russian ruble should become the single currency for non-cash transactions in the both countries, the realization of the intent to implement a real single currency in 2008 appears highly problematic, due to a considerable difference in the levels of economic development and population's income in the countries.

Last year, Russia's trade turnover with Belarus was worth USD 9,299.4 mln., or at 33.1% more than in 1999. The volume of export supplies rose at 46.9%, while imports from Belarus grew almost by 17%. Belarus's balance in its trade with Russia is negative: according to the data on 2000, it accounted for USD 1,771.

The share of export-import operations with Belarus in Russia's total foreign trade turnover was 6.8% last year, while the respective Russia's share in Belarus's foreign trade turnover made up almost 60%. It is mineral and raw materials that traditionally form major Russian exports: last year the proportion of crude oil, natural gas and ferrous metals in the total volume of Russian supplies to Belarus accounted for 50.3%. About 30% of the overall export volume comprise machinery and means of transportation, chemicals, and non-ferrous metals. At the same time, for instance, Russia satisfies at 100% Belarus's needs in coal, gas, grain combines; at 90%-crude oil and timber; almost at 70%- in the produce of the ferrous and non-ferrous metallurgy.

It is machinery and means of transportation, food stuffs, chemicals and textiles that form the main part (over 75%) of the structure of imports from Belarus.

The proportion of barter transactions accounts for over 50% of the goods turnover between the two countries. It is likely that this

kind of trade would prevail further on, due to the Belorussian importers lacking foreign exchange resources.

Kazakhstan

Russia merchandise comprised almost half of Kazakh import: the Russian supplies satisfy a. 50% of the country's need in electric power, over 90%- in petroleum derivatives, a. 60%- in machinery and equipment. As concerns exports, Russia's share in the Kazakh exports accounted for over 40%. Russia purchases ores and concentrates of iron, aluminum, chromium, zinc, as well as meat and grain. Thus, the iron ore imported from Kazakhstan for further processing accounts for the half of the whole barter import from the CIS countries. In 2000, the supplies of Kazakh machinery, equipment and means of transportation grew notably, however, their share in the total volume of the country's exports remained fairly low- a. 4%.

Some disagreements between Russia and Kazakhstan in the area of mutual trade have entailed almost a 30% fall in the mutual goods turnover in the first half 2000. In February 2000 the Kazakh government passed a Resolution "On temporary protective measures on single goods" that introduced temporary duties collected in addition to the existing regular customs duties rates on some chemicals, construction materials, and electricity counters. The imposition of increased duties on the goods supplied from the counties -members of the Customs Union undoubtedly breaks the basic principles of its functioning.

However the negotiations on economic issues held during the RF President's visit to Astana in October 2000 generated the emergence of some positive trends. Thus, the parties adopted an important document on principles of collection of indirect taxes (VAT

and excises), and henceforward the both countries' exports, except for oil and gas supplies, should be subject to zero tax rate.

In addition, Russia has agreed to raise the quotas on transportation of the Kazakh oil through its pipeline network from 10 to 14 mln.t. in 2000. This decision cannot be judged ambiguously: on the one hand, that should generate additional budget revenues, however, on the other hand, with the pipeline system's transportation capacity remaining unchanged, Russian companies' export capacity should somewhat fall. The growth of Kazakh oil output and exports to a certain extent weakens Russia's positions in the CIS market for energy sources: thus, Kazakhstan and Belarus have already signed an agreement on the expansion of Kazakh oil supplies to Belarus where oil-refining tariffs are very low and, therefore, extremely favorable for Kazakhs.

In all, during 11 months of 2000, the goods turnover between Russia and Kazakhstan demonstrated a 1.8-fold growth relative to its respective period of 1999 and reached USD 4 bln., thus approaching the level of 1998.

A significant rise in the volume of export-import operations in the first half 2000 has shown Russia overcoming the effects of the financial crisis in the area of its trade with the CIS countries. Should the situation in the world markets remain favorable, Russia may seize the opportunity to expand its trade with both Far-Abroad countries and with its partners in the CIS.

2.7. Ensuring Military Security and Military Reform in Russia: Economic Problems

Economic Aspects of Military Reform in Year 2000

Year 2000 should have become the final year of the first stage of the military reform started in mid-1997.

All preceding years had in many respects brought results quite different from those envisaged in the process of designing the reform:

- The necessary investment in the development of the military became available only in two last years;
- Military and political relations with NATO and the USA have complicated, especially after the bombing of Yugoslavia in 1999;
- Combat operations conducted within the Russian territory (Chechnya and Dagestan) tremendously affected the process and the concept of the development of the military.

The Duma elections, resulted in changes among heads and personnel of respective Duma committees, the election of the new RF President (the Supreme Commander of the Armed Forces), and the appointment of the new government also were factors affecting the military reform. On the whole, the first stage of the development of the military was not completed by end-2000, as it was stressed both by the RF Security Council and the President.

The new RF President made more precise the wording of the most important document concerning the development of the military – the Concept of National Security (CNS) of the Russian Federation. CNS plays the most important system-forming role among numerous normative acts related to the RF security issues. Some shortcomings of this documents are analyzed below.

First comment. It begs to differ with the CNS statements that it is always in the interests of our state to maintain the “*inviolability*” of the constitutional system, the economic and social “*stability*.” Such statements deny the necessity to perfect the RF Constitution and to adjust the course of the economic reform in the country. Moreover, these statements do not take into account the discontent with the present economic and social situation of the RF military organization and related sectors of science and industry.

Second comment is related to the statement about the “*priority*” of measures aimed to ensure the national security and protection of Russia’s interests in the economic sphere. The same idea is expressed in a CNS paragraph: “*Ensuring the military security of the Russian Federation is the most important aspect of the state activities. The key objective in this area is to ensure the potential for an adequate reaction to treats, which may emerge in the 21st century at a reasonable level of expenditures for the national defense.*”

However, it is necessary to counter military threats from all sources, both external and domestic. Therefore, the tasks of military security shall be compared with the total military expenditures, not only those earmarked for defense. There exists a rather distinct community of “armed agencies” in the RF, which is officially defined as “*the military organization*” and includes the Armed Forces, other troops, military units and agencies. Yet in 1998 the military tasks were distributed among the components of the RF military organization in accordance with the “Fundamental Principles of the RF Military Policy in the Area of the Development of the Military for the Period till 2005”. The funds earmarked by the state for the performance of these tasks shall be distributed accordingly.

Table 2.39 presents the composition of the RF military organization as set by totality of laws defining this organization, expendi-

tures for the military organization as targeted by the federal budget for year 2000 (No. of the budgetary item, or No. of a supplement to the budget), and recipients.

TABLE 2.39

No.	Composition of the RF military	Tasks	Expenditure item in FB / recipient of funds
1	RF Armed Forces (Ministry of Defense)	1) Defend the country; 2) Defend and guard the RF state airspace and underwater borders; 3) Defend the RF state land and sea borders by military methods;	Sup. 6 / Ministry of Defense /
2		<i>Other troops</i>	
2.1	RF Federal Board Service troops	5) Guard state land, sea, river, lake, and other water borders;	Sup. 6 / FBS /
2.2	RF Ministry of Interior troops	6) Suppress, localize, and neutralize internal armed conflicts within the national territory;	Sup. 6 / MIA /
2.3	RF railroad troops	8) Cover (in technical terms) and restore railroad networks for the purposes of national defense;	Sup. 1 / FRTS /
2.4	Troops of the FAGCI under the RF President	9) Ensure governmental communications and informational security;	? / FAGCI /
2.5	Civil Defense troops	10) Civil defense.	Sup. 1 / MES /
3		<i>Military Units</i>	
3.1	Engineering technical troops at the federal executive bodies	11) Cover, improve fail-safe operation of the RF communications networks for the ensuring of state governance, defense, and security;	? / FSCS; State Technical Commission /
3.2	Road construction troops at the federal executive bodies	12) Construct objects designated for special and industrial purposes serving the defense and security of the state, including objects of the nuclear complex; 13) Cover (in technical terms) and build motor roads;	Sup. 1 / FSCS
4		<i>Agencies</i>	
4.1	Foreign Intelligence Service	14) External intelligence;	? / FFIS
4.2	Federal Security Service	15) Combat terrorism, political extremism; 16) Counter intelligence operations of special services and organizations of foreign states;	? / FSS
4.3	Federal Board Service	See item 5	Sup. 6 / FBS
4.4	Federal agencies for governmental communications and information	See item 9	? / FAGCI
4.5	Federal Protection	17) Protect persons under state guard at places of	? / FPS

No.	Composition of the RF military	Tasks	Expenditure item in FB / recipient of funds
	Service	their permanent or temporary residence or en route;	
4.6	Federal agency for ensuring mobilization preparedness of state administration	18) Ensure mobilization preparedness of federal bodies of state administration and their staffs, and of the RF Presidential Administration;	? / GUSP
5	Servicemen attached to other structures	19) Operate within other structures at the federal and regional levels in the interests of defense and security;	?
6	Administration of the RF military organization	20) Administer the military organization for the fulfillment of all defense and security tasks.	?

Note: the second and third columns of the table are composed basing on Federal law No. 53-FZ of March 28, 1998, "On Military Duty and Military Service," "Fundamental Principles..." and regulations concerning respective agencies defined as "armed" ones. As concerns the inclusion of units of the RF tax police in the number of "armed agencies," and the role played by the Treasury in the military organization, these issues are rather problematic. These units were not included in the table. Question marks in the table were inserted in cases where no data from the open part of the federal budget for year 2000 were available.

This "motley" composition of the military organization can be reasonably justified neither from the military, nor economic points of view. The present composition of the RF military organization and its relation to the classification of budgetary expenditures are dissatisfactory. The "Fundamental Principles..." failed to settle this organizational and economic problem.

The next, *fourth comment*, although important in its own right, is closely related to the remarks on CNS and, in general, the problem concerning the composition of the RF military organization. This comment was brought about by the following CNS statement concerning the delimitation of authority among the subjects responsible for the ensuring of the national security:

The RF Government "taking into account the priorities in the area of RF national security, set in the annual Presidential Addresses to the Federal Assembly, coordinates the activities of federal executive agencies" (what agencies? CNS is not specific about this)

and besides “according to the established procedure forms federal budgetary items to realize concrete target programs in this area” (it is unclear who is responsible for their elaboration and economic substantiation), while the Federal Assembly shall “form the legislative base” in the same area.

However, the RF Budgetary Code differently describes the financing of the RF targeted programs, and the role the Federal Assembly plays in the process of forming the federal budget, as stipulated by the Code, looks more substantial and active.

Moreover, all stages of the budgetary process are important to ensure the RF national security: not only its formation, but also its preliminary financial planning, execution, and reporting.

CNS correctly reflects the fact that the national security of the RF concerns not only the state, however, the document apparently understates the importance of such subjects as the society and especially the individual in the ensuring of the RF security, including the civilian control over government agencies ensuring all types of security. But, in fact, these are the indubitable interests characterizing the political maturity of the modern democratic state, which are often infringed upon in our country.

Another most important document, which made more precise terms, tasks, and principles of ensuring the military security of the RF, and of successful development of the military, is the Military Doctrine (MD) adopted in year 2000. The necessity to renew the version of the military doctrine approved in 1993 was emphasized by Yeltsin yet. The new version of the doctrine had been discussed for a long time and published as a draft in September of 1999.

The drafters strove to take into account all changes in the external and internal situation. After all necessary amendments had been made, the doctrine was approved by the President, published, and came into effect. As compared with the draft, the approved ver-

sion contained more moderate wording with regard to external military threats to the RF.

However, some principal military and economic critical comments on this conceptual document may be made. The RF Military Doctrine still reviews nuclear weapons as the main type of strategic weapons, although the intensive development of high-precision long-range non-nuclear weapons made them strategically important, especially if used en masse. This fact was confirmed both by the wars in the Persian Gulf and in Yugoslavia. The combat experience clearly demonstrated that such non-nuclear weapons (different types of cruise missiles and high-precision aircraft-borne armaments) are able to win a military campaign. There are even examples of their successful application in the course of combating international terrorism. It is especially true for the most modern “smart” weapon systems. The aforementioned uncertainty is fraught with the lack of attention to the development of such weapons, what may be reflected in the budget. This is dangerous from the military point of view and ineffective in the economic aspect.

The intensive development of production of “smart” weapons in the RF and their supplies to the Russian Armed Forces is an exceptionally urgent problem. These weapons may increase the containment potential and besides the sales of such weapons on the international market of armaments may stimulate the buildup of technologically-intensive profitable production. They may be effective only as retaliation weapons against an aggressor and never as weapons of aggression.

In this connection the statements about the readiness to reduce nuclear weapons without the necessary reference to the fact that from now on strategic weapons may be limited and reduced only on the condition that their aggregate (nuclear plus non-nuclear) potential is to be taken into account are inadmissible. Declaring the

readiness for nuclear disarmament it is inadmissible to ignore this fact even at the level of political slogans, since it undermines the actual balance of strategic forces in the modern world and disorients Russian military and military-industrial experts. This is also fraught with negative consequences for Russia and its allies, especially CIS countries, which, as shall be remembered, after the dissolution of the USSR agreed to transfer all Soviet nuclear weapons to Russia on condition of their protection, including, if necessary, with these very weapons. Moreover, the Russian nuclear weapons are a substantial component of the global stability. Proceeding to comment the second section of MD it shall be noted that the proclamation of such RF aim as the deterrent (prevention) of aggression without pointing out what agency shall be responsible for the fulfillment of this task in fact nullifies the idea of deterrence by force. Since the document reviews exactly the force aspect and points out the type of weapon as “nuclear,” taking into account the above remarks about the “smart” weaponry, non-nuclear weapons also shall be viewed as a means of deterrence by force. Foreign experience (especially that of the USA) reveals that non-nuclear deterrence is impossible without specific actions on the part of the national Armed Forces undertaken precisely in the time of peace and over the threatened period. These actions include the detection and collection of data about the strategically important objects of a potential aggressor, the threat to which have a “stopping effect.” They include preparation of so called flight missions and reference images of such objects (targets) to guide the “smart” weapons. They include a convincing demonstration of the readiness of the Armed Forces to immediately destroy the vitally important objects of the aggressor in a massive retaliation counterstrike. It shall be noted that in the modern world not only the USA, but also many other developed states successfully implement deterrent policies in order

to increase their international roles and ensure their national interests.

The military and economic principles stated in the third section of MD are unfortunately isolated from the new economic realities existing in the country and correspond more to command and administrative measures aimed to ensure the military security than economic ones. The last version of the military doctrine ignores the federal budget as a chief tool to manage the military economy. The planning of the development of the military is reviewed outside the general framework of the budgetary process, although the RF Budgetary Code all agencies shall comply with has been already effected.

In the area of military organization MD declares the application of the uniform planning based on the target program approach. However, it does not envisage the long-term financial planning, while such planning should have been not just a supplement to the set of programs and plans traditionally elaborated by the Defense Ministry, but a systemic document conforming the feasibility of plans of the development of the military on the whole and the balance and resource consistency of all other plans.

Moreover, the single system of programs and plans shall be elaborated at the pace of the budgetary process at large, and not in arbitrary set time. Therefore, the information about the expenditures required to implement all measures envisaged by this system shall be in accordance with the RF budgetary classification. The annual state defense contract (SDC) shall be in agreement with the budget for the same year, otherwise, no “guaranteed” execution of programs and plans will be possible.

MD reduces the essence of the military and economic ensuring of the military security to a primitive formula: the requirements stated by the military organization shall be promptly met in full.

The reservation set in the text: “*within the available resources of the state*” only fogs the procedure of military and economic ensuring of the development of the military. It turns out that the military organization is cut off the budgetary process, although in fact it has to participate in this process each year. On the whole, the new MD only complicated the understanding of the meaning of the term “military organization” instead of clarifying it.

Actually, MD states that the RF military organization also includes “*a part of national industrial and scientific complexes intended to ensure the fulfillment of the tasks of military security,*” however, it fails to clarify what this part is. This apparently vague wording only renders more difficult the task to analyze the expenditures of the federal budget in economic terms. Therefore, in order to avoid confusion the traditionally defined military organization and the part of national industrial and scientific complexes involved to ensure its operation, but not financed via the military organization, hereafter will be referred to as the “military system” similarly to previous IET surveys.

The problem of the military reform was further developed in two Presidential statements: the budgetary statement “On Budgetary Policy for Year 2001 and for a Short-Term Perspective” and the annual statement “What Russia Are We Building,” as well as in the materials discussed at a number of meetings of the RF Security Council.

For instance, the Budgetary statement sets a higher priority to the task to ensure the internal and external national security in relation to budgetary expenditures. In the situation still requiring tough budgetary constraints this task may be performed only in case the military reform is implemented and a part of the army is gradually converted into a professional one.

An effective system of managing state finances shall settle these problems and put in place open and fair relations between the state and the society. Among most urgent problems faced by the RF budgetary policy is the task to complete the formation of the Treasury system at the federal level and to develop it more rapidly at other levels of the budgetary system. The Treasury system does not embrace a substantial part of expenditures borne by armed agencies as yet, while at the regional level the process of transition to the Treasury system has only started. By end-2000, all armed agencies shall be serviced via the system of federal Treasury. However, it shall be remembered that the present Treasury system may function well only in the peace time, while the military organization shall effectively function also under quite different conditions.

The key elements of the work of financial agencies shall also become the mandatory publication of detailed budgetary information and development of really competitive system of government procurement via tenders.

However, the technology of financing and reporting is not the key factor. What really matters is the fact that the present situation of the Russian army and navy is critical according to the official evaluation. The main factor behind this situation has been the absolutely insufficient levels of financing annually earmarked by the budget over the preceding years and the chronic “under-financing” of even those levels. The budgetary means were barely sufficient to maintain the irrationally cumbersome military organization (see IET surveys for 1997 through 1999). The funds were absolutely insufficient to supply the RF Armed Forces with modern armaments (their present share is at 11 to 18 per cent, while it makes up to 75 to 80 per cent in NATO countries). The “under-financing” of R&D and arms production coupled with mounting

debts of the state to MIC enterprises resulted in the failure of the planned restructuring of the MIC.

Only over two last years some positive shifts have been observed. These shifts were noticeable not only in terms of statistics, but via some real improvement of the social position of servicemen and MIC employees, increasing procurement for the needs of the national Armed Forces, larger number of profitable arms contracts with foreign countries, and, accordingly, growing profits.

In this situation it was expected that a detailed and more specific plan of the military reform for the period till 2005 (or even a longer-term one) concerning all aspects of the development of the military will be elaborated basing on the positive trends registered in the economy and on the above mentioned revised concepts (CNS and MD). However, the actual developments in this area failed to come up to expectations, in part, from our point of view, because of the above mentioned shortcomings of these documents. Therefore, the elaboration of the reform of the whole RF military organization was postponed till year 2001.

Military and Related Expenditures in Year 2000

The potential of the development of the military economy in year 2000 was mainly determined by the amount of assignments for the defense, law enforcement, and national security stipulated by the federal law “On Federal Budget for year 2000.”³³

³³ It shall be noted that this law has been twice amended after its approval. The last amendments were introduced on December 26, 2000. Such changes in the parameters of the federal budget provides some grounds to consider the first version of the budget as “initial” (hereinafter this version is referred to as FB-2000₀, while the last (second) amended version is referred to as FB-2000₂ shall

The open section of the federal budget presents rather scant information about the expenditures for the military organization (several lines in Supplements Nos. 1 and 6 to the federal budget and some text items). The organizational structure of expenditures for the Defense Ministry and the majority of other federal agencies being components of the military organization are presented in secret Supplement 2. Supplement 4, which contains key indicators of state procurement, and Supplement 27 earmarking financing of some target programs are also classified documents. In spite of the direct instruction given by the RF President in his budgetary statement for 1999 to make the budget rationally transparent, FB-2000 is even less open than preceding budgets.

As has been repeatedly stressed, the total veil of secrecy renders more difficult independent examination and civilian control. It is especially dangerous in the situation of economic difficulties experienced by the Russia's economy. It is difficult to find out what the Russian military organization really costs the country. However, such an analysis is necessary, taking into account the urgency of this problem faced by the society.

The military expenditures pertaining to the whole RF military organization are presented in Table 2.40 based on the budgetary classification.

It shall be noted that the federal budget for year 2000, similarly to the 1999 budget, includes a number of special text items earmarking additional expenditures for the national defense, law enforcement, and national security supplementing the military expenditures stipulated by major budgetary items formed in accordance with the budgetary classification.

be viewed rather as preliminary report on the execution of the budget than the data on the target expenditures.

Among the funds earmarked for the military needs of the RF text items stipulate the following: Rub. 5,500.00 million from the Federal Road Fund, a portion of state revenues received as a result of the activities of the FBS and as a recompense for the damage to property being at the disposal of military units and military agencies, as proceeds from the sales of armaments, military and special equipment, a part of funds received by the federal budget in excess of amounts stipulated by budgetary items Nos. 1 and 29, including payments of foreign air companies for flights over the RF territory and of foreign shipping companies for transit of their ships via Russia's territorial waters, proceeds from privatization of federal property via auctions and tenders and sales of shares in joint stock companies established in the process of privatization, a part of revenues of the Defense Ministry derived from paid contract services related to training of foreign personnel, military and technical cooperation and other services permitted by the law. The text items did not clearly define either the amounts, or terms of supplementary expenditures. This vagueness by no means facilitated the fulfillment of the tasks faced by the national military organization.

The comparison of the data presented in Table 2.40 with the structure of the RF military organization (Table 2.39) reveals that the budget does not embrace all components of the RF military organization. Apparently, some of them were listed among general expenditures for agencies responsible for state security (marked with symbol (*) in the table). Some expenditures are listed only in classified supplements. For instance, it concerns the military units presented in Table 2.39. The expenditures for servicemen attached to various non-military agencies and organizations are in part open (the Ministry of Justice), but their bulk is

concealed among budgetary expenditures of the agencies they are attached to.

TABLE 2.40

Item #	Expenditure	Amount Rub. mil.	% of the budget	% of GDP	Source of information
1	Expenditures for the military organization included in item "National Defense"				
-	TOTAL EXPENDITURES FOR "NATIONAL DEFENSE, including:	140852	16,5	2,63	Sup. 6 FB
		209445	20,7		Sup. 6 FB
1.1	Development and maintenance of RF Armed Forces	137780	16,1	2,58	Sup. 6 FB
		205812	20,3		Sup. 6 FB
1.2	Ensuring of mobilization and extra-military preparedness	150	0,02		Sup. 6 FB
		167	0,02		Sup. 6 FB
2	Expenditures for the military organization included in item "International Activities"				
2.1	Peacekeeping activities of the RF military organization	1625	0,19	0,03	Sup. 6 FB
		2556 =	0,25		Sup. 6 FB
		2190+366			Item 104 FB
3	Expenditures for the military organization included in item "Law Enforcement and National Security"				
	Total expenditures for "Law Enforcement and National Security," including:	51324	6,0	0,96	Sup. 6 FB
		111547	11,0		Sup. 6 FB
3.1	Board Service (agencies and troops)	7727	0,90	0,14	Sup. 6 FB
		11383	1,12		Sup. 6 FB
3.2	Troops of RF Interior Ministry	5787	0,68	0,11	Sup. 6 FB
		14329	1,41		Sup. 6 FB
3.3	State security agencies*	12202	1,43	0,23	Sup. 6 FB
		14361	1,42		Sup. 6 FB
4	Other expenditures for the military organization				
4.1	Maintenance and equipment of MES troops	1736	0,20	0,03	Sup. 1 FB
		2094	0,21		Sup. 1 FB
4.2	Federal Railroad Troops Service	1180	0,14	0,02	Sup. 1 FB
		1413	0,21		Sup. 1 FB
5	Additional expenditures for national defense, law enforcement, and national security				
5.1	Portion of revenues of Federal Road Fund earmarked for these purposes	5500	0,64	0,10	Item 81 FB
		5500	0,54		Item 81 FB
5.2	Funds to be obtained in the course of privatization of state property, sales of shares in joint stock companies established in the course of privatization, from paid contract services of Defense Ministry, FBS proceeds, and other revenues	No amount set			Items 94, 97, 101,104, 105 FB
		No amount set			Items 94, 97, 101,104, 105 FB

Note: the expenditures stipulated in the initial version of the budget are set in plain type, the final figures are set in bold type.

The open data presented in Table 2.40 demonstrate that the expenditures for the RF military organization targeted at about Rub. 173687 million (20.31 per cent of the total budgetary expenditures, i.e. 3.25 per cent of GDP) were later increased up to Rub. 257615 mil. (25.4 per cent of the total budgetary expenditures).

While analyzing the total RF military expenditures (for the whole military system as defined above) it is also important to take into account their part assigned to other agencies outside the military organization, and other financing of military expenditures not included into the funding of the military organization. These expenditures are presented in Table 2.41.

TABLE 2.41

<i>Item #</i>	<i>Expenditure</i>	<i>Amount Rub. mil.</i>	<i>% of the budget</i>	<i>% of GDP</i>	<i>Source of infor- mation</i>
<i>Contained in "National Defense" item (see item 1, Table 2)</i>					
1.2	Military program of Atomic Energy Ministry	2909 3453	0,34 0,34	0,05	Sup. 6 FB Sup. 6 FB
1.4	Russian Defense Sports and Technical Organization (RDSTO)	13,3 13,3	0,002 0,001		Sup. 6 FB Sup. 6 FB
-	<i>Contained in other sections and subsections of the budget</i>				
0.1	Mobilization preparedness of the economy	450 834	0,05 0,08		Sup. 6 FB Sup. 6 FB
0.2	Civil defense	20 20	0,002 0,002		Sup. 1 FB Sup. 1 FB
0.3	Federal Special Construction Service	360 431	0,04 0,04		Sup. 1 FB Sup. 1 FB
0.4	Grants and subsidies to CATE budgets	6071 8071	0,71 0,80		Item 55 FB Item 55 FB

Note: the expenditures stipulated in the initial version of the budget are set in plain type, the final figures are set in bold type.

Similarly to direct expenditures for the RF military organization, military expenditures outside the military organization presented in Table 2.41 are far from being complete. The information on the expenditures of the Chief Directorate for Special Programs and the Committee for Conventional Problems of Chemical and Biological Weapons at the RF President.

TABLE 2.42

Item #	Expenditure	Amount Rub. mil.	% of the budget	% of GDP	Source of information
1	Military pensions	20282 22113	2,37 2,18	0,34	Sup. 6 FB Sup. 6 FB
2	Utilization and liquidation of arms	2070 3676	0,24 0,36		Sup. 6 FB Sup. 6 FB
3	Conversion of military industries	392 428	0,05 0,04		Sup. 6 FB Sup. 6 FB
4	Target program of restructuring and conversion of military industries for years 1998 through 2000	1146 1173	0,13 0,12		Program 9.1 Sup. 4 FB Program 9.1 Sup. 4 FB
5	Target program for retraining and employment of retiring servicemen, demobilizing citizens and members of their families	24 24	0,003 0,002		Program 1.7 Sup. 4 FB Program 1.7 Sup. 4 FB
6	Target program for social protection of disabled servicemen for years 1997 through 2000	38 38	0,004 0,003		Program 1.2 Sup. 4 FB Program 1.2 Sup. 4 FB
7	Target programs for rehabilitation of territories and population suffered in the result of previous military activities	48 49	0,006 0,005		Programs 5.14, 6.3, 6.4 Sup. 4 FB
8	Fund for promotion of military reform	No amount set 2903	0,29		Item 102 FB Sup. 6 FB
8.1	Financial resources assigned by the RF government for the implementation of measures in the framework of the Presidential program of CHC in year 2000 and repayment of certificates issued in year 1999.	Up to 3800 Up to 3800	0,44 0,37		Item 103 FB Item 103 FB

Note: the expenditures stipulated in the initial version of the budget are set in plain type, the final figures are set in bold type.

The funds assigned for some agencies (for instance, aviation and space agency, agencies for ammunition, conventional weapons, control systems, shipbuilding, etc.) may be to a degree viewed as military expenditures. However, it is extremely difficult to distin-

guish these expenditures from non-military spending, and besides their amounts are relatively small, since they are assigned for maintenance of comparatively small administrations.

On the whole, it is clear that military expenditures outside the RF military organization are relatively small. These expenditures were targeted at Rub. 9823 million (1.15 per cent of the total budget), the actual spending (estimate) was over Rub. 12822 million (1.26 per cent of the budget).

It is appropriate to include in the analysis the indirect expenditures related to previous military activities (see Table 2.42).

As concerns the Fund for promotion of the military reform, it shall be noted that it was not established by the moment the budget was approved; however, according to item 102 of the federal budget the RF government created this fund, and it was additionally assigned up to Rub. 3000 million for the financing of the Presidential program "State Housing Certificates" in year 2000 and Rub. 800 million to finance the repayment of housing certificates issued in 1999.

The expenditures related to previous military activities were set at Rub. 27800 million (3.29 per cent of the budget) and made (estimate) Rub. 34204 million (3.37 per cent of the budget).

The important fact is that the majority of the expenditure targets for year 2000 were exceeded. The total military expenditures (for the military organization and other military-related spending) made not Rub. 183510 million (21.47 per cent of the budget), but Rub. 270437 million (26.67 per cent of the budget).

The aggregate expenditures for present military needs and those related to previous military activities made not Rub. 211310 million (24.92 per cent of the budget), but Rub. 304641 million (30 per cent of the budget).

TABLE 2.43

Item # Code	FB section	FB-2000 ₀ Rub. mil	Monthly administration of FB-2000 ₀ Actual amount per month / integrally, Rub. mil., Actual amount per month / integrally, % of FB-2000 ₀					
			January	February	March	April	May	June
			1 0400	National defense	140852	11649 /11649 8,3%	10121 /21770 7,2%	20198 /41968 14,3%
2 0500	Law enforcement and national security	79802	3302 /3302 4,1%	7144 /10446 13,1%	7383 /17813 10,0%	7211 /25024 9,0%	8445 /33469 10,6%	9801 /43270 12,3%
3 2300	Mobilization preparedness of the economy	500	19 /19 3,8%	20 /39 4,0%	107 /146 21,4%	12 /158 2,4%	19 /177 3,8%	37 /214 7,4%
4 3110	Target budgetary fund for promotion of the military reform	It. 102, 103 no exact amount set	136 /136	127 /263	97 /360	63 /423	43 /466	41 /507
1 0400	National defense	9739 /91960 6,9%	16900 /108860 12,0%	12536 /121396 8,9%	22811 /144207 16,2%	19516 /163723 13,9%	27067 /190790 19,2%	209445
2 0500	Law enforcement and national security	6500 /49770 8,1%	7393 /57163 9,3%	8680 /65843 10,9%	8066 /73909 10,1%	10048 /83957 12,6%	21433 /105390 26,9%	111547
3 2300	Mobilization preparedness of the economy	36 /250 7,2%	37 /287 7,4%	48 /335 9,6%	60 /395 12,0%	92 /487 18,4%	157 /644 31,4%	834
4 3110	Target budgetary fund for promotion of the military reform	219 /726 50%	239 /965 57,4%	283 /67%	267 /79%	239 /97,4%	471 /129%	Over 2903

An analysis of the data presented in Table 2.43 reveals an important distinctive feature of the administration of the 2000 budget: the financing of military expenditures was much more stable as compared with preceding years, without sharp downfalls and payment arrears. Some insignificant downward deviations from the average monthly level (targeted at 8.33 per cent of the budget) were registered only episodically and promptly corrected. The practical experience confirms that this circumstance is to a certain degree as important for the military organization as the provision of the total amount of military financing.

The fact that as on 1.01.2001 the amount of military expenditures was below the targets set by the amended budget may be ex-

plained rather by political factors behind the adjustment than economic requirements.

The state started to gradually repay its debts to the military organization and those accumulated in the course of defense procurement over preceding years, what became the most important development of year 2000. Practically all servicemen-related payment arrears were settled in this year. However, the problem of housing provision persisted.

It shall be stressed that in the very end of year 2000 the RF President sponsored the decision to repay the debt to the MIC. It is evaluated to be at about Rub. 50 billion and shall be soon repaid either by “cash,” or by bonds maturing in two years. Due to this fact the government could considerably improve its performance in terms of meeting its liabilities and obtained the moral right to require the same of all those directly or indirectly responsible for the military security in year 2001.

Military Economy: Trends and Some Recommendations

The recovery of the RF military economy in year 2000 does not seem to be an accidental development.

It shall be noted that the process of the degradation of the RF military organization taking place in stead of its reduction and rational reformation, and, most important, the collapse of the MIC economy (in stead of its conversion and restructuring) was arrested yet in 1999. This development was behind a sharp turn of the situation. The realistic budget for year 2000, favorable price situation on the world market of energy resources, and satisfactory administration of the budget by the government permitted to start the rehabilitation of the military economy as an equal and rational sector of the national economy at large.

The recovery of the military economy is important not only for the military organization *per se*. It is much more important that the factors behind the recovery shall make a major contribution to the development of the technology-intensive sector of the Russia's economy on the whole.

Year 2000 not only stirred up hopes, but also presented some examples coming up to the expectations. The space industry successfully participates in the work on the project of international piloted space station. Proceeds from commercial launches of foreign satellites are growing. The aircraft industry has started the full-scale production of new mass passenger airplanes Tu-214 and light combination airplanes designed by Sukhoi. A new dry cargo "river to sea" ship was commissioned by a St. Petersburg based enterprise formerly engaged in the military shipbuilding. All these products answer the international standards. The traditional profits from the international trade in arms, which increased from US \$ 2.6 billion in 1998 to US \$ 3.7 billion in year 2000, were supplemented by proceeds from the sales of licenses for military production and from sales of non-military goods and services in the framework of so called offset transactions.

The evaluation of the further development of the military economy would be incomplete without taking into account the dynamics of military expenditures observed over preceding two to three years. For instance, these dynamics may be appraised basing on the comparison between the expenditures set by the budget for year 2001 and the spending over preceding years (see Table 2.44).

Due to numerous requests of the experts in the field of military economy some types of military expenditures were declassified. For instance, separate supplement No. 41 to the budget lists the expenditure for current maintenance of the RF Armed Forces.

TABLE 2.44

FB section	FB – 1999 (Rub. mil.)	FB-2000 (Rub. mil.)		FB- 2001 (Rub. mil.)	Change (%) in relation to FB- 1999 (not adjusted / adjusted for inflation)		
		Be- gin- ning of the year	End- year		ФБ-	ФБ-	ФБ-
					2000 ₀	2000 ₂	2001
“National Defense”	93702	14085 2	209445	214688	+50,3 / +25,1	+123,5 / +86,0	+129,1 / +70,2
“Law Enforcement and National Security”	51324	79802	111547	131621	+55,5 / +29,4	+117,3 / +80,8	+156,5 / +90,5
“Mobilization Prepared- ness of the Economy”	450	500	835	500	+11,1 / -7,6	+85,5 / +54,3	+11,1 / -17,5

Note: inflation rates were assumed to be at 20.2 per cent in year 2000 as compared with 1999, and at 12 per cent in year 2001 as compared with 2000.

Now, when all strata of the society demonstrate an increasing interest in the economic problems of the military security and the military reform, the concept of the RF military security shall be reviewed.

Proceeding from the results of the analysis conducted above and other analytical materials, the key principles of the improved concept of the development of the RF military may be stated as follows.

In order to ensure its military security the state needs a compact, economically feasible, professional military organization capable to effectively fulfill the task to prevent wars and suppress illegal hostilities, alongside with a trained military reserve, which also is an effective factor containing aggression.

The principal economically feasible and politically expedient task faced by the RF Armed Forces and other troops in the peace time is to stop possible aggression and external attempts of coercion by force, as well as to counter the danger of unleashing of a civil war and terrorism within the country. The content of this task

is determined by the strategy of (nuclear and non-nuclear) deterrence by force accepted by the leading states of the world, and it shall be fulfilled via implementation of an integrated program of political, economic, military, and other measures.

In case aggression or internal conflicts and terror are unleashed, the key aim is to repulse the aggression and to inflict upon the aggressor the damage considerably exceeding the benefits expected to result from the war, which will put an end to the aggression.

Both these tasks shall be mainly performed by standing professional forces equipped with weapons of highest quality.

At present time the RF military organization is not completely ready to perform these tasks. The key factors behind this are the uncompleted military reform, unacceptably low social position of servicemen, the lagging behind developed countries in terms of availability of modern weaponry to the Armed Forces and the Navy, insufficient financing of the military organization (taking into account its present size). Although at present the redundancy problem is being settled in practical terms, the settlement of other problems is postponed till year 2001 and the next years of the reform.

At present, the most urgent problem is to take a decision on the recruitment method the military organization shall employ.

Many political parties and movements put forward the recommendation to form the RF Armed Forces and other troops only on the contractual basis. The effectiveness of this principle is confirmed by the experience of a number of countries. However, all modern states create also military-trained reserves.

Taking into account this factor, it would be feasible to support the recommendation, published by IET experts in the beginning of year 2000, to replace the present mixed system of recruitment with two related systems:

1. To recruit the personnel for Armed Forces and other troops being in the constant and higher state of combat preparedness exceptionally on the contractual basis;
2. To form military-trained reserves by conscripting young people for six to eight months with the aim to train them for mass military professions and simultaneously employ them for maintenance and guarding of reserve military equipment.

The alternative military service (a respective law shall be approved soon) may be used to train personnel performing auxiliary functions in the war time (care of the wounded, recovery operations, etc.).

This recruitment method may be easily integrated into the present system of military training of officers both at higher military education institutions (for the Armed Forces and forces being in the state of constant combat preparedness) and at some civilian institutions having military education departments (for the reserve).

The recommended concept will allow to reduce the total number of servicemen within the RF military organization and considerably improve the level of their social security at the present level of financing of the RF military organization.

The following avenues of the military reform are of equal importance: to create really unified national military organization, to improve the system of planning, formation and administration of the military budget within the framework set by the RF Budgetary Code, to ensure rational transparency of the national military expenditures, and to introduce really effective civilian control over the RF military organization. These developments shall be supported by a number of new federal laws.

The conversion of national Armed Forces into “Armed Minds” shall become the general principle of the further development of the RF military organization. This shall be achieved via the mainte-

nance and development of the national scientific and technological potential of the military organization *per se* and the MIC. In the 21st century, the development of the RF military shall be aimed to equip the troops with “smart” weapons capable to selectively and effectively strike the military objects of aggressors and terrorist strongholds, promptly detect real military threats to Russia and to counter them by deterring any aggressor. Due to the special qualities of such weapons, they may become the major type of technology-intensive military products exported by the RF, while the high dual-purpose technologies shall become a key factor behind the recovery of the technology-intensive civilian production based on the principles of free enterprise and competition.

It is necessary to review some previously formed sub-systems of the military organization in order to comply with the CNS requirement to set a higher priority to attention to the economic effectiveness of the ensuring of national security. These sub-systems include structures involved in procurement of all types of non-pecuniary rations for the troops, agricultural and some other enterprises, R&D, educational and health care establishments. In the course of reorganization the components not vitally important from the military point of view and ineffective in economic terms shall be excluded.

In social and economic terms the professional personnel of the RF military organization shall obtain the status of a natural component of the middle class and become the reliable mainstay of the democratic Russia ruled by the law.

SECTION 3. SOCIAL SPHERE

3.1. Household Finances

Cash incomes. Year 2000 saw certain positive changes in living standards of the Russia's population. Real disposable cash incomes increased by 9.1 per cent over the year; however, they are still 10 per cent below the pre-crisis level (first half-1998). Growth of incomes was positively affected by increases in pensions and wages of those employed by organizations financed from the budget, and by further decrease in wage arrears (by 27.6 per cent as in December of 2000). In year 2000 average per capita monthly cash incomes made Rub. 2,112.00 (as compared to December figures at Rub. 3,112.00).

As concerns the inter-regional differentiation of incomes, in November of 2000 average cash household incomes registered in Moscow were by 5 to 10 times higher than respective indicators calculated for regions in the Central Economic Region (in 1999 by 7 to 10 times, in 1998 by 6 to 9 times).

The increase in wages was more substantial than that in total incomes – the average wages and salaries grew by 22.5 per cent in comparison with 1999 figures. The average monthly gross wages and salaries made Rub. 2,268.00 in year 2000 as compared with Rub. 1,523.00 in 1999.

Although in year 2000 the average monthly wages across the majority of Russia's regions exceeded average per capita incomes, in Moscow it made only 38 per cent of the level of average per capita incomes (42 per cent in 1999, 48 per cent in 1998, 41 per cent in 1997).

The inter-sectoral differentiation of wages and salaries continued to increase – in May of 2000 wages differed by 8.4 times across

sectors. In November of 2000, the average wages in fuel industry was 3.2 times higher than the all-Russian average (2.95 times in 1999, 2.37 times in 1998), while relatively underpaid sectors financed from the budget sunk even deeper as compared with the national average. For instance, the average monthly wage at the public health sector was registered at 58 per cent of the all-Russian average (60 per cent in 1999, 67 per cent in 1998), and that in the sector of education, culture, and arts made 54 per cent of the national average (55 per cent in 1999, 60 per cent in 1998).

The average monthly gross pension (as adjusted for compensatory payments) made Rub. 694.2. The amount of real pension increased by 28 per cent as compared with 1999 figures.

The ratio between the average pension and subsistence minimum for pensioners improved somewhat. While in 1999 the average pension was by 31 per cent below the subsistence minimum for pensioner, in the third quarter of 2000 it made 74 per cent of the subsistence minimum for pensioners.

The ratio between the average wages and the subsistence minimum for the employable population also improved somewhat over year 2000. In the third quarter of 2000 it made 168 per cent, while in the previous year this ratio was below 156 per cent.

However, the share of the earned labor incomes and social transfers in the total household incomes did not change perceptibly. According to the RF Goskomstat, the share of wages and salaries in the income structure increased from 65.5 per cent to 65.6 per cent, while the share of of social transfers grew from 13.2 to 13.4 per cent.

It shall also be noted that in spite of some economic growth the differentiation of household incomes remained at the same level. Changes in the decile coefficient of differentiation of funds (it decreased by 0.4 per cent) and Gini coefficient (it increased by 0.006

per cent) registered at the end of the third quarter of year 2000 were insignificant.

TABLE 3.1.

Structure of Cash Household Incomes in 1999 through 2000, %

	1990	1991	1992	1994	1995	1996	1997	1998	1999	2000
Cash incomes, total	100	100	100	100	100	100	100	100	100	100
Wages and salaries, including concealed payments	74,1	69,7	73,6	64,5	62,8	65,9	65,7	64,9	65,5	65,6
Social transfers	14,7	16,3	14,3	13,5	13,1	14,0	15,0	13,6	13,2	13,4
Property-based incomes	2,5	2,8	1,0	4,5	6,5	5,4	5,7	5,5	7,2	7,2
Business-related incomes	3,7	4,1	8,4	16,0	16,4	13,6	13,0	14,2	13,2	12,6
Other incomes	5,0	7,1	2,7	1,5	1,2	1,1	0,6	1,8	0,9	1,2

Source: RF Goskomstat

TABLE 3.2

Total household cash incomes across income groups, coefficients of differentiation and concentration of incomes in 1991 through 2000, %

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Incomes, total	100	100	100	100	100	100	100	100	100	100
Group 1 (lowest incomes)	11,9	6,0	5,8	5,3	5,5	6,2	6,2	6,2	6,2	6,1
Group 2	15,8	11,6	11,1	10,2	10,2	10,7	10,6	10,5	10,6	10,3
Group 3	18,8	17,6	16,7	15,2	15,0	15,2	15,1	14,9	14,9	14,5
Group 4	22,8	26,5	24,8	23,0	22,4	21,5	21,4	21,0	21,0	20,5
Group 5 (highest incomes)	30,7	38,3	41,6	46,3	46,9	46,4	46,7	47,4	47,3	48,6
Decile coefficient of differentiation (Funds)	4,5	8,0	11,2	15,1	13,5	13,0	13,2	13,2	14,5	14,1
Gini coefficient	0,26 0	0,28 9	0,39 8	0,40 9	0,38 1	0,37 5	0,38 1	0,37 9	0,39 4	0,40 0

* Third quarter of year 2000

Goskomstat registered the following stratification of the RF population with regard to the average per capita income in year 2000:

TABLE 3.3

Population Groups as Broken Down by the Amount of Per Capita Cash Income, Rub. thousand (% of the total)

	1999	2000
Total population	100	100
Including groups with per capita cash incomes at Rub.:		
Below 400.0	3,4	1,4
400.1-600	8,1	4,3
600.1-800	11,0	6,9
800.1-1000	11,6	8,4
1000.1-1200	10,8	8,8
1200.1-1600	17,5	16,5
1600.1-2000.0	12,2	13,4
Over 2000.0	25,4	40,3

Since the first quarter of 2000 the amount of subsistence minimum has been calculated according to a new methodology employing the standard-based method for the calculation of food and non-food components of the minimal consumer goods basket. The new structure of the subsistence minimum envisages a considerable increase in expenditures for non-food goods and services. As a result, its value exceeds the subsistence minimum cost calculated in accordance to the methodology used in 1992 by 15 to 20 per cent. Therefore, in the early 2000 the changes in the subsistence minimum calculation methodology resulted in an increase in the size of officially registered poor population. For instance, in case the data for year 2000 have been processed according to the methodology of 1992, the share of the poor population registered in the second quarter of 2000 would be at 27.6 per cent (according to the new methodology it was at 34.7 per cent).

On the whole, the share of population with incomes below the subsistence minimum decreased from 41.2 per cent in the first quarter to 31.8 per cent in the third quarter of 2000.

Cash spending. Positive shifts in the income sphere are confirmed by a growth in the real amounts of household consumer spending over 12 months (in third quarter of 1999 through third quarter of 2000). In the third quarter of 2000 the amount of real consumer spending was by 10 per cent over the level registered in respective quarter of 1999, however, it was below the spending observed in the third quarter of 1998. Nominal consumer spending made Rub. 1900.1 in November of 2000.

In the first quarter of 2000, there was observed an increase in the share of household expenditures for purchase of goods and services as compared with the total household incomes (from 75.8 per cent in the fourth quarter of 1999 to 84.6 per cent); however, in the second quarter of 2000 this indicator began to fall: it made 79.8 per

cent in the third quarter and 76.8 per cent in the fourth quarter of 2000. The share of household savings in the total amount of household incomes remained at a relatively low level over the whole year. In the first half-year it made 5.1 per cent, in the fourth quarter it fell to 4.1 per cent (a similar level was registered in the fourth quarter of 1999).

The share of household expenditures for purchase of foreign exchange decreased to 7.1 per cent of the total cash incomes in year 2000 (it made 8.1 per cent in 1999).

Over the whole 2000 the retail trade turnover was steadily over the indicators registered in 1999 – the excess in the retail trade turnover fluctuated from 7.3 to 10.3 per cent. On the average the retail turnover increased by 8.9 per cent in comparison with 1999 figures and made Rub. 2,251.4 billion, i.e. was practically at the level observed in 1998. There were registered some shifts in the macro-structure of retail trade turnover – the share of food products decreased from 48.1 per cent in 1999 to 46.4 per cent in year 2000.

3.2 Sectors of social and cultural sphere

The high rate of economic growth and the presidential elections positively influenced the availability of resource for the sectors of social and cultural spheres, The amount of financing allocated for them out of the federal budget in real terms increased by 30% in respect to the similar period in 1999. Along with that expenses of the budgets of the Russian regions grew only by 15 and the total growth of appropriations in the consolidated budget amounted to 5% per annum. The most significant increase of expenditures for mass media – 61% - was taking place along with allocations from the federal budget growing by 2.2 times. Substantially increased financing of education out of the federal budget by 28% - although the expenditures for these purposes in the regional budgets went down by 2% Government expenditures in health care (budget appropriations and contributions by employers into mandatory medical insurance) grew up by 7%.

The increase of the budget financing of the social and cultural spheres and the expenses of the federal budget are apparently related to the election campaign and an attempt to reduce wage arrears to the government employees. In the first four months of 2000 the amount of wage arrears in the social sector was reduced by 43%. In the following months the evolution of the budget arrears was fluctuating and by the end of the year its size in nominal value amounted to 47% of the figure registered at the start of the year. With that the federal budget in the total amount of arrears accounted only for 1.6% of the due wage payments, while the budgets of the regions – 98.4%. In sectoral cross section the correlation of the amounts of the federal and regional budget arrears in education amounted to 6.6% and 93.4%, in health care – 0.4% and 99.6%, in culture and arts – 1.2% and 98.85 respectively.

Along with the reduction of the aggregate budget arrears during the first four months of 200 there occurred a dramatic reduction of labor unrest movement and the period from May until September no strikes took place. Such dynamics of the striking movement naturally were connected to the fact that the Presidential elections and active measures by the government undertaken in the first months of the previous year aimed at reducing government debts helped raise the level of trust among the government employees, which helped them stay away from the struggle for their rights despite the growth of wage arrears in the sphere of education.

TABLE 3.4

Budget wage arrears in 2000

	1.01	1.02	1.03	1.04	1.05	1.06	1.07	1.08	1.09	1.10	1.11	1.12	1.01.01
Total, mil. Rubles	10165	10213	9422	7064	6391	6406	6923	7077	6298	6433	6296	5888	4942
Including: Social sphere sectors	6223	6290	5672	3821	3398	3478	3946	3982	3469	3579	3595	3493	2947
Out of those:													
Educa- tion	2026	2205	1815	812	603	664	992	940	583	688	859	858	683
Health care	1023	988	803	296	197	216	287	373	351	373	374	336	246
Culture and arts	312	322	260	108	80	92	122	126	106	117	120	117	84

Source: State Statistic Committee of Russia

TABLE 3.5

Strikes in 2000

	Dec. 99	Jan.	Feb.	March	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Number of entities participating in strikes:													
Total	729	477	210	83	22	-	-	-	-	-	12	71	48
Including:													
Education	702	472	204	76	16	-	-	-	-	-	8	68	47
Health care	3	1	-	1	-	-	-	-	-	-	-	-	-
Culture and arts	-	2	3	-	-	-	-	-	-	-	-	-	-
Number of involved employees, (thousand people.):													
TOTALA:	28,5	13,0	8,8	4,5	2,1	-	-	-	-	-	0,8	3,2	1,7
Including:													
Education	25,5	12,6	8,0	2,4	0,4	-	-	-	-	-	0,4	1,7	1,6
Health care	0,3	0,2	-	0,2	-	-	-	-	-	-	-	-	-
Culture and arts	-	0,0	0,2	-	-	-	-	-	-	-	-	-	-

Source: State Statistic Committee of Russia

Health care

The indicators of the death rate of population continued growing in 2000 (15.3 of deceased per 1000 people compared to 14.7 in 1999) and the rate of sicknesses in 19 out of 34 types of sicknesses registered by the government statistics. In particular the number of the people contracting TB grew by 11%, the hepatitis virus – by 46%. Of particular concern is the dramatic increase by 2.9 times compared to the previous year is the number of exposed cases of AIDS and HIV contractions. During the past year 52 thousand new patients were registered with this diagnosis, which constitute 635 of the total number of cases registered in Russia for the past 14 years (83 thousand total).

Along with that the statistics for the level of sickness went down in the group of respiratory infections which are managed by the means of special prevention and which apparently one can explain by certain improvements in the preventative injections campaign. The number of those who contracted measles have shrunk compared top previous year by 46%, German measles – by 25%, diphtheria – by 11%. Not a single case of poliomyelitis was registered. Only the statistics for whooping-cough became an exception in this group by growing by 1.5 times.

The previous year was marked by the first weak attempts by the Ministry of health of Russia to introduce mechanisms of financial planning which improve the efficiency of the use of budget allocations by the federal health care institutions. With funds appropriated to the Ministry of health care of Russia its own scientific research institutes and the Russian Academy of medical Sciences are being finances together with scientific research centers and medical universities' hospital (in the part of financing their clinical activities). By the start of 2000 there were 236 of such prevention-hospital institutions of federal subordination which had 62 thousand hospital beds, which constituted almost 45 of the in-patient capacity in the country. These institutions provide high technology expansive types of medical aid.

The main part of appropriations from the federal budget is directed into these institutions without any account of factual volumes of medical aid which they provide, and covers only part of their expenses. At the same time they receive money from the Moscow fund of mandatory medical insurance and from the budgets of the Russian regions for each patient , who they receive for treatment. With that there is no distinction being made between the accounts of financing form different sources. On top of that the planning for appropriations from the federal budget is done without

taking into account the funds coming from other types of sources. As the result the same kind of activity of these institutions in effect becomes the subject of financing. Investigations conducted by the audit agencies as a rule did not bring any sanctions upon these institutions for the cases of dual financing.

On February 28, 2000 the Ministry of health of Russia and the Russian Academy of Medical Sciences adopted a joint directive #70/14 "On improving the efficiency of the use of financial resource in the health care institutions of federal subordination". It envisages introduction of a system of planning of operations of these institutions by the Ministry of health care of Russia. This planning will be conducted through compilation of an order for the provision of a special medical aid out of the federal budget expenses. This order will be comprised of the volume of medical aid (the number of treated patients and illnesses), which correspond to the planned amounts of budget appropriations. In other words, each federal medical institution will receive money from the federal budget for the specific volumes of medical aid which the government is able to pay for. These volumes may constitute only a part of the capacity of an institution but will be paid for under at the full tariff rate which compensates for all necessary expenses. The remaining part of such a capacity could be legally utilized to provide medical aid for the money paid from the mandatory and voluntary medical insurance and for the provisions of services on a per charge basis. The implementations of envisage measures, without doubt will promote a more rational expenditures of the budget resources and will make a contribution to a resolution of the problem of a financial destitution of the government guarantees of free medical service to the population.

These decision were met with a lot of negative attitudes by the majority of managers of the health care institutions: they were in-

terested in maintaining the status quo, which provided them with a considerable economic independence with a minimum of economic responsibility. Only a few institutions agreed to work under a new system of financing. However, the way until the start of 2101, this system was not introduced even in the experimental procedure.

The subjects of the Russian Federation justifiably raised the issue about the need to get specific quotas for free treatment of patients in federal clinics, but until 2000 they had to pay for every patient, who they had sent to these institutions. The executives of these institutions explained this by the lack of and insufficiency of allocations from the federal budget, which could cover only part of realistic expenses. In July in the joint directive by the Ministry of health care of Russia and the Russian Academy of Medical Sciences "On organizing the provision for a high technology (expensive) types of medical aid in the federal health care institutions" (#252/50 of July 10, 2000) quotas were established for such an aid to patients, who came for treatment from the Russian regions. The total number of patients from the regions to whom federal health care institutions must provide medical aid paid for by the federal budget in 2000 amounted to 92 thousand people. It should be stressed that such quotas were defined for the so called high-technology types of medical aid which constitute only part of the total amount of activities of the institutions in question financed out of the federal budget.

In 2000 the old story with the government draft legislation on the introduction of changes and amendments into the medical insurance law received further unexpected development. It was submitted to the State Duma by the government of Russia back in 1996 and envisaged exclusion of non-government insurance companies from the list of entities offering mandatory medical insurance (MMI). The insurers were then able to launch collective action against the adoption of this draft law. An alternative draft legisla-

tion was submitted to the Duma's consideration which reflected their interests. As the result of the process of discussion of both draft laws the process was postponed for several years. In 1999 Primakov's cabinet started insisting on the adoption of the first draft. In June 1999 it was passed by the State Duma in the first reading. But medical insurance companies again were able to rally effective opposition to this legislative initiative. In June 2000 the government of Russia upon the request of the Ministry of health care of Russia suggested to the MPs that they should not rush the passage of this legislation through its second reading.

The destiny of insurance companies and the whole system of mandatory medical insurance will depend upon the general course of social and economic policy which will be pursued by the new President and the new government. As is known the preparation of the respective program document was being done during winter and spring of 2000 in the Center of strategic development. This work analyzed work for further development of health care system. So this area invariably would lead to reforms. If no active action is undertaken, further strengthening of differences in the accessibility of medical aid should be expected for households with different levels of income, for the population of different regions, towns and villages. If no serious changes are made in the current system of MMI and the current schemes of combining the budget and insurance financing of health care then the most probable course of events would lead to a liquidation (possibly in several stages) of the institutions of mandatory medical insurance.

The main component of the health care reform should be represented by the changes in the system of financing and health care management. It is precisely the way they are to be conducted that might influence possible speed of resolution of a much broader circle of problems related to health care. Three main options of strate-

gy for implementing organizational and economic changes in the sphere of health care were considered.

Option 1: a conservative one (partial restoration of the old system). The solution of the problem of government guarantees misbalance and their financial provision is connected to the need to increase government expenses on health care (revival of the former level of the government financing for this sector). Whereas the current level of government expenditures for health care expressed in percentages of GDP does not change (3% of GDP), then with an optimistic evaluation of economic growth perspective the government resources would still not be sufficient for the full coverage of costs involved in the provision of the government guarantees for the next decade. But if the amount of government financing in health care is to grow at higher rate than GDP, but with that no organizational or economic changes are to take place, which could provide the improvement of the efficiency of the resources used in the sector, then the injections of the government money would be “eaten” by inefficient cost bedridden health care system. In implementing such a strategy the population will still have to pay for medical aid compensating with its expenses for the inefficiencies of the health care system.

The organizational and economic changes thus will be aimed at eliminating the system of the mandatory medical insurance. It is being integrated into the budget system of health care financing. The territorial MMI funds will be administratively subordinate to the regional agencies of health care management. This will allow for a simple administrative method to set up control over a coordinated use of budget appropriations and MMI funds and even might slightly reduce the overhead management costs. However, this method does not guarantee a more rational distribution of the aggregated financial resources. Health care institutions upon their

own initiative will never support such methods of distribution of available financial resources, which reduce the total volume of medical aid provided by each such institution and its personnel. In order for the health care institutions to conduct a policy of improved and efficient utilization of resources there should be a very strong pressure exerted upon them by the financial agencies with a high level of executive discipline and transparency in their actions. The fulfillment of these conditions could be problematic in case the restoration of the old system of health care is attempted.

In order to improve the manageability of the health care system attempts will be undertaken to partially reestablish the vertical line of administrative subordination of health care institutions of different levels. But in order to implement this policy certain changes will have to be introduced into the Constitution and the Federal law on local administration which might meet with a strong opposition in both chambers of the Federal Assembly.

Option 2: moderate reforming. A formal free status of medical aid to the population is retained. The solution of the problem of the gap between guarantees for free medical aid and their financial provision is connected to the restructuring of health care which might help reduce the need for the government expenditures. However the required transfer of approximately of a quarter of the in-patient services into an out-patient clinical sector, the reduction of the guaranteed volumes of free provision of drugs to patients in in-patient institutions and the volumes of provision of emergency medical aid shall be done gradually in the course of 3-5 years.

No attempts are being made to radically reconsider the current division of financial resources in the Russian regions between the MMI system and the system of budget financing of the medical aid and prevention institutions. To be able to overcome the eclectic system of the budget insurance financing in health care a method of

slow and evolutionary improvement is being selected. The starting point then will be the changing of the mechanism of financing medical institutions. Currently the budget resources and MMI funds are directed to financing separate and very often different expense accounts of hospitals and clinics. This eclectic mechanism is substituted by a coordinated shared financing of medical services at full tariff rates, which would include all types of expenses. The composition of such full tariff rates reflects the share financed by MMI funds and the share financed out of the budget of a Russian region. The correlation of these shares in different regions will be different, reflecting a historical proportion between the budgetary and an insurance financing. The scheme of a shared financing as opposed to an account type of financing does not initiate direct incentives to a cost deficient economic operation and creates favorable conditions for the introduction of progressive methods of payment for medical aid, which in its turn create incentives for the restructuring of the health care system. The shared payment for volumes of medical aid will enable medical organization to freely and flexibly utilize the funds received for the financing of different types of expenses. A transition to the shared financing will be accompanied by a gradual improvement in the territorial health care planning, and the mechanisms of MMI funds management and control of their operations. This would create conditions for a gradual increase of the part of the budget expenses in health care, which is paid into the MMI funds as a payment for a non-working population. With the growth of the share of MMI money in financing medical aid there will also appear the prerequisites for transforming the MMI funds into the sole holders of funds that are allocated for the payment of medical aid, envisaged by the basic MMI program and in such a way it will achieve the completion of the process of introducing mandatory medical insurance. However this will last for 5-10 years.

Option 3: implementation of radical changes. The solution of the problem of the lack of financial support for the government guarantees can be achieved through the following changes :

- Completion of a transfer to a primarily insurance form of mobilizing financial resources for health care and to the insurance financing of medical institutions;
- Restructuring of the existing network of medical organizations; the exclusion of financially unsound institutions from the system of public health care;
- Strengthening of the government regulation of paid medical services, which is provided by the government and municipal health care institutions;
- Gradual legalization of participation of public in the payment for medical aid.

The solution of the problem of coordination of actions of government authorities of different levels with each other and MMI funds will be supported by the introduction of the system of comprehensive territorial planning in the health care and a consideration of mechanisms for the management of MMIs.

Apart from the above mentioned changes the efficiency of the system of health care will also be assisted by:

- Introduction of new forms of paid medical aid;
- Provision of economic independence of government and municipal health care institutions and the expansion of the spectrum of organizational and legal forms of organizations;
- Changes in approaching payment for the work of medical personnel.

The proposed measures will help resolve key organizational and economic problems of health care in the immediate perspective (2-3 years). This will serve as a basis for practical implementation of a policy aimed at establishing legal and economic conditions for

the development of preventative medicine, development of healthy way of life, growth of investments of employers and employees into improving health care conditions, improvement of quality of prevention and treatment practices.

A radical option is the most preferable one: it creates better institutional conditions for improving efficiency of functioning of the health care system. But it would require an increased administrative expenses compared to the current status of things. Additional expenses will be connected to the preparation of a necessary legal and methodological guidelines, training of MMI and health care institution personnel.

A radical option is politically the most difficult to implement. The main political obstacles to the mentioned innovations is the position of the regional and local governments. Implementation of the radical method of changes is only possible in case the of health care is initiated by the highest political leadership of the country and remains in its direct control.

It was precisely the radical option which was put into the basis of “The strategy of the reform of health care” section in the program paper “the main directions of social and economic policy of the Government of the Russian Federation for the long term perspective”, which was discussed and basically approved by the Government of the Russian Federation at its meeting on June 28, 2000.

In the adopted plan of action by the Government of Russia in the area of social policy and modernization of economy for the years of 2000-2001 (The Government of the Russian Federation Decree of July 26, 2000 # 1072-p) three main priorities were identified in the health care reform policy: the establishment of a unified system of medical and social insurance; the creation of an economic independence and the increase of diversity of organizational and

legal forms of medical institution; rationalization of the program of government guarantees of free medical aid.

Perspectives of forming a system of medical and social insurance

A perspective way of developing medical insurance is related to a creation of a single system of mandatory medical and social insurance (MMSI) on the basis of unification of existing systems of mandatory insurance (MMI) and social insurance. The possibility of such a unification is related to the fact that MMIs target an illness of an insured person – which is the main object of current system of social insurance. However, the mechanisms of financing payments of inability allowances and financing treatments are separated. AS the result of making a decision on the selection of a form of intensive treatments, and duration of treatment, rehabilitation and prevention takes place without considering the costs involved in paying allowances. Besides the doctors often act without appropriate control from the officers of the system of social insurance and are in a position of abusing their responsibilities by issuing sick lists to healthy individuals.

The need to establish a single system of medical and social insurance is determined by following conditions:

1. Unification of two systems of insurance will help form institutional prerequisites for conducting rational policy with respect tot different types of expenses connected to common insurance cases.
2. Creation of a new system will help reconsider areas of application of expenditures of social insurance, rationalize conditions for payment of allowances and reduce expenses which are not related to clearly defined insurance cases.

3. Formation of a single system would open new opportunities of dealing with the problem of transfer of contributions from the regional budgets to provide insurance to the non-working population and incompleteness of an introduction of a system of insurance financing of the main part of the medical aid provided to the population.
4. Creation of a new system on the basis of merging MMI funds and social insurance will make it possible to set up a better managed system compared to the current MMI mechanism.

Possibility of rationalization of aggregate insurance expenditures. Creation of a single system of medical and social insurance opens up an opportunity for conducting a single rational policy towards the different types of expenses connected by a single insurance case: expenditures on prevention, treatment, rehabilitation, payment of inability allowances. For example the reduction of sickness statistics as the result of preventative work and an application of more efficient clinical methods of treatment would reduce expenditures on payment of allowances for temporary inability, and this could achieve savings which might exceed additional expenditures on prevention work and improve the quality of medical aid.

In the case of a unification of financial institutions which provide social and medical insurance there would appear entities that are economically interested in improving the use of aggregate resources intended for implementation of different types of insurance expenses related to illnesses. But one should bear in mind that the pursuit of such a policy and an achievement of a real effect of rational use of unified resources of medical and social insurance is possible only in case of an equilibrium between the government guarantees for medical care and its financial provisioning as well as a diligent testing of its mechanisms of financial planning and an organization of payments of allowances in the unified system, crea-

tion of incentives for doctors to reduce periods of treatment without doing harm to patients, etc.

Rationalization of the system of allowances. Creation of a single system of medical social insurance will make it possible to introduce into the list of directions of changes and create order in a location of accumulated financial resources compared to the current system of social insurance.

These changes may include:

- A new scheme for payment of allowances for temporary inability (an allowance for the first three days of sickness will not be paid, limitations will be introduced on maximum financing of such a condition in a monetary value);
- Rationalization of the order of financing of the spa treatment for the insured (the use of insurance money only for payment of rehabilitation treatment under medical prescription and the creation of a higher share of compensation for expenses on spa treatment through the utilization of individual savings).

Any reduction of the list of allowances which must be financed from the medical and social insurance resources currently is not justified from the point of view of the attitudes currently prevailing in the Russian society towards such ideas as social justice and possible political ramifications from such a decision.

The solution of the problem of contributions into insuring non-working population. In the current MMI system the problem of transferring money from the regional budgets as contributions into insuring non-working population is not resolved. The amount of transferred funds generally in the country is six times less than the estimated amount. To try and utilize the means of economic incentives to encourage the Russian regions to effect the mentioned payments in full or to withhold the due amounts through a judicial action is futile. It seems impossible to resolve this problem without

securing financial sources for such contributions, for example, by identifying as such a source a certain amount of collection from individual income taxation. Otherwise it would not be worth while creating a unified system of medical and social insurance or keep the existing system of mandatory medical insurance. Meanwhile, the return to the old system of the government health care financing would mean the end to an opportunity of developing a system of social security, which could realistically equality of the rights of the citizens to an efficient utilization of government funding.

The improvement of the system of mandatory social insurance. In case the MMSI system is given the necessary tax source for the creation of its revenues, the federal MMSI fund would accumulate funds sufficient to balance out financial conditions for payment of medical aid in the Russian regions and provide uniformity of enforcement of government obligations in a free medical aid provision to the population in different territories.

Placement of the sources of insurance contributions into the MMSI system would enable to implement the simplest organizational scheme, from the point of view of its manageability: reorganization of existing Federal and territorial mandatory medical insurance funds and the funds of social insurance of the Russian Federation into a single MMSI Federal Fund. This approach would improve the level of manageability of the mandatory social insurance in the broad sense of the term. From September 2000 under the auspices of the Ministry of economic development and trade work is being done to draft a law on mandatory medical insurance. Its concept envisages changes in the composition of the components of the MMSI system. The government of Russian could become an insurer of the non-working population. The medical insurance entities could become insurers of the working population and Federal MMSI fund with regard to providing medical aid through

its offices in those territories where the insurance organizations do not operate. The main advantage in keeping the insurance companies as components of the MMSI system is the possibility of exerting a strong pressure on insurers from their competitors and customers, who will force them to operate more efficiently. If the citizens are given the right of freedom in selecting their insurer, then the insurance companies by trying to maintain an expand their insurance practice would be economically interest to maintain the quality of the service and protect the rights of the patients. On the contrary if the functions of insurers in the MMSI system are to be performed only by MMSI offices then there will be no competitive pressure on the funds in principle, and the possibilities for the consumers would remain similar to what there used to be under the system of the budget financing. The acknowledgement of the justification for keeping insurance organizations as the components of the MMSI system combines with the need to strengthen the government requirements to their activities and control over their operations in order to exclude any possibility for them to generate profits through simple funneling of money from MMSI funds into medical aid institutions. Such requirement must be written into the law as the criteria for an issuance of a license for participation in MMSI and should also contain conditions for its revocation.

Education

In the course of 2000 in the area of education a whole number of government documents were adopted which were able to define future development of this sphere for a substantially long perspective. But here the question about what kind of a perspective it will be currently remains unanswered, because a prevalent majority of such documents are dedicated only to modernization of mechanisms of financing educational institutions. Main area of moderni-

zation, rationalization of federal, regional and local budget expenses through an introduction of regulatory principles for the distribution of these expenses and equally the provision of transparency in the distribution and utilization processes. An important feature of the planned changes is the inclusion of non-budgetary funds, which are received by educational institutions from their commercial activities into a single budgeting procedure. From an economic point of view justification for this innovation should not bring up serious doubts because a very strict regulation of the use of the funds earned by the educational institutions might undermine their intention to maximize non-budgetary revenue as well as for a rational use of the available aggregate financial resource.

A thorough consideration of issues of financing of education was combined with substantially smaller level for the improvement of contents of educational process. Truly significant documents in this area address only to items: strengthening of standard beginning in the system of higher education and logistical issues related to students going from one stage of education to another.

According to the intention of the authors of idea of transition to a 12-year education in a secondary school this measure was to facilitate the improvement of quality of secondary education by reducing burden on students and raising quality of educational process. However, the analysis of the drafted documents prepared for introduction of this innovation demonstrate that in fact these attempts limited themselves to extending old content of educational process for a more lengthy period.

The Parliamentary hearings on the problem of introducing a secondary 12 year schooling, which took place in June 2000 became an important component of the process of public debate of the initiative of the Ministry of education. The result of the hearings was the statement by the State Duma committee on education and

science concerning the untimeliness of the proposed innovation. This composition by the committee was also supported by the representatives of the Duma factions of SPS and "Yabloko". Along with that at these parliamentary hearings a recommendation was voiced to experimentally test the proposed innovation in several pilot regions.

A number of government agencies' normative act served the purpose of raising the quality of education. Firstly, one should stress the directive by Ministry of education of Russia # 686 of March 2, 2000 "On adopting government educational standards in higher professional education". Its importance is defined by the fact that first the government educational standards in their final form have been approved based on a specified list of occupations and areas of expert training, bachelors and masters degrees, and secondly a bachelor degree was now legalized, whose absence in the qualification references created certain difficulties for the graduates of the first stage of higher professional education during their search for employment. One should note other regulatory documents of the Ministry of education adopted in the previous year: Directive # 1012 of April 6, 2000 "On creating a coordination council of the Ministry of education of Russia for the development of the system of tests" and Directive # 1122 of April 17, 2000 "On certification of the quality of training test material".

The most important for the development of the Russian system of education for the long term perspective one can consider a set of documents dedicated to a strategy of social and economic development prepared in the Center for strategic developments. Proposals on the strategy of development of the Russian education envisage the following main principles and areas of the reform in the system of education:

- personification budget financing (transition to a regulatory individual specific financing of educational institutions);

- freedom of selection of educational institution implemented through provision of conditions for the versatility of options for transiting from one stage and/or forms of education to another;
- changing of a legal status of educational institutions;
- introduction of direct contract relationships between all those involved in the educational process;
- improvement of quality control in education through creation of an independent federal service and a transition to a single national examination;
- introduction of co-financing by households in addition to the government financing of standards of educational services;
- introduction of recipient specific social support for the students from low income households;
- establishment of the system of identification of and support for specially gifted children;
- introduction of tax exemptions for individuals and corporations on the basis of their expenditures for education;
- establishment of educational system development budget;
- provision of an educational system reform aimed at strengthening its government-public content.

These principles and directions were planned for implementation through the system of new mechanisms and separate measures among which there were:

- revival of mass pre-school education in the form which allows for a provision of respective preparation of a child for a successful studying in a preliminary school;
- modernization of the general and secondary educational system, including a renewal of its content and structural reorganization of educational process for the purpose of transiting to 12 year educational process as well as a provision of a direct budget financing for schooling institutions;

- restructuring of the development of a rural schooling including creation of a basic secondary full cycle schooling and transportation of rural students to these schools;
- creation of a system of monitoring educational quality;
- strengthening of professional education and its targeting towards the demands expressed by the labor market ;
- the reform of the system of budget financing of professional education through the introduction of the system of the system of personified government financial obligations, differentiated in accordance with the result of students passing uniform centralized examination;
- establishment of university facilities through creation of associations and consortia of educational institutions of different types and levels;
- development of non-budgetary financing for all types of government and municipal educational institutions and creation of public forms of management of such non-budgetary resources (trustee councils).

Implementation of the above mentioned principles and their supporting measures envisaged introduction of substantial changes in the existing legislation because a whole range of measures contradicted the Civil, Budget, Tax and other Codes and regulatory acts. For example, the principle of personified financing of educational process suggested in the strategy of educational reform does not conform to the current law “On education” in which article 41 stipulates that the norms of the budget financing of educational institutions are determined on the basis of calculations per one student and are differentiated on the basis of types and categories of educational institutions and not by the level of training of students defined by the system of quality control of education. Further on the development of the system of co-founding of educational institutions will require a change

in a Federal Law “On maintaining the status of government and municipal educational institutions and the moratorium on their privatization”, because it does not allow to introduce into the number of founders of already existing government and municipal educational institutions of non-government organizations and private individuals.

Proposals prepared in the Center for strategies development served as the foundation for the plan of action by the Government of the Russian Federation in the area of the social policy and economic modernization for the period o 2000-2001. In the section devoted to the reform of education such measures were defined as those of priority like the increase of the budget expenses for education and provision of co-financing out of non-budgetary sources, introduction of tender based procedures for placement of government order for training of experts, restructuring of the network of government educational institutions for the purpose of saving expenses, as ell as gradual introduction of the mechanisms of per capita budget financing. However, as opposed to quite radical organizational and financial innovations contained in the education development strategy the document adopted by the government can be distinguished by a significantly softer approach to the process of reforming education and by fewer details. No specific forms are being defined by it through which the above mentioned directions of the reform of the organization and financing the sphere of education are to be determined.

The issues of reforming the education are not reflected in the government document which points to a still insufficient level of their preparation. The same can be mentioned about the education development strategy itself,, which among the considered issues is covering the development of content and quality of education which had a very insignificant level of attention attributed to it. In other words, ideological work for considering basic documents intended to define the immediate and long term perspective for the development

of the Russian educational system was based upon an assumption that the main problem of domestic education is the lack of financing and not the lack of a clear understaffing of a new mission of education in the changing Russian society. Since education does not offer pure individual benefits then in this area hopes are not justified for the well prepared market mechanism to automatically transform the system education into its optimal precondition by “putting everything in its rightful place”. Consequently at the present stage attempts by experts must be aimed at producing a clear understanding of the mentioned mission.

The issues of the quality of education and the social efficiency of functioning of educational system do not boil down exclusively to the contents of educational plans and programs. The most important reserve for their improvement related to the budget process is the improvement of the structure of the budget expenses for education at the federal and regional (municipal) level. In other words a resolute review of correlation of separate articles of government financing should take place. So for example in the structure of expenditures by Ministry of education of Russia adopted for 1999 expenditures for wages were twice higher than expenditures for purchasing equipment (see table 3). Although the budget for 2000 had the expenditures for purchasing equipment raised dramatically exceeding 1 billion Rubles, while wages were planned in the amount of approximately 8 billion Rubles.

Similar tendencies are seen during the analysis of performance of budget targets for expenses on the educational needs in separate accounts. So whereas generally throughout the sector “Education” approved in 1999 the federal budget was completed at 101.7% including the higher professional education at 101.0%, the budget indicators for publication of training literature for special education institutions were completed at 48% only, and in publication of new

generation of training materials for medical higher educational institutions no planned expenses were never incurred.

Basically, the analysis of the functioning of educational institutions points to the fact that during the whole period of reform purchasing of equipment and training material depended upon availability of non-budget revenues in the educational institutions while the funds of the government budget played the role of the social support for a big number of teachers.

The analysis of the structure of expense accounts dedicated to educational needs represented in the federal budget for 2001 allows to a certain extent to talk about a number of certain positive improvements. It provides for:

- increase of the level of wages of educational workers on the basis of reestablishment of classification reference (ETC) which was being used until April 1, 1999, which corresponds to the indexing of wages of the mentioned personnel from January 1, 2001 by 1.2 times on average;
- increase of a number of stipends and additional meal allowances to students who are supported by the government programs;
- increase of expenses for payment of compensation for purchasing of training materials by teachers;
- payment for communal, utility services in the amount exceeding 75% of appropriated recourses in kind, the amount of financing for communal services would increase 2 times compared to year 2000. However it should be noted that the achievement of this level is provided in fact through the use of non-budgetary resources of educational institutions.

TABLE 3.6

Distribution of Russian Ministry of Education revenues per subject accounts in 1999-2001 (mil. Rubles)

	Ap- proved budget of 1999	Ap- proved budget of 2000*	Budget draft 2001**	Deviation of 1999 budget from 2001 draft budget %%	Deviation of 2000 budget from 2001 draft budget %%
Ministry of education - total	14315,3	22256,1	32343,2	226	145,5
Including:					
Wages	6238,0	8166,9	10909,1	177	133,5
Accruals on wages	2365,5	3106,9	3847,0	162	123
Foodstuffs	688,6	1339,1	2970,2	427	221,8
Payment for municipal services	247,3	2198,6	4503,2	1803	204,8
Other current expenses:	200,1	127,3	1513,3	714	1188,7
Including:					
- Health care measures	200,1	127,3	625,6	312	491
- addition to library fund	-	-	400,0	400,0	400
- studying practice	-	-	402,2	402	402
Stipends	3793,4	3709,3	4808,4	127	130
Other transfers to popula- tion (compensation for book publishing, orphan children)	584,9	895,6	931,3	159	104
Purchasing of equipment	28,5	1120,4	1147,8	393,1	102
Capital repairs	20,9	825,6	1085,2	5141	131
Federal purpose specific programs ***	7,0	18,1	265,3	3790	1466

* incl. Federal purpose specific program "Development of education" – 1500,0 million Rubles.; purchasing of equipment 1050,0 million Rubles; capital repairs – 350,0 million Rubles; payment for current repair of buildings and facilities – 100,0 million Rubles.

** incl. Federal purpose specific program "Development of education" –1748,9 million Rubles; purchasing of equipment - 1120,4 million Rubles.; capital repairs – 628,5 million Rubles.

*** Federal purpose specific programs for 2001: «Orphan children», «Gifted children», «Russian language», «Scout» and «Ocean», «Comprehensive measures countering misuse of narcotics and their illegal trafficking».

Source: based on the data from the Ministry of Education of Russia.

Despite notable positive changes in the situation with payment for communal services the state of thing in this area in 2001 will remain very complex. The problem of communal payment is further deteriorated by a significant increase of tariffs for fuel supplies

in many regions of Russia (2 times higher in some of them). The attempts by the Ministry of education to resolve this problem through active engagement of non-budgetary resources of educational institutions, higher educational institutions in the first place had some limitations. Firstly, higher educational institutions are not interested to spend their revenue exclusively on settling arrears for communal services. Secondly, the biggest amounts of non-budgetary resources are concentrated in higher educational institutions located in major industrial centers, which already allocate up to 30% of such resources to the payment of utility services. The ability of the higher educational institutions and the institutions of preliminary and secondary professional training located outside of these regions to pay for utility services out of non-budgetary funds are quite limited.

The development and support of material and technical basis in educational institutions is envisaged in expenditures of the federal budget only within the framework of implementation of the federal purpose specific program “development of education” (see table 3). However, the resources appropriated in 2001 are extremely limited particularly taking into account the fact that in the proceeding years this program practically had no financing. Besides more than 50% of educational buildings and hostels were built 40 years ago and as a minimum require capital repair. The level of availability of equipment in educational institutions – computers etc – remains extremely low and does not exceed 1% of current needs in higher educational institutions, 22% in technical schools, and 12 % in professional technical schools.

Consequently there is a need for a very detailed action to be undertaken to define priorities in appropriating budget resources because the program itself does not have any precise definitions. It should be noted that applications submitted by educational institu-

tions into the ministry of education in Russia requesting capital repairs of buildings and facilities by a considerable margin exceed the whole volume of resources identified within the federal program “Development of education”.

The special federal programs written into the federal budget for 2001 in the area of education (see table 3), although apparently makes it possible to resolve some problems, do not fully conform to the priorities of the development of education, do not have a respective connection with each other and the programs financed by the federal budget in the adjacent spheres.

It should be noted that the planned documents which were mentioned above as special federal programs at a closer consideration turn out to be sets of incomprehensive and weakly interrelated measures, and there are no guarantees that their implementation could allow to resolve respective problems. In other words these documents are far from being special. The methods for coordinating the programs, that are being designed by separate ministries, when they are targeting similar types of problems, require sufficient improvement. So it can be stated that practically nothing is being done to ensure a necessary level of coordination.

SECTION 4. INSTITUTIONAL AND MACROECONOMIC PROBLEMS

4.1. Privatization in Year 2000: Outcomes, Objectives, Institutional Constraints

The developments in the sphere of privatization sales only slightly differed from the situation, which existed over the last two years. Initially the targets set for year 2000 included the sale of blocks of shares in 66 large enterprises (important in financial terms), among them Gazprom (two blocks of shares – 2.5 per cent and 0.87 per cent), ONAKO (85 per cent), LUKoil (several small blocks of shares, including ADRs for 4.5 to 7 per cent of shares to be floated on Western markets), Slavneft (19.68 per cent), Rosneft (25 per cent plus 1 share), SIBUR (14.78 per cent), VNK (36.8 per cent), Kuznetskugol (80.67 per cent), NORSI-oil, Roslesprom, “Orlenok” Hotel, a number of construction and power, and wine and spirits producing enterprises. The total list included 242 public JSCs belonging to 24 different industries and shares in 1500 JSCs created on the basis of state unitary enterprises (SUE); the list also included real estate, military surplus property. Many of these planned sales failed.

However, in year 2000 the budgetary privatization revenues were significantly over the initial target (Rub. 22 billion) set by the government (see Table 4.1). In the first half-year the federal budget privatization revenues made Rub. 11.16 billion (including Rub. 4.2 billion resulting from sales of property and Rub. 6.98 from the management of federal property).

On the whole, in year 2000 the estimated revenues from the use and sales of state-owned property made Rub. 50.6 billion, including Rub. 31.4 billion derived from sales, Rub. 9.8 billion being the revenues of “Vietsovpetro” joint venture, Rub. 5.6 billion being divi-

dends on state-owned shares (1020 JSCs), Rub. 3.4 billion from the rent of federal property, Rub. 0.44 billion worth of revenues from federal property abroad.

The major share of revenues from sales of state-owned property was generated due to the sales of shares in ONAKO oil company (85 per cent of shares, US \$ 1.08 billion); blocks of shares in LUKoil oil company (a special auction, 0.5 per cent, Rub. 1.4 billion); shares in Mezhdurechenskaya and Krasnoyarsk coal companies, Bolshevichka factory. In the summer of 2000 the last block of shares in “Norilsk Nickel” owned by the state (0.25 per cent) was offered at a special auction held in 30 regions. The sale of seven (7) shares in “Norilsk Nickel,” which remained unsold after the special auction at a separate auction looked rather absurd. Although this was done in compliance with the formal requirements set by law, the cost of the sale was much higher than the revenue received by the state.

TABLE 4.1.

Privatization in 1995 through 2000

	1995	1996	1997	1998	1999	2000
Number 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 ^{ef} (total 18,5)	18 billion ^{ef} (total 23,7)
Actual revenues	7,319 trillion	1,532 trillion	18,654 trillion ^b	14,005 billion ^e	8,33 billion ^c (total 17,3)	31.4 billion ^c (total 50.6)
Dividends on blocks of shares in federal ownership	115 billion	118 billion	270,7 billion	574,6 million	6,15 billion	5.6 billion

a - the approved budget was adjusted in December of 1995, 70.8 per cent of the actual revenues were derived at the expense of loans-for-shares auctions.

b - including \$ 1.875 billion for shares in “Svyazinvest.”

c - only for property sold.

d - adjusted to Rub. 15 billion in April of 1998 (at the governmental level).

e - including Rub. 12.5 billion for 2.5 per cent of shares in “Gazprom.”

f - not included in budgetary revenues

In September of 2000 the government introduced a draft privatization program for year 2001 to the State Duma. Traditionally, the list of privatization objects stirred up the most heated controversy. The list included shares in some largest enterprises (holdings), privatization of which had been several times postponed. This might be an evidence of a formal attitude the government assumed toward the document, since the State Duma repeatedly refused to approve the list since 1997. The draft new law on privatization deprives the State Duma of the right to control privatization by approving lists of largest enterprises subjected to it. In this connection, in September of 2000 the State Duma passed (in the first reading) a draft law (amendments to the law on privatization) introduced by the CPRF and the agri-industrial group of deputies prohibiting sales of state-owned shares in large JSCs (with balance sheet value exceeding 5 million minimal wages as on January 1, 2000) until a privatization program is approved. The draft budget 2000 was amended to the effect that any transactions concerning large enterprises were prohibited until a privatization program is approved.

For year 2001, privatization revenues were targeted at no less than Rub. 30 billion, including Rub. 18 billion resulting from sales of state-owned property and Rub. 11.98 from the management of state-owned property. Among major privatization objects is the block of shares (25 per cent minus 2 shares) in Svyazinvest; however it may be sold only after the reorganization of the holding and some presales measures. The list includes about 700 large enterprises (for instance, 19.68 per cent of shares in Slavneft, 2.5 per cent of shares in Gazprom (only after the unification of Gazprom shares market), shares in Rosneft, Aeroflot, Sheremetyevo and Vnukovo airports).

The Concept of Managing State-Owned Assets and Privatization in the Russian Federation (approved by RF Government Deci-

sion No. 1024 of September 9, 1999) stipulates that the largest and most attractive objects shall be privatized according to the most effective and transparent sales methods and taking into account business situation. Already in early 2000 Western consultants suggested that the State Property Ministry (SPM) shall employ a new “transparent” privatization method (via the issuance of ADRs) with regard to the blocks of shares most attractive to investors. It was presumed that this method of the floatation of state-owned shares would generate more revenues (as compared with the domestic stock market) and permit to avoid accusations of the application of “non-transparent” procedures. The problem is that the privatization law currently in force lacks the option of direct issuance of derivatives (including ADRs) for sales on foreign markets. The State Duma and the Federal Commission for Securities (FCS) also periodically rise questions regarding the necessity to regulate issuance of depositary receipts.

The outcome was that no transactions with LUKoil and Gazprom ADRs took place on foreign markets in 2000. In late 2000 the government worked out for LUKoil a privatization scheme, which took into account the current favorable oil prices situation and permitted to circumvent the amendments to budget-2001 (the amendments prohibited sales prior the approval of a privatization program). The transaction envisages that the Russian Federal Property Fund will transfer 6 per cent of LUKoil shares (out of 14 per cent of shares still owned by the state) to the authorized capital of specially created public joint stock company “Project Privatization Company” fully owned by the state). The authorized capital is set at Rub. 14 billion. The JSC’s board of directors shall include 5 representatives of the state. There shall be issued level-three ADRs to be floated at the New York Stock Exchange. The revenues are expected to be at about US \$ 800 million (US \$ 16 per share as com-

pared with US \$ 2.6 per share gained when 9 per cent of shares were sold to a Cyprus-based company in 1999).

At least three questions remain unclear. First, the dependence of the effectiveness of sales on the general business situation on the US stock market. Second, as British Petroleum sold a block of its shares (6.99 per cent, partly on the open market and partly in the form of convertible bonds) it negatively affected the price of ADR floatation. Third, according to some estimates the costs of sales via ADRs (taking into account commissions charged by Western banks) may be higher than the costs of domestic placement (in case prices abroad and in Russia are close). The outcome was that the RF government initiated the suspension of the transaction in February of 2001.

On the whole, the expected privatization revenues in 2001 are rather modest. The most probable development will be a considerable decrease in revenues, since, first, in 1999 the revenues from sales of state-owned property were excluded from budgetary targets (lease of federal property and dividends on state-owned shares remain among the budgetary revenues). In 2001 these funds are planned for the servicing of the RF debts. Another objective factor behind the decrease in privatization revenues is the lack of financially important privatization objects to be sold effectively (i.e. taking into account a favorable price conjecture, taking relevant pre-sales measures, having an approved reorganization program in place, ensuring real interest of investors, avoiding political confrontation, etc.) in year 2001.

The general **strategy for next few years** is to take concrete decisions with regard to each Russian enterprise fully or in part in state ownership. Such enterprises shall be either transformed into unitary state-owned enterprises, JSCs with 100 per cent state own-

ership, privatized, transferred to the ownership of a subject of the Russian Federation (via an off-set or for free)¹.

These measures require to conduct a wide-scale inventory, which, in a broad sense, includes not only the inventory of property, but the monitoring of the management's actions. The necessity to make a unified register of state-owned property was obvious yet in early 1990s. The government approved some measures in this area in July of 1998 (requirements concerning state-owned enterprises, organizations, and JSC with state participation using federal property to submit certain documents to the Committee for the Management of State Property (CMSP)); however, no sanctions for failure to present these documents were stipulated.

According to the Ministry for State Property (MSP), while by September of 1999 only about 10 per cent of the total number of legal persons were included into the register, by the summer of 2000 it included 83 per cent (52 thousand enterprises). This number includes 11,200 state unitary enterprises, 32,700 federal agencies, 3,500 JSCs with state participation or using federal property, 4,500 legal persons in other organizational and legal forms. The increase in the number of enterprises included in the register apparently generate growth of federal budget revenues. For instance, the number of rent agreements in the Vladimir Region increased from 480 in 1998 to 6,100 in 1999. At the same time, only 12 per cent of legal persons are registered in Moscow. In 69 of the RF subjects there exist 1,232 legal persons declared as federal ones in the regions, but not registered with respective federal agencies. Although there were stipulated some measures preventing the exclusion of property from registration, they failed to settle the key problem – withdrawal of

¹ The inventory and effective use of the RF property abroad is a separate problem.

assets via long-term investment (no MSP approval is required for transfer of funds in case daughter companies are created).

Another problem is the monitoring of directors' actions, which, in fact, should force state unitary enterprises to transfer part of their profits to the budget. The monitoring will most certainly fail even if respective agencies work out "economic and financial norms." The cancellation of contracts (and decisions of certifying commissions) conducted on these grounds may be easily disputed in courts (taking into account the priority of Labor Code stipulations). The law (Article 295 of the RF Civil Code) envisages that state unitary enterprises shall transfer a share in their profits to the budget, however, no such case has been registered yet. The real monitoring may be conducted via regular independent audits, however, this way may prove very expensive.

The most radical way to settle the problem is the liquidation of the institute of state unitary enterprises (less than 3,500 enterprises shall be owned by the state, taking into account the managing capacity of the state).

According to the MSP data, 90 per cent of assets belonging to 30,000 enterprises and organizations remaining in state ownership (mostly small, including 14,000 state unitary enterprises) may be referred to as unmarketable. In this connection, there exists the problem of creating a more sophisticated privatization tool kit (including other tools than the conversion of state unitary enterprises into JSCs), which would allow the state to get rid of this burden, at the same time generating demand on the part of individuals and small businesses. Another important fact is that MSP detected five million square meters of unused industrial and administrative premises, warehouses, and non-completed construction objects in 1998 through 1999.

The transfer of several blocks of shares in some enterprises to the Moscow government (Decision of the RF Government No. 974 of December 15, 2000) is an example of the free transfer of federal property to a subject of the Russian Federation. These blocks of shares were transferred as a partial compensation of costs involved in the performing of functions of the RF capital. Another Decision of the RF government (No. 1366 of December 9, 1999) envisages the transfer of federal unitary enterprises in the ownership of subjects of the Russian Federation.

The following changes may be envisaged in the sphere of the **management of state-owned blocks of shares** (for details see section “State Participation in the Management of Corporate Structures: Normative and Legislative Base and Real Situation” of this survey):

- to differentiate approach to the evaluation of the effectiveness of state representatives’ actions at enterprises depending on the size of state-owned blocks of shares and their potential to influence the decision-making processes (at present 92 per cent of the total number of state representatives (3,000) are recruited from respective sectoral departments and 70 per cent – from regional bureaucrats); the further plans may include the sale of minor blocks of shares or creation of “portfolio funds”;
- to establish the institute of “authorized representatives,” who shall work at JSCs on the full-time basis;
- to develop the institute of trust management based on open competition (according to the most radical variant it shall become the only form of management), what is hindered by the present legal base;
- to achieve real strengthening of the state’s authority with respect to voting (Federal law No. 109 of August 5, 2000,

introduced some changes in the privatization law, according to which shares in JSCs created in the process of privatization owned by specialized organizations, have the right to vote at shareholders' meetings). It is necessary to note that the lack of criteria defining the "*bona fide*" character of such decisions generates a considerable risk of abuses of the voting rights;

- it is recommended to unify the allotted blocks of shares in more than 500 enterprises include in the "strategic" list (100 per cent, 75, 50, 25 per cent plus one share);
- it seems appropriate to sell minority blocks of shares (up to 25 per cent), excluding those in financially important enterprises.

The strong **trend toward the strengthening of the federal vertical of power** was also apparent in the sphere of ownership relations. For instance, there was envisaged a revision of the relations with regions, where the right to manage federal property had been transferred to the territorial administrations and where the revenues from the utilization of state property (rent, etc.) fell (it concerns more than 25 per cent of the total number of the RF subjects in 2001). The functions of regional CMSPs failing to perform according to targets set by the government should be transferred to special territorial agencies. Such agencies (created in Moscow, Voronezh, and Irkutsk) shall be managed directly from the federal center. Therefore, it is planned to implement an administrative reform aimed at some increase in budgetary revenues and the introduction of clear criteria governing the delimitation of the federal and regional (municipal) assets. It seems that this problem shall be also settled in terms of legislation.

Yet another change in year 2001 may become the creation of a state company to be a professional operator of the securities market.

Its source of funds for operations on the securities market may be revenues from the massive sale of state-owned non-liquid assets (to be transferred to the company), which later may be invested in “blue chips” aiming to generate budgetary revenues (as dividends or prices of shares). This idea may prove to be not unambiguously positive in spite of some favorable foreign examples². On the one hand, this structure may enable the state to implement more flexible sales policies, which would take into account changes in the market situation. On the other hand, the sales of small blocks of shares will hardly produce the expected effect on the “gray” market of large blocks of shares. It means that the government intends to “play” on the Russia’s narrow and speculative securities market. Taking into account the government’s potential in this respect, the consequences for all segments of the financial market may be very grave. At last, there exists a number of other problems: the choice of the blocks of shares to be transferred to the company; transparency of operations and the criteria defining what operations answer the state (budget) interests, and the purchase strategy, i.e. nationalization. It shall also be noted that the law on privatization lists stock market operations among privatization methods, however, such operations may also include purchase of shares.

The elaboration of a **new law on privatization** is caused by a large number of accumulated unsettled problems. For instance, it is necessary to make some changes in the sphere of privatization methods, evaluation of property, rent of state property, institution

² In the course of the crisis of 1997 and immediately after it the Hong Kong government purchased a considerable number of shares in private companies (including telecommunications, power engineering, and airlines) as an anti-crisis measure. Later these shares became the basis of a state investment fund, which offered its shares to the public.

of the “golden share,” to introduce special privatization methods with regard to small blocks of shares (up to 10 per cent).

The draft federal law “On Privatization of State and Municipal Assets” (drafted by the RF State Property Ministry, 2000) envisages the following positive novations:

- to abolish the requirement to annually adopt a law stipulating the state privatization program (this requirement has been never complied with anyway);
- to delimit the state assets according to their liquidity (it requires the respective differentiation of sales methods and degrees of transparency);
- to broaden the privatization tool-kit (see Table 2) taking into account the interests of small and medium-sized businesses;
- to clearly define permissible privileges for insiders;
- to introduce some mechanisms permitting to lower the risks of non-compliance with investment and social obligations;
- to include land plots of privatized enterprises in authorized capitals of newly created JSCs, the sale of the said plots to existing JSCs at normatively set prices, or their inclusion into authorized capitals as the contribution of the state;
- to take into account enterprises’ exclusive rights for their intellectual property (to be evaluated and included into the property of the newly created JSC, or to be prohibited to privatize).

On the whole, it is necessary to have a clear notion what goals privatization and reform of the management of state assets shall pursue. In the first half of 1990s the key goal of privatization was to ensure structural changes and the institutional base of the systemic transformation including a social contract suitable for that time (this model could not be realized without support of directors of

state enterprises). By present time, this systemic goal has to a considerable degree transited into the sphere of corporate governance problems. Another goal of privatization – the budgetary one - was (with many reservations) pursued over the late 1990s. At present, it also is not self-sufficient for the development of privatization process. Accordingly, some burden shall be transferred to the public sector, which will exist for a rather long time yet.

TABLE 4.2

Privatization Methods

Federal Law "On Privatization of State-Owned Assets and the Framework of Privatization of Municipal Assets in the RF" (No. 123-FZ, signed by the RF President on July 21, 1997, in effect since August 2, 1997).	"The Concept of Managing State-Owned Assets and Privatization in the Russian Federation" (approved by RF Government Decision No. 1024 of September 9, 1999) A broader tool-kit due to:	Draft Federal Law "On Privatization of State-Owned and Municipal Assets" (RF State Property Ministry, the spring of 2000)
(1) Sales of assets at auctions, including sales of shares at specialized auctions	(1) Issuance of derivatives backed by state-owned assets permitting to place the securities on foreign stock markets (deferred right to purchase shares being in the state ownership)	(1) Transformation into JSC
	(2) Sales and purchase of shares on the stock exchange and over-the-counter market aimed to optimize the state participation	(2) Sales of assets at auctions
	(3) Sales via direct negotiations with investors, including cases when results of an auction (tender) were nullified (the price of the object shall be at or over its initial price set for the nullified auction)	(3) Sales of shares at special auctions (public floatation)
(2) Sales of assets at commercial tenders with investment and/or social conditions (mandatory condition for enterprises as property complexes or blocks of shares no less than 50 per cent)	(4) Sales of state-owned assets on deferred payment plans on security of banks	(4) Sales of assets at commercial tenders including investment and/or social obligations (only enterprises as property complexes or no less than 25 per cent of shares in a JSC)
(3) Sales of shares to the employees	(5) Commercial tenders including social obligations	(5) Sales of shares to the owners of securities certifying the right to purchase such shares (by applying methods 3 and 7)
(4) Redemption of leased property	(6) Sales of not-yet-commissioned construction objects; buildings and structures not used for state needs, primarily aimed to create new production capacities (on the condition that new owners assume obligations in accordance with the system of controlled indicators, which is under development)	(6) Sales of derivative securities certifying the ownership rights for shares (via tenders aimed to choose specialized financial organizations vested with the issuance, floatation and depositary servicing of such securities) on foreign security markets
(5) Transformation of unitary enterprises into JSCs 100 per cent of shares in which are owned by the state or a municipality	(7) For minority blocks of shares (less than 25 per cent):	(7) Sales of shares at stock exchanges
		(8) Commission sales of assets (in case methods 2 or 4 failed, or only 1 purchaser participated)
		(9) Direct sales of assets basing on negotiations (in case 8 failed), it concerns only non-liquid enterprises

TABLE 4.2 CJNTINUED

(6) Transfer of property as contribution to authorized capitals of JSCs	- to increase state-owned blocks of share up to the blocking level by transferring state-owned assets to authorized capitals of JSCs, or by purchasing shares in such JSC on the secondary market aiming to sell these blocks of shares to strategic investors;	(10) Sales of assets to leaseholders under leasing agreements permitting to redeem the leased assets (except property complexes)*
	- to transfer state-owned blocks of share to the issuer, or a subject of the Russian Federation (a municipal entity) on account of the budgetary financing on condition that wage arrears will be repaid and no further arrears of wages, mandatory payments due to budgets of all levels, and other arrears will be generated in the future;	(11) Sales of property complexes to enterprises' personnel with mortgage (in case the number of employees is less than 51 and no less than 2/3 of them founded the purchasing organization)*
(7) Sales of shares to the owners of state or municipal securities certifying the right to purchase such shares	- to transfer minority blocks of shares to authorized capitals of other JSCs;	(12) Transfer of the real estate via public tenders of investment projects (in case failed)*
	- to sell state-owned blocks of shares to enterprises' personnel at preferential prices including cases of creation of so called "peoples' enterprises."	(13) Transfer of property as contribution to authorized capitals of JSCs (14) Sales of shares to their issuers (less than 10 per cent of the authorized capital in case the market price is below 50,000 MW (minimum wage))*
(8) Sale (transfer) of ownership right concerning the property as an offset against internal and foreign debt liabilities of the Russian Federation, RF subjects, or municipal entities, or exchange of property for other property (money, goods, and services) in the framework of method (7) may be conducted only by a special decision of respective authorities	Note: highly liquid enterprises shall be privatized taking into account the balance between the amount of attracted investment and funds due to the budget basing on the real price evaluation maximally close to world levels. The remuneration of financial advisers shall depend on the amount of budgetary revenues. Enterprises having liquidity problems may be sold at minimal prices upon submission of business plan and implementation of measures permitting to control the system of indicators of enterprises' operations.	(15) Sales of shares to managers operating on terms of trust
		(16) Preferential sales of shares to employee (up to 10 per cent of voting shares in the authorized capitals at a 30 per cent discount on the nominal price)*
		(17) Preferential sales of shares to the management (up to 10 per cent of voting shares in the authorized capitals at a 20 per cent discount on the nominal price)
		(18) Sales of 100 per cent of shares in JSC created as "people's enterprises"* Note: there are envisaged 3 categories of assets: highly liquid (methods 2, 3, 6), liquid (methods 2, 3, 4, 6, 7), and low liquid (any method)

* The new draft legislation submitted for approval in the late September of 2000 does not contain these privatization methods (they were excluded either by right-wing, or left-wing deputies). Besides, there were introduced the new criterion dividing all enterprises in liquid (attractive in terms of investment) and non-liquid (not attractive in terms of investment). The criterion is of formal nature: cost of fixed assets at 5,000,000.00 MW (minimal wage). There is also a stand favoring the principal prohibition to privatize enterprises "attractive in terms of investment" (this stand is taken by left-wing forces and the RF Accounting Chamber). "Public offering" and "sales in the absence of contest" were included in the list of privatization methods.

The third goal is to attract investment, however, its realization pursued over the 1990s has practically failed due both to objective (realization of systemic or budgetary goals) and subjective factors. The latter was related to the fact that methods seemingly applied to

attract investment were in truth used to cut off competitors, organize management buyouts, etc.

At present the task to optimize ownership structure at the micro-level and at the level of the national economy shall be moved to the forefront. At the same time, exactly in this area there exists a number of constraining factors, which will be of paramount importance for a long time.

First, the task to inventory the state-owned assets. This process will objectively accompany the new possible intensification of privatization process.

Second, there are long-term quantitative constraints. It is unlikely that Russia will implement any new mass privatization program (due to a considerable heterogeneity of objects), while the proposed sale of 8 to 9 thousand of transformed state-owned unitary enterprises will take years. Moreover, the process of inventory reveals numerous “unaccounted for” state-owned unitary enterprises (according to some estimates their number is already close to 17 thousand).

Third, the further development of the privatization process will be constrained by the pace and quality of the transformation of existing state-owned unitary enterprises into JSCs. Any mass transformation of state-owned unitary enterprises into JSCs may be accomplished only in case the clearly defined mechanisms of future functioning of such enterprises are in place (they shall be granted a special status or function as ordinary JSCs in the framework of existing corporate law). This process was also affected by the trend toward growing state participation in companies (see below), which became perceptible in 2000.

Fourth, it is a favorable price situation. Both business situation on commodity markets, and factors related to the redistribution of assets and company securities prices are of importance. The latter

process intensified after the financial crisis of 1998, and new stages of this process lay ahead.

Fifth, it is the ambiguous stand the government took on the problem of nationalization. It seems that this process is impossible in political terms (at the level of theoretical approach). However, in practice the process of nationalization has been developing for a long time: attempts to revise the results of investment tenders, courts nullifying certain privatization transactions, the growing number of state-owned unitary enterprises (after the bankruptcy of enterprises due to debts to regional and local budgets), debt restructuring processes, return or pledge of blocks of shares to governmental agencies, arrest of shares due to debts, transfer of blocks of shares to state-owned holdings, etc³. These problems require a unified approach and a civilized legislative environment. However, the law on nationalization was not approved in 2000, while it is a certain declaration of intent stipulating the terms and amounts of compensation, sanctions applicable to previous infringements. It is also necessary to settle the issue of the statute of limitations with respect to privatization transactions.

3 For instance, the RF Accounting Chamber basing on the results of its audit recommended the government to revise the privatization of two aircraft construction enterprises (“Aviakor” and “Aviastar”). The State Duma requested the Accounting Chamber to check privatization of a block of shares in TNK (49,806 per cent of shares at US \$ 66.7 million plus an investment program at US \$ 185.2 million) in the summer of 2000. The problem of returning shares in the state ownership with regard to canceled sale contracts with winners of commercial tenders held before the privatization law of 1997 was approved (Volzhski Trubny Zavod, Ust Ilim LPK) persists. However, the Moscow City Court, for instance, nullified the results of the auction of 1994, at which 29 per cent of shares in “Sapphire” plant (high-precision weapons) were sold, and returned the shares to the Russian Fund of Federal Property (*Russ. abbr.* RFFI).

The key problem faced by the further development of the privatization process is the **contradiction** between the considerable potential for the development of privatization in medium and long-term outlook and the presence of very serious institutional barriers preventing effective privatization. This concerns the general institutional environment preventing the application of new methods and improvement of existing ones: effectiveness of the laws currently in force, issues of ownership rights protection, problems of the institutional “arrangement” of corporations⁴, enforcement, judicial system, execution proceeding.

Many of the issues mentioned above were left outside the governmental program for year 2000. It is necessary to clearly understand that, for instance, the reform of the judicial system may become an indicator of true intentions of the authorities concerning the reform of the Russia’s economy and its social system.

⁴ See: Radygin A., Sidorov I. Russian Corporate Economy: A Hundred Years of Solitude? In: *Voprosy Ekonomiki*, 2000, No. 5, pp. 45 – 61.

4.2. Concentration of Property and Integration in the Corporate Sector: Specifics of year 2000

The Corporate Sector in Year 2000: Some General Characteristics

In year 2000 largest Russian companies demonstrated positive changes across practically all indicators¹. Aggregate returns and undivided profits of 50 largest companies increased by 15 per cent on the average, while the growth of owned capital made over 6 per cent. The enterprises in the oil and natural gas sector still account for the major share of the total returns and profits, what reflects the sectoral structure of revenues in the national economy. The amount of sales carried out by oil companies made 71.5 per cent of total returns as compared with 64.4 per cent in the previous year. Largest metallurgical enterprises were at the second place (their share in the total returns increased from 12.7 to 15.2 per cent), while other industries lagged behind.

The aggregate amount of profits shown by 50 largest enterprises over the period from 01.10.99 till 30.09.00 made US \$ 12.9 billion as compared with US \$ 11 billion over four previous quarters. Profitability of these companies increased from 20.8 to 21.6 per cent that being an evidence that financial and economic activities of enterprises became more effective. At the same time, profitability growth rate decelerated. The aggregate owned capital of 50 largest companies made US \$ 67.2 billion, or about 65.4 per cent of assets. This ratio remained practically at the same level (in the previous

¹ Basing on the ranking of 50 largest issuers (the data collected from 01.10.99 till 30.09.00 and at the end of the third quarter of year 2000) composed by the Agency of Corporate Information NAUFOR (National Association of Securities Market Operators).

year the share of owned capital in assets was at 65 per cent, while the amount of owned capital made US \$ 63.3 billion). Capitalization of 50 largest companies made US \$ 50 billion: the oil and natural gas industry increased its weight from 68 per cent to 89 per cent, power engineering – from 16 per cent to 18 per cent, while capitalization of communications enterprises remained at the same level (8 per cent).

In year 2000 about 15 large Russian corporations announced their plans to issue depositary receipts. It is also important to note that the majority of Russian corporate borrowers on the eurobond market strove to timely meet their current liabilities. The revival of interest to the market of corporate bonds became a characteristic feature in 1999 through 2000.

While before and in the course of the crisis of 1998 “capital flight” from Russia was of total character, in 1999 and 2000 there was observed **a certain growth of capital reinvestment**. This process resulted from growth of profitability and the effectiveness of investment in Russian enterprises after the Ruble devaluation, since the rate of profit in some industries was much higher than currently available anywhere abroad. However, it does not mean that the “capital flight” problem² becomes less urgent, since this fact just

² According to GUBEP MVD RF (Chief Directorate for Economic Crimes of the RF Ministry of Internal Affairs) only active export and import contracts accounted for US \$ 23 to 25 billion annually remaining abroad before 1999. In 1999 this figure fell to US \$ 16,5 billion. Year 2000 showed an upward trend (this figure made US \$ 11 to 15 billion over the first half year). For instance, only oil sales (selling higher-quality oil as lower-quality product) may bring up to US \$ 3 to 4 billion a year. Individuals account for about US \$ 10 billion flowing out of the country annually. G. Gref, Minister of Economic Development and Trade, also stressed the intensifying outflow of capitals in year 2000 relating the fact to the persisting lack of confidence in the domestic market (conference “Restructuring of Companies, Alliances, Mergers, Takeovers,” Moscow, October 24, 2000).

reflects an increasing *inflow* of previously exported capitals in the form of pseudo-foreign credits and other forms.

TABLE 4.3

Changes in the ownership structure of medium-sized and large Russian JSCs in 1994 through 2000, % of the authorized capital *

	1994	1996	1998	2000
Insiders	60-65	55-60	50-55	30-35
Outsiders	15-25	30-35	35-40	50-55
State	15-20	9-10	5-10	10-12

* The data contained in the table are only to illustrate the most important qualitative trends (based on surveys by IET and other organizations) and can not be utilized for precise empirical evaluation. The table does not take into account the largest JSCs (holdings), strategically important enterprises (with blocks of shares fixed at the ownership of the state), differences across industries. The real share of insiders (managers) may be somewhat higher in case affiliated structures (attributed to outsiders) are taken into account.

The available data for year 2000 show a considerable change in **the structure of share capital** of Russia's enterprises (see Table 1)³. The qualitative turning-point occurred in 1998. A sharp downfall of insiders' (employees) share and growing share of outsiders reflect, first, the post-crisis processes of ownership concentration (including those related to a sharp drop in the value of shares), second, a decrease in officially registered share of managers (on average, from 12 - 16 per cent in 1996 to 7 - 8 per cent at present⁴. The latter fact may be attributed either to direct sales of shares to outsiders (sales or offset against debts), or to more broad application of

³ The ownership structure of largest Russia's JSCs is undoubtedly different from the "typical" one. This structure is characterized by higher shares of holdings participation (including state-owned ones), considerably lower share of employees of all types, relatively higher share of non-residents of different types.

⁴ See: Radygin A., Entov R.: Institutional issues of the corporate sector development: ownership, control, securities market. Moscow, IET, 1999, pp. 65 - 66.

informal control on the part of managers (transfer of shares owned by managers to affiliated structures or purchase of shares on their behalf).

Ownership Rights and Corporate Conflicts

It may be noted that after the corporate legislation was effected in the late 1990s the ownership rights somewhat stabilized and the struggle continued in terms of law. Although the factor of corrupt courts and state institutions somewhat “corrects” the results of such struggle, rivals mostly resort to quasi-legal methods or use “gaps” in the legislation. However, occurrences of legal nihilism, when usurpers of management of corporations ignored the real structure of their share capital and nuances of management procedures, were also characteristic of year 2000.

The most important corporate conflicts in year 2000 were related to reorganization of companies, or processes of expansion of large enterprises or industrial groups. On the whole, there was registered a shift from intra-corporate conflicts to hostile takeovers from outside.

First of all, it is necessary to note infringements upon shareholders’ rights related to **reorganizations of joint-stock companies**. Undoubtedly, motives behind reorganizations differed considerably.

The problem of mergers and takeovers became especially urgent in year 2000 (see below). This process was most noticeable in metallurgy and oil and natural gas sectors. On the average, the Ministry for Anti-Monopoly Policy (MAMP) permits about 94 per cent of transactions, 5 per cent are permitted on certain conditions, 1 per cent of applications is rejected. A key issue in this process is the *beneficiary ownership and general structure of the forming group*.

The most important transaction in the aluminum industry (consolidation of 70 per cent of assets in the framework of “Russki Alumini”) obviously required special attention on the part of MAMP. According to available data, JSC “Russki Alumini” was registered in the town of Omsk in the summer of year 2000, however, blocks of shares in aluminum and aluminum oxide enterprises remained in the ownership of offshore companies. Accordingly, the transaction was outside MAMP competence, since it was “just redistribution of capitals within joint-stock companies... Some offshore companies sold to other offshore companies blocks of shares they owned.”⁵ However, the official point of view expressed by MAMP was that such structures as “Russki Alumini” have the right to exist due to their orientation toward export, while the existence of three holdings in the industry (“Russki Alumini,” “SUAL,” and “Severo-Zapad”) assure sufficient domestic competition.

A typical example of MAMP potential in this sphere is the alleged purchase of natural gas distribution pipelines by “Mezhregiongaz” company. MAMP has no information that “Mezhregiongaz” is buying up pipelines, since takeovers are carried out by companies founded by “Mezhregiongaz” where the share of the founder is formally not large.

However, in year 2000 RF MAMP was granted the right to request information on sources and amounts of funds used to carry out such transactions⁶, what may permit to find out real connections

⁵ Here and below we refer to the points of view expressed by I. Yuzhanov, Minister for Anti-Monopoly Policies, A. Tsyganov, Deputy Minister for Anti-Monopoly Policies, and A. Golomolzin in their interview to *Kommersant* newspaper.

⁶ As stipulated by Federal law No. 3-FZ of January 2, 2000, “On Amendments and Additions to Article 18 of the RSFSR law ‘On Competition and Restraints on Monopolistic Activities on Commodity Markets,’” a federal anti-monopoly agency has the right to reject an application (about a transaction) in

between formally independent transactions. MAMP has the right to investigate the matter until the end-beneficiary is disclosed. In 2001 it is planned to simplify the system of approval of applications for mergers and takeovers and to introduce new rules governing such transactions.

It seems that the problem of beneficiary identification shall be settled along three key guidelines:

- toughening of legislation concerning the transparency of the ownership structure (including end-beneficiaries) aimed to find out the goals and interested parties of such transactions;
- liberalization of threshold indicators defined by the legislation as requiring the approval by state agencies;
- defining of owners' or managers' (in case it is impossible to identify owners) responsibility for submitting misleading information, potential damage to parties of transactions and participants in corporate relations, etc.).

There were also registered attempts to squeeze certain shareholders out to new companies experiencing financial problems, or, to the contrary, to transfer assets to structures not controlled by outsiders. An illustrative example is the attempt to "reorganize" the shareholding structure of AVVA company (an infamous financial pyramid of the early 1990s). The company managed to keep certain

case it may result in the applicant (an economic agent or a group of individuals) acquiring or strengthening its dominant position and (or) restricting competition, or in case the applicant presented misleading information affecting the decision, or *the parties of the transaction failed to timely present information on the sources, terms of receipt, and amounts of money necessary to transact the said business upon the request of the federal anti-monopoly agency*. The federal anti-monopoly agency has the right to comply with the application in case the requirements set to ensure competition were met. See also Order of the RF Anti-Monopoly Ministry No. 785 of October 31, 2000.

assets and to exchange its pseudo-shares (so called shares deposit certificates, SDC) for “AvtoVAZ” shares being at its disposal (the control interest in “AvtoVAZ” was pledged to the government in the course of restructuring debts to the budget). However, a large number of outside shareholders refused to participate in the exchange. In year 2000, AVVA beneficiaries applied to the Federal Commission for Securities (FCS) aiming to squeeze stubborn outsiders (SDC owners) out to a new JSC (probably possessing less assets).

Largest Russian companies objectively need to carry out reorganizations for further long-term development. However, according to the estimates of the Institute for Corporate Law and Corporate Governance these processes differ in terms of transparency of operations for small shareholders. Three types of reorganization may be singled out: consolidation of “Norilsk Nickel” and “Surgutneftegaz” (small shareholders were presented with a *fait accompli*); restructuring of “UES Russia” (small shareholders were informed, but not invited to participate in drafting the program); communications companies (small shareholders were informed and invited to participate in designing of programs).

It shall be noted that many problems faced in the process of reorganization of largest holdings are related to the process of their creation and privatization. A widely publicized conflict between the management and small shareholders of “UES Russia,” which took place in year 2000, is rooted in the company’s ownership structure formed yet in the mid-1990s. It is a well-known fact that the government has a controlling interest in “UES Russia” (the government pursues long-term goals with a strong social factor, however, it understands the need of a radical technical and technological reconstruction), while minority shareholders have short-term interests related to the dynamics of stock prices, and shareholders from the

number of employees are specifically interested in stability of jobs and wages. Although conflicts related to the latter group will be of importance somewhat later⁷, they affect the relations between the UES and regional authorities (social interests and control over regional energy structures). While the non-optimized ownership structure is a generator of potential conflicts, a certain compromise may be achieved via working out still lacking principles of corporate governance.

The representatives of minority shareholders in “Gazprom” raised the question about “Gazprom” relations with “Itera” company (more precise, a group composed by about 100 companies) and “Stroitrsgaz.” Although no serious allegations were voiced, the key addressed problem was the lack of transparency with regard to the most important decisions concerning the assets and transfer of “Gazprom” assets to companies affiliated with its management, what resulted in its under-capitalization. In February of 2001 the situation remained unclear, however, the “Gazprom” management had less opportunities to promote its own interests (since June of 2000 the Board of Directors consists of 5 representatives of the government, 4 representatives of the management, and 2 representatives of the minority shareholders). The possible resignation of R. Vyakhirev (in the summer of 2001) may even further strengthen the position of the state in the company.

The reorganization of “Gazprom” similarly to the case of “UES Russia” will be directly related to changes in the JSC’s ownership structure and affect all types of shareholders. In 1999 seventeen “Gazprom” subsidiaries were reorganized as JSCs with independent accounting and had to get rid of structures not involved in their basic activities. The governmental recommendations for “Gaz-

⁷ The strike of “Avtovaz” employees against the announced plan to restructure the JSC and transform it into a holding in year 2000 is a similar example.

prom” (worked out by December of 2000 and in many respects similar to those concerning “UES Russia”) envisage the separation of “Gazprom” monopolistic structures (pipelines as compared to “UES Russia” power grids and dispatcher controls) from companies involved in competitive operations (extraction and sales as compared to generating capacities and sales at “UES Russia”).

A relatively new practice is **consolidation of shares** in a company. In the autumn of 2000, FCS declared the current consolidation practices aimed to squeeze out “outside” shareholders unacceptable. Moreover, under discussion are amendments to law “On Joint Stock Companies” concerning the exclusion of the norm of consolidation of shares. However, in September of 2000 the FCS St. Petersburg department registered the issue of 20 ordinary shares in JSC “Severnaya Neft” (Republic of Komi), which should be exchanged for all other shares (after an additional issue, which diluted shares of a number of shareholders). The shareholders having blocks of shares insufficient to be converted into one share (i.e. holders of so called fractional blocks of shares) will receive pecuniary compensation.

“Sibneft” company justified the necessity to consolidate shares of its subsidiaries by the fact that remaining small shareholders (less than 5 per cent of shares) did not react to the proposal to transit to single share and there is no possibility to communicate with them. In this situation consolidation is a way to transform minority shareholders into creditors (via the proposal to redeem fractional blocks of shares). In December of 2000, the meeting of shareholders in “Sibneft – Omski Neftepererabatyvayushchi Zavod” approved consolidation (72 shares). A similar decision was taken at JSC “Sibneft – Omsknefteprodukt.” However, the small shareholders were offered a choice between a pecuniary compensation for fractional blocks of shares, exchange of their shares for shares in

the holding (i.e. "Sibneft") before the completion of consolidation, or creation of a consortium of "fractional" shareholders jointly owning several shares. After the share in subsidiaries makes 100 per cent, it is envisaged to reorganize them as closed joint stock or limited companies to simplify management procedures and increase the potential of the parent company to manipulate assets.

In general, it shall be noted that in year 2000 conflicts between companies and minority shareholders over **transition to single share** (mostly related to coefficients of exchange) were more often than not settled in a constructive way via negotiations. The first among Russian oil companies to initiate the transition to single share was "LUKoil," followed by "Surgutneftegaz," "UKOS," and "Sibneft." By the beginning of 2001 "Sibneft" was close to the completion of consolidation, while at "LUKoil" and "Surgutneftegaz" this process was underway with regard to some of their subsidiaries. It is interesting to note that in the process of consolidation companies became more transparent and open for minority shareholders. For instance, "UKOS" and "Sibneft" adopted corporate governance codes, invited "independent directors." "UKOS" announced the transition to internationally accepted financial book-keeping and excluded the provision about announced shares from its charter.

The settlement of corporate conflicts with the help of **enforcement structures** became a fact of everyday life. In 2000, the most publicized examples were Moscow-based JSC "Kristall" and "Moskhimfarmpreparaty," "Babayevski" confectionery concern, Kachkanar Iron Ore Dressing Works (*Russ. abbr.* GOK), JSC "Uralkhimmash," Kamyshlovski Construction Materials Plant (Sverdlovsk Region), etc. A common practice is to initiate protests on the part of employees (demonstrations, pickets, armed resistance) as a way to mount pressure on enterprises. An exotic, alt-

though effective method was applied at JSC “Varyeganneft” – the representatives of the owner of a 17 per cent block of shares were not allowed to enter the building, where the meeting of shareholders took place, under the pretext that some blasting works were carried out near the building.

An important precedent was set by the Supreme Arbitration Court (SAC) decision (December of 2000) that **enterprises have the right to repay their debts with their shares**. This practice was first employed by creditors of the Leningrad Metal Works, who in 1999 transferred the controlling interest in the enterprise to the “Interos” group via a closed additional floatation of stocks in order to repay the debt. It is important for future economic activities that SAC confirmed this right of creditors in spite of the protest of a large shareholder supported by the Federal Agency for Financial Rehabilitation. The SAC justified its decision by the fact that normal managing bodies of JSCs do not function at the time bankruptcy procedures are underway.

It is also necessary to mention the fact that some amendments to law “On Insolvency (Bankruptcy)” were submitted to the State Duma in year 2000. The amendments shall grant external managers the right to approve additional issuance of shares. While in the course of the bankruptcy procedure meetings of shareholders may be viewed as the successor of functions performed by normal managing bodies, the granting of this right to arbitration managers may worsen the situation even further.

On the whole, over the 1990s the institution of bankruptcy was used as a way to redistribute (size, keep, privatize) property, or a highly selective method of political and economic pressure on enterprises on the part of the state. There is observed a paradoxical situation: bankruptcy procedures are applied to enterprises of relatively good standing (since competitors have a favorable opportuni-

ty to size control over such enterprises), while hopeless enterprises avoid this procedure (since nobody wants to size these enterprises, while there is no chance to recover debts in the framework of bankruptcy procedure). It is necessary, on the one hand, to ensure the protection of creditors' rights in the course of bankruptcy of enterprises, and, on the other hand, to protect debtor enterprises against simplified methods of unscrupulous seizure of control over enterprises or some of their assets via bankruptcy procedures.

In fact, initiation of bankruptcy procedures became a *low-cost* (in case of potential collusion between arbitration managers and creditors, arbitrators, and FCFR officials) *alternative to hostile takeovers* via buying shares up on the secondary market. In this connection, the hypothesis about a direct link between the effecting of the law "On Insolvency (Bankruptcy)" in 1998 and the low level of resistance demonstrated by the Russia's stock market in 1998 through 2000⁸. It is also of importance that law "On Joint Stock Companies" contains numerous legal ways to effectively repulse corporate aggressors in the framework of corporate law, while the bankruptcy procedures currently in force (if well applied) are a safe way for aggressor to succeed.

In this connection, courts shall *less widely resort to the practice of applying bankruptcy procedures as a routine method to recover debts* in order to protect enterprises from unscrupulous seizure of control over them (or some of their assets). According to Article 10 of the RF Civil Code such practice shall be viewed as abuse of the

⁸ See: Volkov A., Privalov A. A nu-ka otnimu! (Why Don't I Try To Take It Away!) – In: Ekspert, 2001, No. 1 – 2, pp. 28 – 29. The relatively new practice to seize the control by an instant replacement of seals, bank control cards, account control cards, etc. is also of interest. The latter is possible either by forcing the general manager to resign, or via a shareholders' meeting (even of questionable competence).

law. Initiators of the bankruptcy procedures shall be obliged to submit sufficient proof of impossibility to recover debts by other means.

It is also of importance that in January of 2001 stipulations of law “On Insolvency (Bankruptcy)” and the Code of Arbitration Procedure concerning the right of debtors to participate in court proceedings were reviewed by the RF Constitutional Court. The Constitutional principles of the right of defense, contentiousness, and equality of parties are not realized in the framework of the legislation currently in force. It would be appropriate to include in the new law on bankruptcy provisions stipulating the right to appeal against court decisions on bankruptcy and actions of arbitration managers (who remain uncontrolled at present) and to ensure equal priority of all creditors’ claims notwithstanding the time they were submitted (the introduction of collegial principle for claims concerning bankruptcy, participation of all interested parties).

There were registered attempts to intimidate government agencies into privatization of enterprises (Kamski TsBK (Pulp and Paper Integrated Works), “Bor,” “Orgsteklo,” “Korund”) at “suitable” prices via “suitable” privatization methods under the threat to introduce external management. External management may be introduced also in case the state intends to relieve the general director of a JSC with state-owned block of shares (so this person might be appointed as the external manager).

However, there were also registered instances of **destabilizing activities on the part of the state**. Among these instances is the attempt to dispossess cellular telephone companies “Vympelkom” and “MTS” of some their frequencies in the autumn of 2000. According to some evidence, the conflict concerning airline “East-Line” and privatization of “Domodedovo” airport, which broke out in 2000, was also related to the attempt of some governmental structures to size control over financial flows. The government

failed to take a clear stand with regard to corporate conflicts in year 2000 (even after the Presidential elections held in the same year). On the contrary, it may be noted that the government demonstrated passivity even with regard to cases where the control over enterprises was seized via clearly illegal methods (by force). General declarations with regard to protection of ownership rights, banning of criminal redistribution of property, and the dictatorship of the law shall be propped up by serious practical deeds.

Realization of the measures aimed to protect ownership rights, which are stipulated by the draft “Key Guidelines of Social and Economic Policy for Long Term Outlook” (June of 2000) elaborated by the RF government, may become an important step forward. At the same time, the further passing of draft amendments to law “On Joint Stock Companies” aimed to protect the rights of minority shareholders (the State Duma passed them in the third reading on June 2, 2000) was blocked by the initiative of several largest companies. The new draft amendments approved by the State Duma in the late 2000 envisage the following:

- general meetings of shareholders have exceptional right to take decisions on increases in authorized capital;
- general meetings of shareholders shall approve the floatation of all shares by closed subscription and public floatation of more than 25 per cent of shares;
- Boards of Directors shall unanimously approve additional issue of shares;
- additional shares issued on JSCs property shall be floated among existing shareholders in proportion with their respective shares;
- in case a JSC is reorganized (split-up of a JSC or separation of a part thereof) existing shareholders shall receive shares in proportion to their shares in the main JSC;

- in case there are more than 50 shareholders in a JSC, its register shall be kept by a specialized registrar.

From our point of view, the approval of such amendments does not mean that the law and the state shall only support small shareholders in their struggle with large ones. From the angle of the dominance of the general principle of ownership rights protection, it is no less important to keep *a balance between interests of different groups of participants of corporate relations*, to defend issuers from unscrupulous practices (blackmail) on the part of minority shareholders⁹.

There were registered numerous instances of unjustified destabilization of JSC's management within the corporate legislation framework. A novation of year 2000 is the application of Article 49 of law "On Joint Stock Companies," which permits a shareholder (including a one-share holder) to sue the company for potential loss inflicted by a decision taken by the general meeting of shareholders. Most often shareholders resort to this practice aiming to ban pending meetings of shareholders (called to take important decisions concerning the JSC or appointment of a new manager) claiming that the board of directors convening the meeting is not legitimate. Obviously, such a conflict is initiated not by the formal claimant owning one share, but competitors or a real party behind the intra-

⁹ The common for all large JSCs traditional problem of "free rider" shall also be taken into account. For instance, 12 to 15 per cent of "Gazprom" shareholders (individuals, who became shareholders in the course of privatization) ignore the issuer's announcements about general shareholders' meetings, its suggestions to vote via proxies, etc. (as per the data presented by S. K. Dubinin, "Gazprom"). Следует учесть и традиционную для всех крупных АО проблему "free rider". Например, в PAO «Газпром» 12-15 % акционеров (физические лица, которые стали акционерами в ходе приватизации) никак не реагируют на сообщения эмитента об общих собраниях, предложении о выдаче доверенности и др. (данные С.К.Дубинина, PAO «Газпром»).

corporate conflict. Besides, the owner of one or a few shares having the formal right to lodge the claim has little chance to suffer real losses. JSC “Kristall” was sued by its shareholder “Technogres” company contesting the appointment of a new general manager. As concerns “Norilsk Nickel,” the plaintiff contested the voting method used by the meeting of shareholders to settle some issues pertaining to the restructuring of the company. The case of JSC “Polimerstroimaterialy” was only aggravated as the company attempted to ignore the court ruling.

In terms of the law, it is important to find a reasonable compromise between, on the one hand, the necessity to ensure legal protection of small and foreign shareholders in case their ownership rights are infringed upon and, on the other hand, to avoid unsubstantiated claims “clogging” the judicial system¹⁰. However, new legislation shall aim to create an effective control mechanism suitable for conditions existing in Russia in order to prevent insiders from manipulating assets to the detriment to the enterprise itself, its outside shareholders, and the state.

Concentration of Property and Vertical Integration

It is necessary to mention a new and on the whole positive trend noticeable in 1999 and 2000, i.e. the transition from relatively amorphous entities (conglomerates) to vertically integrated structures of more homogeneous type with clear organizational and legal boundaries. This process was most pronounced in oil and metallur-

¹⁰ According to M. B. Khodorkovski, “YUKOS” lawyers failed to work out effective measures against corporate blackmail in the course of a detailed analysis of laws currently in force. However, it does not mean that the law shall be amended. This protection shall first of all base on court proceedings (materials of conference “Privatization in Russia: Possible Scenarios of Development,” Moscow, July 5, 2000).

gy industries, however, it was also registered in chemical and food processing industries, civil aircraft manufacturing, a number of MIC (Military and Industrial Complex) sectors (although the attempts to establish or, more precise, to restore vertically integrated structures “from the top” have been failing over years).

The most wide-scale example was the process of formation of a vertically integrated holding, which observers link to activities of a number of formally unrelated structures such as Urals Mining and Metallurgy Company, “Russki Alumini,” “Sibirski Alumini,” “EAM Group,” “Eurazholding,” “MDM Group,” and others, including foreign firms¹¹. The holding’s form is vague, probably due to its continuing expansion and accepted management principles. Subholdings, run by partners, managers on trust, or old managers who retained their shares in the authorized capital and became “junior partners, control considerable segments of copper industry, ferrous metallurgy, coal mining, aluminum industry (70 per cent), automobile industry. In the latter case, “GAZ,” “PAZ,” Zavolzhsky Motor Works, bearing-manufacturing plants are already within the holding’s sphere of interest. Some observers view intensification of stock exchange operations with regard to “AvtoVAZ” shares in the autumn of 2000 as a sign of preparation to a takeover. The conflicts between “Interross” group and the Urals Mining and Metallurgy Company appear to be linked to the holding’s interest in “Norilsk Nickel.”

Taking into account the overall role these structures play in the Russian economy, a most important issue is the level of and the economic and political factors behind the support the holding’s ex-

¹¹ Although the members of the group usually deny any mutual property and business relations, numerous publications and surveys found in the business-related mass media in 2000 through 2001 concerning the formation of this group permit to conclude that the reverse is the case.

pansion finds with authorities. Apparently, the completed mergers and takeovers, as well as necessary for these purposes financial resources (probably including some reinvestments from abroad) are of a scope requiring some approval from the very top. Even the formally passive stand taken by the authorities is a certain indicator permitting to evaluate the real concept the authorities are going to pursue in the course of further structural transformation of the economy.

There are also other numerous examples, although of a lesser scale. For instance, Gazprom took control over expanding SIBUR group in petro-chemistry. Gazprom also controls "FarmTEK" group, which in year 2000 took over considerable pharmaceutical production capacities. "Svyazinvest" is carrying out a program aimed to enlarge its regional subsidiaries (in the Ural and North West regions in year 2000), at the same time it consolidates its shares in regional cellular operators under auspices of specially created "MobiTel" company. In year 2000, JSC "Rostelekom" announced plans for reorganization (affiliation of JSC "MMT). In the course of 2000 it is planned to transform JSC "AvtoVAZ" into a holding company. "Aeroflot" subsidiaries may be transformed into a group of vertically integrated companies. "Severo-Zapadnoye Parokhodstvo" (North West Steamship Company) announced its plans to integrate 15 subsidiaries into a holding. In 2000, a most widely publicized conflict broke out as it was attempted to affiliate shipyard "Krasnoye Sormovo" (Samara) to "Obyedinennye Mashinostroitelnye Zavody" (United Engineering Works) group. The OMZ share in the shipyard was about 30 per cent¹².

¹² The author based on the data presented by "Troika-Dialog." It shall be mentioned that reverse processes also take place. For instance, after consolidating its staple production capacities in the framework of "Russki Alumini" holding, "Sibirski Alumini" (in essence the first vertically integrated company in the alu-

The criteria according to which such structures are formed have also changed (as compared to earlier FIGs (financial and industrial groups)):

- technological, financial and economic desirability to affiliate new assets (enterprises);
- substantially higher level of corporate control over subsidiaries (75 per cent and higher);
- organizational and legal transformation (including mergers, consolidation within and between holdings, transition to single share within holdings, etc.).

Metallurgical industry is a most interesting example allowing to understand the most important institutional trends observed in the corporate sector in year 2000.

First, the process of property concentration reached a new level. In the 1990s (after privatization), the process of concentration of share capital took place chiefly in the framework of one (base) enterprise. The activities of so called FIGs (formal and informal) are not exemplary in this respect, since their acquisition strategies was usually of chaotic nature and did not base on technologies. In years 1999 and 2000 “base” enterprises started to actively pursue external expansion, concentration of property occurred in the framework of vertically integrated groups. In a certain sense it was the mending of intra- and inter-industrial technological links disrupted by privatization. In fact, the former Soviet concerns and amalgamations were being “re-assembled” on the basis of private ownership and without redundant structures.

minum industry) made public its plans of financial expansion in other sectors of the economy. Group “Obyedinennye Mashinostroitelnye Zavody” announced the sale of its auxiliary capacities because of too close integration and ineffective “self-reliance.”

Second, largest groups are completing the stage of open confrontation and start to implement policies aimed to form alliances. This concerns both the raw material base and agreements on “taking over” “yet free” enterprises in metallurgy and related industries. The former case may be illustrated by the intention of “SUAL-holding” and “Russki Alumini” to carry out a joint project (construction of an aluminum dioxide plant in the Republic of Komi to process bauxite extracted at Sredne-Timanskoye deposit. The second case concerns an a priori sharing of remaining property in order to avoid cost-intensive conflicts (while fixing the existing property interests). It is important that owners (managers) of remaining relatively small enterprises have in fact surrendered and are ready to sell their shares, although earlier the level of resistance was rather high (including claims lodged with MAMP).

Although there are different points of view on the effectiveness of vertical integration¹³, its apparent advantage for Russia is related to the process of redistribution of property. Those seizing control over the supplier or consumer may disrupt the operation of the whole vertically integrated chain (in case they wish to put some pressure). Instances of “raw materials” pressure on competitors or shareholders who do not want to yield control are numerous and well known.

For instance, the perceptibly growing interest in coal mining companies (first of all, on the part of ferrous and non-ferrous metallurgic enterprises) in year 2000 was directly linked to the striving

¹³ See: K. Benukidze. Vertikalnaya Integratsiya Rabotayet Tolko Na Nesovershennykh Rynkakh (Vertical Integration Work Only on Imperfect Markets). – In: Ekspert, 2001, No. 1 – 2, pp. 32 – 33. From this point of view vertical integration is effective only in short-time outlook and only if markets have local defects (customs duties restricting competition, monopoly production of raw materials, know-how, etc.).

to regulate volumes of output and deliveries, prices, and to ensure effective pressure on power engineering companies. In year 2000, there were sold Mezhdurechenskaya and Krasnoyarskaya coal mining companies, 38.7 per cent of shares in “Khakasugol” company (the auction for 43 per cent of shares in the company failed, so this block of shares shall be put up for a next auction). “MDM Group” purchased a 38 per cent share in highly profitable JSC “Vostsibugol” (although it remains unclear if it was on behalf of “Russki Alumini” or SUAL-holding) out of a 43 per cent block of shares in the enterprise offered at an auction announced in December of 2000. The control over this company permits to impose dictate on “Irkutskenergo.” In 2001 it is planned to sell federally owned blocks of shares in coal mining companies “Yakutugol,” “Kuzbassugol” (80 per cent), and “Kuznetskugol” (81 per cent). According to available information, Novolipetski Integrated Iron and Steel Works plan to purchase the federally owned block of shares in “Kuzbassugol,” while “EvrAzHolding” will purchase shares in “Kuznetskugol” (to supply Zapadno-Sibirski and Kuznetsk integrated iron and steel works). In 1999, regional authorities sold their shares (16 and 15 per cent respectively) to structures affiliated to potential purchasers. Structures pertaining to “Sibirski Alumini” purchased 15.75 per cent of shares in “Chtinskaya Ugolnaya Kompaniya” in the autumn of year 2000. In the course of several above mentioned transactions “Alpha-Eko” company (which owned blocks of shares in metallurgical enterprises and planned to form its own vertically integrated holding) competed with the actual purchasers. Structures affiliated to JSC “UES Russia” also show interest in a number of coal companies.

Purchase of energy producing capacity is the next logical step for new vertically integrated groups (with metallurgic “core”). The sale of power generating companies in the framework of potential

restructuring of “UES Russia” will apparently result in metallurgic groups buying them up thus obtaining unlimited influence on the national economy. It is also of importance that a single center exercising ownership control over the whole complex “power engineering – coal – metallurgy” permits to effectively direct financial flows from all links to exports and “optimize” tax policy.

On the whole, in the aspect of formation of *real* control poles, narrow *groups of partners* – real owners – continued to consolidate power and management levers (not necessarily based on ownership of shares). It shall not be excluded that the processes of consolidation of shares underway may become only a stage on the way to transformation into closed joint stock and limited companies. Some largest (private) companies already review such reorganization in practical terms. Overt or concealed *process of concentration of property (control) in Russia’s corporations is a key medium-term trend* to be considered in the course of elaboration of state regulation measures.

Strengthening State Control at Corporations

In year 2000 the trend towards enlargement of state-controlled structures and consolidation of state-owned blocks of shares in the framework of holdings became very perceptible (consolidation of “Rosneft” subsidiaries, MIC enterprises – “Antei” and “Almaz” concerns, alcohol holding “Rosspirtprom” – 89 enterprises, consolidation of all structures involved in production and sales of nuclear fuel in the framework of a single corporation, creation of an energy generating company embracing all nuclear power stations (on “Rosenergoatom” base), etc.). It may be assumed that the strategic goal is to retain (create) at least one state “power center” constructed of fragments remaining in the state ownership (state-owned unitary enterprises and blocks of shares) in each staple industry.

Shareholders' meetings held by "Gazprom," "UES Russia," and "Aeroflot" in year 2000 also demonstrated that the federal authority strive to toughen control via corporate procedures. For instance, 10 out of 15 directors of "UES Russia" represent the state, while six state representatives on the board of directors of "Aeroflot" control over 50 per cent of shareholders' votes. State-owned company "Rosneft" may become the monopolistic representative of state interests in matters related to production sharing agreements.

The toughening of state control via formation of large holdings and expansion of state representation in existing companies is related to a number of objective factors: the requirements of technological integration, the need to create larger structures to meet the challenges of international competition, to put stronger fiscal pressure on enterprises. At the same time these measures are implemented only in isolated cases at the background of the general crisis of the system of management of state-owned property. Probably, in this crisis situation enlargement and merger of state-owned assets seem a most simple decision.

In a certain sense, the apparent trend towards toughening of state control via enlargement of economic agents is extended to private companies at the level of ideology. As it was noted above, the creation of the largest aluminum holding "Russki Alumini" on the basis of two formerly competing private-owned groups in year 2000 was hardly possible without an approval from the very top. Such an approval from the very beginning presumes the absolute transparency of the deal, including names of real owners and beneficiaries of financial flows.

In more general terms, it may be assumed that there exists an *alternative strategic approach* basing on the entrustment of certain private companies (groups) to function as managers representing the federal center in a concrete region (for instance, Tumen), or an

industry (for instance, ferrous and non-ferrous metallurgy). The benefits obtained by private groups under such arrangements are also apparent and related not to just carrying out banal “gray” schemes with impunity, but to a *carte blanche* for expansion with political support of the federal center. The demonstratively “equidistant” stand taken by the RF President to the contacts with largest financiers and industrialists does not negate this approach but just stresses that any “trusted” manager may be dismissed in case not complying with the rules.

Despite these rather perceptible trends, the state still remains a serious *factor of uncertainty* for Russia’s corporations. Although after the Presidential elections held in year 2000 the political stability, an important general factor to lower corporate governance risks, is definitely at work in Russia, the old problems of the negative effect the state has on the corporate sector still exist, and there emerge new ones.

First, the practice to use the state (state and local authorities) as a tool in the struggle for control over a company and/or against competitors persists. Uncertainties related to this practice remains a serious factor behind existence of high corporate governance risks in Russia.

Second, commercial interests of various departments and agencies may come into conflict with interests of private companies with high probability to be settled in the administrative way.

Third, the process of formation and strengthening of the new leadership means that there will arise new destabilizing factors related to the modification of real control centers in the economy. The tough political struggle for and against plans of reorganization of largest natural monopolies (“Gazprom,” “UES Russia,” MPS (Ministry for Transport Routes)) to a considerable degree reflects these processes.

Fourth, the establishment of the new leadership (probably, there were present some elements of national and / or private / departmental financial and economic interests) was related to “tough” actions of state (mainly tax) agencies against “LUKoil,” TNK, “AvtoVAZ,” “Gazprom,” “Norilsk Nickel,” etc.). Taking into account the real organization of the ownership structure and financial flows of largest Russia’s companies¹⁴, for the state to investigate and *carry through* cases of tax crimes is one of few effective methods to influence corporations and their principals (beneficiaries). However, there are three principal commentaries. First, it is necessary to carry out a radical tax reform (a mass single restructuring of tax arrears as a substitute for tax amnesty is an option). Second, every force action shall be justified in legal terms, and criminal cases initiated on the basis of proved facts. Third, taking into account the *systemic* nature of offences the key problem is what actual goals initiators of *selective* investigations pursue.

¹⁴ See: Radygin A., Sidorov I. Russian Corporate Economy: A Hundred Years of Solitude? In: Voprosy Ekonomiki, 2000, No. 5, pp. 45 – 61.

4.3. Participation of the government in the management of corporate structures: legal foundation and real status

An appearance along with other types of corporate management of a mixed private-government control became in the 90-s a characteristic feature of the majority of countries with transitional economics. However, probably only in Russia the issues related to the functioning of this specific type of companies started playing a very important, for lack of a better word, role for the subsequent development of the country at the stage when the task of reviving sustainable economic growth became a priority. The Russian realities in 1995-1998 eloquently highlighted a very important role of the government as a shareholder in the period following the end of mass privatization. To a large extent this was facilitated by changes in economic and political situation in the country after the financial crisis in August-September of 1998. It allowed with a large degree of probability to forecast an intensification of the process of formation of corporate associations with government participation in the wake of the government declared course for strengthening economic regulations and implementation of an active industrial policy.

Development of legal foundation for government participation in corporate management

- The start of a new stage of reforming the proprietary relations in Russia was made by the Concept of the management of government property and privatization in the Russian Federation (hereinafter – Concept), adopted by the Government of Russia Decree # 1024 of September 9, 1999. One can consider as symptomatic the mere fact that probably for the first time since 1992 the problem of gov-

ernment property management was raised to a high level of priority against the backdrop of formal changes in proprietary forms. Dramatic loss of the value of enterprises and their shares of stock after the Ruble devaluation acted as a logical precondition for moving the emphasis in the actions by the federal center in 1998-1999 towards the increase of non-tax budget revenues through the utilization of government property which automatically required better clarity and precision in the relationship between different branches of power.

- This document as well as the one approved by the government in the summer of 2000 titled "The main guidelines of social and economic policy of the Government of the Russian Federation for the long term perspective" was based on the fact that under current conditions the main directions of the government policy in the area of the government property management can be the following:
 - improvement of the efficiency of management of the government property remaining the property of the government;
 - privatization of a considerable number of the government property.

Here one might identify three main targets of such a policy: 1) government enterprises; 2) economic association with the government participation; 3) real estate. In accordance with such targets a program of specific measures was proposed.

The implementation of the main provisions of the Concept with regard to economic associations with government participation, whose prevalent majority is made up of joint stock societies, is able to promote better implementation of the government interests in the sphere of corporate management. In practice, a lot will de-

pend upon the specific mechanisms for implementing the main provisions of the Concept.

After the Concept a whole set of very important documents was adopted which introduced into practice a new range of instruments for regulating relations between the government and economic associations in which it participated. The work was being done in two main directions: 1) regulations of the work of the government representative in economic associations; 2) creation of a legal environment for the operation of economic associations themselves.

The adoption of the Government of Russia Decrees of October 4, 1999 # 1116 and March 7, 2000 # 195 became a long awaited event.

In accordance with the first of above mentioned documents a typical form of reporting has been introduced for the representatives of the Russian Federation in open joint stock societies (to be submitted to the higher management bodies twice a year). They include a standard set of information on profit and loss of a company, dividends, the size of its receivables and payables, rate of return (including indicators of liquidity, financial stability, business activities, value of its shares and net assets, settlements in non-monetary forms), the areas of profit application, possible indicators of insolvency and reports on participation in shareholder and board of directors meetings. Besides on an annual basis reports on financial and economic activities of open joint stock society are submitted to the higher government management bodies, which should reflect such issues as distribution of shareholder capital, different aspects of economic and production activities of an enterprise, payment of wages, including those to the general director, coordination of work with commercial entities and foreign investors.

The second document approved the Provision on the order of appointment and functioning of representatives of the Russian Fed-

eration in the management bodies and in the audit commission of the open joint stock societies, established in the process of privatization whose shares are in the federal ownership and for which a decision was made to utilize a special right for the participation of the Russian Federation in the management thereof (“The Golden Share”). It provides classification of the representatives of the government in open joint stock societies (those can be government officers,, officers of the Russian Federal property Fund and its territorial offices and other citizens, acting on the basis of the agreement on representing government interests), their responsibilities and conditions for terminating such an authority. For the first time a detailed regulation for the interaction of the government representatives with the Ministry of proprietary relations and the bodies of sectoral management depending upon the size of the government owned stock, including temporary notification terms, submission of proposals, clearances, issuance of written directives, reports on the participation in the corporate management bodies. It also defined that the government representatives in the management structures and audit commissions of the joint stock societies, for which a decision was made to utilize the “Golden share” right could be government officers only, but as far as 167 open joint stock companies were concerned (the biggest and most important enterprises) the respective personnel decisions are to be done by the Government of Russia.

Another area of improvement of the system of management of the government owned shares of stock in economic association was an establishment of control mechanism over the operations of such companies. Apparently the first step for its creation must be the receipt of information about operation of companies and its analysis. That is why one should consider as very important a creation of the Registry of indicators of economic efficiency of operation of open

joint stock companies with the government participation in their capital on the basis of sectoral and territorial data bases, envisaged by the Government of Russia Decree dated January 11, 2000 # 23⁵. Along with the adoption of the order of reporting of government representatives in open joint stock companies this opens up a very good opportunity for the implementation for a whole spectrum of management decisions by the government in relation to the joint stock societies with the participation of the government in their capital, the most natural of which was the collection of dividend payments due, which in its turn is a derivative for generating profit on the basis of achieving certain levels of efficiency in the current economic activity. Logically the next stage on the way of implementing the Concept became the Government of Russia Decree of February 3, 2000 # 104. This document envisages an annual approval for the joint stock societies with the share of federal property not exceeding 50% as well as for the federal government unitary enterprises, indicators of economic efficiency, control over the use of property, determination of the amount of dividends, recommended for voting by the representatives of the Russian Federation in the management bodies of these enterprises.

The Resolution by the Ministry of proprietary relations of Russia dated November 16, 2000 # 1024-p provides for the written directive to the government representatives in the joint stock societies for the purpose of using them in voting procedures within their management authority and must include on a mandatory basis the issue of transferring shareholders registries of companies with the

⁵ The Resolution by the Ministry of proprietary relationships of July 10, 2000 # 183-p adopted Methodological recommendations for organizing and conducting an analysis of the efficiency of operations by federal government unitary enterprises and joint stock companies, whose shares are in the government ownership.

government stock to authorized registrars in the Ministry. Back on the eve of the approval of the Concept of management of government property by the decree of the Ministry of State Property of Russia on September 7, 1999 #1249-p provisions for tenders were adopted, which could provide with their results a basis for selecting companies, which will be granted a status of authorized registrars and a pattern agreement for the provision of such services.

The significance of all of the above mentioned measures is beyond doubt, but their adoption came at least two or three years later than was needed. There was an immediate need for them right after the end of mass privatization in 1994-1995 and under present condition a quick achievement of positive results is not apparent. Probably it will be possible to evaluate the efficiency of the Concept of the government property management only in two or three years time. The main indicator of the efficiency could be the absolute and relative size of the budget revenues from the shares of stock belonging to the government.

Practical status of management

- Despite all the innovations stipulate by the Concept the government representatives in the corporate sector are the government officers after all. Hiring of management from the private sector is very rare.
- In 1999-2000 a very characteristic phenomenon for the preceding years continued, which was securing the controlling shares of stock in the government ownership during incorporation of entities as joint stock societies and the inclusion of the "Golden share" into their charter capitals. In the course of implementation of privatization programs the main mass of enterprises, subject to unconditional privatization, changed their proprietary form right after the end of

the voucher privatization stage (1992-1994). The rest of their numbers were “picked” in the course of the monetary privatization in 1995-1997. As the result the main quantity of enterprises kept in the government ownership and which were involved in the process of changing their proprietary form in the second half of the 90-s (apart from the specially selected or still remaining shares of stock in the government property in the joint stock societies, which had been set up in the first half of the 90-s) was represented by the entities, whose privatization was determined by certain limitations and hence related to the realization of typical control procedures.

- That is why one might consider as logical a drastic increase in 1998-2000 of an aggregate weight among the newly created joint stock societies of the companies, in which the government, following the formal incorporation, retained its proprietary control of two types: a direct one (through introducing a controlling share of stock) and an indirect one (through including a “Golden share” into the charter capital).
- The dynamics of establishment of companies with the government participation in the course of privatization is shown below (table 4.4.)
- One should note that there was no substantial expansion of the list of enterprises producing products, goods, services of a strategic character (for purposes of national security) and having in their capital structure shares of stock specially registered as the federal property and hence not subject to sale (i.e. regulated by the Government of Russia Decree of July 17, 1998 # 784). During the periods following the adoption of the Concept on September 9, 1999 only 4 addi-

tional enterprises were included into it and only one was introduced into in 2000.

TABLE 4.4

Basic parameters for retaining government participation in the capital of joint stock societies during privatization in Russia in 1993-2000

	Number of companies with controlling share of stock in government property		Number of companies with "Golden share" in their charter capital	
	Quantity	Share in general quantity of established joint stock societies, %	Quantity	Share in general quantity of established joint stock societies, %
1993	439	3,2	204	1,5
1994	1496	15,2	792	8,1
1995	698	24,8	429	15,2
1996	190	16,9	132	11,8
1997	84	16,9	58	11,7
1998	142	39,4	28	7,8
1999	101	39,1	42	16,3
2000	72	36,2	8	4,0
1993-2000	3222*	11,3	1693*	5,9

* - calculated as the total of values per each year and by the start of 2001 does not correspond to the number of JSCs with government participation, since a part of formerly government owned stock was sold.

Source: Russian statistical annual bulletin: Stat. coll./ Russian Committee for Statistics. - M.: Logos, 1996, c. 705; Statistical bulletins on privatization of government and municipal enterprises for January-December 1996 (p.36) , 1997 г. (p. 36), 1998 (p. 58, 121), 1999 (p. 58, 121). Social and economic situation in Russia. January 2001, c. 122. M., Russian Committee for Statistics. Estimations by author.

- The practice of reformation of the government and municipal unitary enterprises into open joint stock societies with placement of 100% of shares into the government or municipal property under the new law of 1997 is considered to be a separate privatization method. Similarly it had a very limited application. During 1998-1999 28 companies went

through such a procedure (18 in 1998 and 10 in 1999). Their prevailing majority (25) is located in Bashkortostan, 2 in Udmurtia, and 1 in Sakhalin region. In the first half of 2000 in the course of privatization there appeared only three such entities in the form of joint stock societies.

- Out of other examples of disseminated approaches of the government property management one should mention the establishment of large holding structure and the transfer of shares of stock into fiduciary (trust) management.
- The State Statistics Committee of Russia before 1998 offered information only about the size of the shareholder capital which in the process of changing into a joint stock societies for former state companies transferred those into a trust or a holding company. With that in the reports by State Statistics Committee of Russia this indicator is represented by one graph which could be compared with the share of stock, registered as the government (municipal) property (table 4.5).

In 1999 like during practically the whole period of 1995-1998 placement of shares into the government (municipal) ownership was more frequent than a transfer of shares into a trust or a holding company. Here it should be mentioned that there were certain exceptions in 1996 only, when a transfer of shares of privatized government companies into a trust or a holding company as to their quantity and nominal value was comparable to placement of shares into government (municipal) ownership. In 2000 (based on preliminary data) shares of stock were not placed into a fiduciary management or a holding company.

From 1998 as part of the government reporting there appeared information about the quantity of joint stock companies in which during the incorporation stage shares of stock were placed into fi-

duciary management or a holding company. Overall for two years (1998-1999) 50 companies were registered for which the respective action was undertaken concerning their capital structure (28 in 1998 and 22 in 1999).

TABLE 4.5

Share of stock placed into government (municipal) property and transferred into fiduciary management or a holding company in the course of privatization in Russia in 1995-2000 in the total volume of issued shares (in %)

	By quantity		By nominal value of stock	
	Placed into government (municipal) property	Transferred into fiduciary management or a holding company	Placed into government (municipal) property	Transferred into fiduciary management or a holding company
1995	32,0	3,0	23,8	3,3
1996	13,1	11,4	9,5	7,9
1997	3,0	0,7	6,5	0,5
1998	73,6	1,9	68,6	1,6
1999	7,0	1,0	24,7	3,6
2000	48,9	...	51,5	...

Source: Statistical bulletins about privatization of government and municipal enterprises for January-December 1995 (p. 70), 1996 г. (p. 70), 1997 г. (p. 70), 1998 (p. 91), 1999 (p. 91). Social and economic situation in Russia. January 2001, p.p. 122-123. M., Russian Committee for Statistics. Estimations by author.

Their majority was located in Tatarstan (16), Archangel region (11), St. Petersburg (6), Bashkortostan (4). In a sectoral division the majority of such companies did not relate to the basic industries: construction (7), timber, pulp and paper industries, construction materials industry (6 in each), metals processing, food, municipal services (3 in each). During a corporate change into a joint stock society 11 companies in 1998 and 2 in 1999 simultaneously with the transfer of their shares of stock into fiduciary management or a holding company placed other shares of stock under government ownership or included “Golden shares” into their charter capital.

As far as the creation of new government companies (holdings) was concerned the most noticeable was the creation on May 22, 2000 of Federal Government Unitary Enterprise “Rosspirtprom” (for the purpose of a centralized management of assets belonging to the government in the alcohol manufacturing industry). As of the fall of 2000 18 government unitary enterprises were part of this holding with the status of branches (basically regional government unitary enterprise intended to manage operations of alcohol manufacturers on a regional scale) and shares of stock of considerable number of the companies in the alcohol manufacturing. During this process further consolidation of government property was taking place.

But the Russian Government in the mean time was mainly trying to achieve current tasks of regulating the functioning of already existing holdings in an evolutionary mode. The most significant events of the past times in the development of companies with the government shares of stock was the discussion of the reforming of natural monopolies RAO UES of Russia and the Ministry of railways, as well as the role of the government in the implementation of available approaches.

As an element of change in power generation sector it was planned to expand a big number of currently existing regional power companies in the form of joint stock societies. Each new company of an interregional significance can unite several enterprises which currently operate within the boundaries of one subject of the Federation in order to improve management and strengthen control (similar approaches were undertaken within “Sviazinvest” holding). A creation of Srednevolzhskaya (mid-Volga river basin) interregional electric power management company on the basis of “Samaraenergo” company, which recently had gained a serious positive progress was a kind of a pilot project. Originally it was intended to

transfer 7-8 regional power companies in the Volga river basin, which have been part of RAO UES of Russia. Later on a circle of potential candidates was limited to the power companies of Penza, Saratov and Ulianovsk regions. Currently work is being done to prepare a transfer under such a management only "Ulianovskenergo" company. The results of this experiment may produce a serious influence on the creation of a new structure of the Russian electric power manufacturing industry already in the next few years.

The Ministry of Atomic energy of Russia is trying to follow the same path (although to a certain extent contrary to the forthcoming reform of RAO UES of Russia) trying to set up a single power generation company (instead of currently existing 9 Nuclear Power Plants) and "Rosenergoatom" concern, which unites 8 NPPs (apart from the Leningrad NPP). A new structure would be conducting the sale of all the electricity produced by the plants.

Within the forthcoming reform of the Ministry of railways and the separation of its management and economic activities there are plans to create "Russian Railroads" joint stock company with 100% of the government owned equity.

As applied to the railroad transportation the Russian government adopted a general concept of changes (without final decision about the terms and methods), however, with regard to approaching changes in power generation lengthy and heated debates are still raging, involving all the interested parties and representing a very broad range of opinions.

Also at the level of consideration there are propositions to create new holdings for the management of government owned shares of stock in the aviation industry (unification as proposed by the Russian Aerospace Agency of the enterprises manufacturing helicopters under such brand names as Mi, "Moscow helicopter plant named after M.L.Mil", "Rostvertol" (in Rostov-on Don), "Kazan

helicopter factory”, “Ulan-ude aviation factory”), cinema industry (this is the attitude by the new management of the Ministry of culture towards the work of the movie studios after the liquidation of the State Committee for Cinematography), agricultural machine building (the initiative by the Ministry of industry and the Presidential representative in the Siberia Federal District, covering Siberian sectoral companies on the basis of conversion of their debts to the budget into shares of stock).

An important role for the subsequent development of holdings in Russian can be played by the Presidential Decree of October 23, 2000 # 1768. This Decree stipulates that for the purpose of concentration and rationalizing defense industry shares of stock of joint stock companies created in the process of privatization should be placed as government contribution into the charter capitals of currently created or already existing holding companies in this industry, which may be allowed only if at least 51% of shares in such a holding company is placed into federal ownership.

It should be noted that the current capabilities of the government are not substantially big compared to 1992-1994, when the government owned a big (and in some cases the main) mass of property, and when a structure of joint stock capitals was in the stage of formation. A demonstration of this is the situation at the above mentioned aviation industry enterprises: the government does not have a controlling share of stock at neither of them (for example 31% in Moscow helicopter factory), and in “Rostvertol” joint stock company the government does not own any shares at all. That is why it already turned in the reason for conflicts with some private shareholders.

One of the first precedents might be the program of reorganization of the “perm motors” holding company in 2001. The program envisages an increase of both the government shares in the parent

company to a controlling size block and a share of the parent company in the subsidiaries to be done in several stages.

A two year conflict at one of the major shipbuilding enterprises in the country received a very wide public notoriety “Krasnoye Sormovo” joint stock company (Nizhni Novgorod, with more than 33% of the government owned stock). The biggest shareholder “United Machine Building Factories” which controls from 30% to 40% of company stock (but directly only 15.5% of the shares), resisted the order of formation of the board of directors, stipulated in the articles of association of the company, according to which 4 out of 9 members of the board had to be appointed by the government. Respective amendments into the articles of association were blocked by the representatives of the regional committee for the management of government property, who voted contrary to the directives from the Ministry of the State Property of the Russian Federation. A compromise reached with the participation of the federal management agencies boiled down to changes in the articles of association (the election process was extended to apply to all of the members of the board of directors) with the general director of the company retaining his position and the election of the government representative turned into the sole authority of the chairman of the board of directors. In 2001 this conflict may receive further development (the sale of the part of the stock belonging to “United Machine Building Factories” may be pronounced as illegal).

Another type of conflict endemic in companies with mixed types of ownership is related to contradictions between managers and various structures, which stand behind them. Here one can talk not only of commercial entities, which are trying to receive competitive advantages by setting up informal ties between the government, management and the business, but also about a more general phenomenon – a conflict between different government manage-

ment agencies (pure business interests in this case as opposed to the conflicts involving private shareholders do not play the lead role, or at least they are well camouflaged).

A vivid example of such a situation was the contradictory positions of the federal and local property management agencies (although both were subordinate to the Ministry of Property of Russia) in the already mentioned conflict at “Krasnoye Sormovo” shipbuilding factory and conflicts between different groups of shareholders concerning personal appointments to the executive positions at the biggest manufacturer of alcohol products – the Moscow based “Crystall” factory. The management of “Radar” joint stock company (St.Petersburg) with 37% of shares placed into the management of “Leninets” holding company (a former government run concern, which united many defense industry companies in town), dissatisfied with the holding’s decision on personal appointments started demanding for the complete return of the company back into the government property.

Such developments are first of all related to a separation of the government owned share of stock into a joint stock company, not to mention the fact that in 70% of cases representation of the government interests even in the federally owned stock is done by local bureaucrats. For example in the charter capital of “Krasnoye Sormovo” shipbuilders 25.5% of shares is registered as the federal property and is managed by the committee for property management of the Nizhni Novgorod regional administration (and more than 80% belongs to the Russian Federal Property Fund). In the period following mass privatization when the administrations of the Federal regions were being involved into the property and utilization (1995-1998), this situation seemed natural and did not provoke any major conflicts. Now,, in view of the concentration of the Federal center’s efforts on achieving a formal financial stability, its at-

tention to the local problems has considerably weakened. A thesis about the expansion of independence of the regions (including the government property management) became very fashionable, the kind of independence for which many regions were not ready, and in some cases the regions simply abused this new kind of authority, which had been granted to them.

The abstention of the government from the management of its own property at all levels and the resulting inter-level management vacuum could only lead to a dramatic deterioration of economic situation in enterprises with mixed proprietary form. For example, in “Rostovugol” joint stock company (with 67% of shares in the federal ownership, additional 20% being under the regional administration management) and an indifference on the part of state representatives towards the growing arrears and violations of financial discipline by the company’s management resulted in major miners unrest in the Spring of 1998. On the verge of insolvency was “BOR” chemical factory (Dalnegorsk, Primorye region; with federal ownership of 51% and the local ownership of 15%).

More or less typical situations when in the charter capital of one and the same joint stock company there were specially placed shares of stock of federal ownership (which not always was of a controlling size along with voting not always being conducted by the representatives of the federal bodies of power) and the remaining stock managed by local authorities, which again was not always owned by them), after 1996 was added by new developments in which the remaining federal stock started to neighbor with the share of stock, that became the property of the federal regions as the result of conversion of tax arrears of companies to the local treasuries into shares in their charter capitals. By way of such an example one could consider the structure of joint stock capital at one of the leading Russian aviation industry entities – “Aviastar” joint stock com-

pany (Ulianovsk), where seemingly meaningless share of federally owned stock (6%) was neighboring on regionally owned stock of (11%), which enabled the regional administration to at least call for an extraordinary shareholders meeting. A similar situation appeared at enterprises, where part of the government owned stock was placed into a fiduciary management. For example, in the equity structure of the cargo handling company “Novorossiysk marine port” the company management owns a blocking stock of shares (25%), while the government representative manages stock of a lesser size (20%).

Changes in political situation in 1999-2000 marked the beginning of a new stage in relations between the center and the regions including the area of regulating proprietary relations with the core issue being in the leadership of the federal center on the basis of priority of the national legislation. The attempt by the federal center to increase non-tax revenues into the treasury by improving government property management and in the long term perspective to conduct the restructuring of a number of industries and attract investments into manufacturing sector entered into an open conflict with the practice of the preceding three years. That was why the intention of the government to regain lost positions in regulating proprietary relations in general looked very logical. This applied to the property formerly transferred to the regions under different conditions. The most feasible way for this was the use of judicial procedures and the involvement of law enforcement agencies.

In February 2001 the Ministry of Property of Russia won a court case in the Supreme Arbitration Court on the recognition of 40% of the shares of “Irkutskenergo” joint stock company as the federal property (a major manufacturer of electricity with tariffs the lowest in the country because of the use of hydro power plants), which on the basis of the Decree by the President of Russia (1992

and 1996) were placed under the local administration's management, which in its turn further placed it under the management of a friendly entity – East-Siberian financial industrial group. With that the administration of Irkutsk region retained the right to manage 15% of the stock without the right to sell, pledge or transfer it to other entities. The most probable perspective of future developments may be turning of “Irkutskenergo” a subsidiary of RAO UES of Russia.

An example of a new style of relations between the federal center and the regions may be a contradiction in the issue of property management with the administration of the city of Moscow, that has recently become very acute. In this regard the actions by the law enforcement agencies in investigating the reason for the retention in the Moscow government ownership of the shares of approximately 100 enterprises became very typical. These enterprises before privatization were in the federal ownership (for example “Mosgorkhleboprodukt”, “Moscow fat factory”, “Moselektrofolga”), with inspections being initiated by court injunctions aimed at investigating the legality of the Moscow government placing its contribution into the charter capital of the Moscow fuel company in the form of the total amount of equity it held in the Central fuel company, and the resolution of the above mentioned conflict at the Moscow “Crystal” factory by transferring the controlling share of stock to the all-Russian “Rosspirtprom” holding.

It should be noted that the initiative of the federal center to centralize alcohol manufacturing management by creating “Rosspirtprom” may enter into a serious conflict with the interests of those regional administrations and businesses related therewith, to whom the control over this industry in the 90-s became an important instrument in the economic policy (including formation of the budget) and the means for a lessor kind of behavior. An exam-

ple of reciprocal action by the local authorities to the establishment of “Rosspirtprom” can be seen in the sale of the main assets (including immovable property) of “Omsklikiorvodka” joint stock company to a local unitary enterprise belonging to the Omsk regional administration, which practically devalued the controlling share of stock intended for the national holding with the resulting interest of the government being undermined and in which the government interests were represented by the regional property fund and a number of departments from Omsk regional administration.

The difficulty of for “Rosspirtprom” in wielding managing influence on that enterprise was related to the fact that not in all of them the government owned the controlling share of stock. This mainly related to the manufacturers of alcohol and spirits. So out of 60 alcohol industry enterprises (their prevalent majority are the manufacturers of the alcohol spirit) the shares of stock of which are specially registered as the government property and according the Decree # 784 of July 17, 1998 they are not subject to early sale, only 10 companies had the government owned share of stock less than 51%. On the contrary in the structure of the capital of many alcohol manufacturers and wineries the government owns less than half of all shares. On the contrary in the structure of the capital of many alcohol manufacturers an wineries the government owns less than half of the total amount of stock. In many cases again there appears the problem of separation of proprietary authority within the government owned stock. For example, in “VINAP” joint stock company (Novosibirsk) out of 33% of government stock “Rosspirtprom” was given only 13%, regional committee owned 20%, the company management – 16%, and approximately 12.5% belonged to a major outside owner.

Another very important method used by the federal center to strengthen its positions in the area of government property man-

agement is in the increase of the government share in the companies with mixed proprietary form. In this respect the practice of previous years could at least be viewed through two events, which have been meaningful to the Russian economy in general.

As the result of additional subscription and the restructuring of the debts from 59% to 76% the participation of the government in the joint stock capital of one of the major machine building and defense industry entities "Izhmash". With that the federal share of stock increased twofold (from 25% to 57%), while Udmurtia region as the subject of Russia ceased to be the biggest shareholder. "Izhmash" might be considered as the first successful example of securitization of the corporate debts to the budget at the federal level without considering as another similar case the debts of "AvtoVAZ", which were not restructured and for which no final resolution was reached between 1996 and 1998 and the restructuring of "KAMAZ" debts, where a major role was played by the government of Tatarstan.

A creation of "Big diameter pipes factory" joint stock society deserves a special mentioning. The decision on the location of the project, the size of its financing was made in the summer of 2000 after lengthy discussions accompanied by an active lobbying for the interests of all the potential participants in the project. A new enterprise in which "Line-5000" became a core element was to be established on the basis of the "Nizhni Tagil metals combine" factory (Sverdlovsk region), to which, similarly to the Russian government through the Russian Federal Property Foundation, a blocking share of stock will belong (25% + 1 share), 19.9% was intended for Gazprom. A search was undertaken for other shareholders and the administration of Sverdlovsk region was also expected to take part (10%). 150 million Rubles, which were appropriated as the result of the budget surplus as advised by the Ministry of finance and the

Ministry of industry of Russia were to be the source for payment of the government share in the charter capital of this factory.

However, the main consumer of the products of the future company – Gazprom – in the course of the entire second half of the previous year never showed interest towards the project, making a principal decision of investing into it only at the beginning of 2001, which happened not without the pressure from the government representatives at its various executive levels. Following this the biggest significance for the implementation of the project was the issue of a possible competition between different manufacturers of big diameter pipes required by Gazprom, because “Severstal” factory (Cherepovets, Vologda region), which even after the final tender results announcement of NTMK as the winner, did not give up on the idea of setting up separate production facility together with the Izhora plant in St. Petersburg in parallel to the one planned for establishment in the Urals. In the light of the latest Russian-Ukrainian agreements in the economic sphere one should not exclude an alternative to the Russian made pipes from the Khartsiz pipe factory in Ukraine, where a controlling share of stock can be purchased by Gazprom as an offset against the debts for the supplies of natural gas into this country.

The significance of this project for the Russian economy can not be underscored by the future import substitution effect during the construction of export gas pipelines and as the result by the growth of hard currency earnings. In essence it is the first one after 1991 which has become a major investment project of the national importance in the Russian basic industries, which shall be done with an open participation of the government and with the respective rights of ownership being retained by the Russian authorities. The level of the project’s success and the acquired experience in not so distant future might define a possibility and conditions for

the government participating with its resources in financing investments in the real sectors of economy, which in its turn could produce a substantial effect for investment and economic development in the country in general.

In the light of the federal center's initiatives to strengthen the power vertical (introduction of the authorized representatives of the President of Russia in 7 federal districts) there might take place a change of status in the area of separation of authority of the Russian Federation, its regions, municipal authorities, property management and control over the quality of such management. For example, in the Southern federal district work is already under way, which analyses situations in enterprises with the government stock in their capital, including financial and economic conditions, personnel, and method of management employed by the government, not excluding a possible increase of the government share of stock to a blocking or controlling size through additional issuance or purchasing of shares. The port facilities of Azov and Black seas and the Astrakhan gas condensate plant were identified as priority objectives. After the conference of the heads of the property management agencies representing all the Federal subjects in the Southern federal district government representatives were appointed to board of directors of 50 companies with the government share in their property (ports and companies in fuel and energy sector). An appearance of an intermediary link within the system of executive power in the form of federal districts might produce significant influence also on the establishment of a new organizational structure in electric power generation industry and communication throughout the whole country.

4.4. Banking sector

Results of 2000

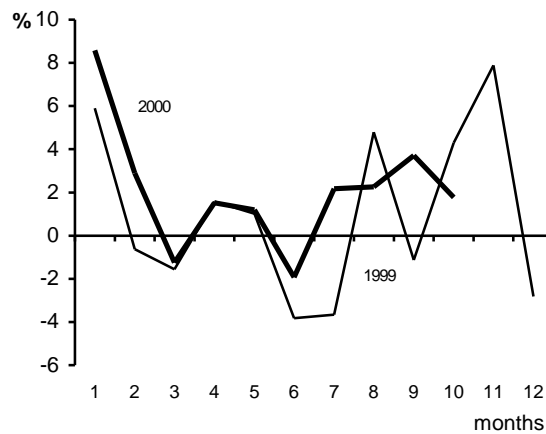
The year 2000 went by under the sign of stabilization for the banking system. Lower percentage of revoked licenses, as well as a smaller share of banks, if compared by total assets, which are leaving the market. The number of banks, whose licenses were revoked by the Central Bank (not considering a loss of a license due to reorganization) turned out to be four times lower than during the preceding year, and the lowest for the seven years since 1993. The total aggregate asset base of the three dozens of banks, whose license have been revoked by the Central Bank during the year by the start of 2000 accounted for only 1% of the total pool of assets of all the then active banks. At the same time the number of new participants in the banking services market has also increased: the Central Bank has registered 18 credit agencies for a year and half of those during the last quarter. As of the middle of the year a positive cash flow reestablished itself in the banking sector apart from the contribution by Sberbank, which in 1999 secured a positive annual result for the whole of the banking system). Fixed price asset growth has accelerated (see pic. 1). Whereas for the first 10 months in 1999 an average monthly asset growth rate according to the CB of Russia was only .7%, then for the similar period in 2000 it was 2.1%. At the same time the post crisis revitalization of the banking business continued to be chaotic. With general agreement on an existing banking system not being adequate to the public requirement, neither the means, nor the terms for its formation have been determined. The government taking advantage of a favorable economic situation pursued the policy towards strengthening its presence in the banking sector, and mainly by way of increasing capital in the banks which already be-

longed to it (Vneshtorgbank, Russian Development Bank) and the establishment of new ones (Rosselkhozbank). Changes in the legislative basis again have been postponed. At the practical level of things, last year the authorities tried a new way of cleansing in Russia which was an acquisition by a major government bank of a major problematic commercial private bank (Vneshtorgbank acquired the controlling share of stock in Most Bank).

Besides, there appeared the first manifestations of the government's new attitude towards a new trend in the market, which was a popular practice among the banks to siphon their assets into the so called clone-banks. And by the end of January 2001 the Audit Chamber in its review of violations of law in Incombank raised accusations against the former management of the bank concerning an illegal alienation of assets from the bank (according to Prime-TASS news agency approximately 630 million US Dollars).

PIC. 4.1.

Fixed price asset growth rates in 1999 and 2000 in %% (deflated by IPC)



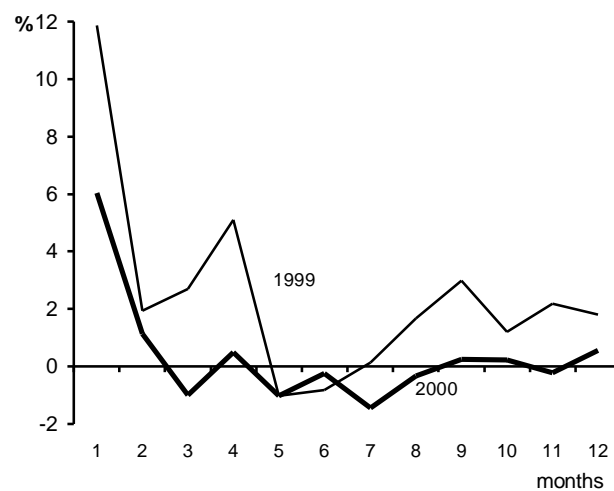
Calculated based on: Banking statistics bulletin

Stabilization of macroeconomic situation in the country surely reflected itself in the banking sector operations. Stabilization of the hard currency exchange rate (see pic.2) prompted banks to shed maximum possible hard currency content in their assets and obligations. The share of hard currency assets in the active banks for 11 months of 2000 went down by 10 percentage points (from 50.3 to 40.3 % of assets). With that the hard currency obligations decreased by 4.6 percentage points (from 40.8% down to 36.2% of the assets). However, this process had a negative side to it along with the positive one – which was growing acceptance of and trust into the Ruble. The crisis had not taught banks to manage their currency risks, while the oversight agencies continued to demonstrate quite a liberal attitude towards this problem. Correlation of net assets and the balance capital in the course of a full year was at the level, which exceeded 50%. And were it not for the policy of artificial support of the Ruble against the Dollar in the exchange market, pursued by the government, many banks would have found themselves in many financial predicaments. Essentially, even in the kind of circumstances, when the Dollar was losing value against the Ruble in the course of 5 out of 12 months, the “collective currency position” maintained by the banking system did not facilitate the extraction of habitual revenue from the exchange rate fluctuations.

Whereas in 1999 hard currency market transactions and reevaluation of hard currency assets provided banks with at least one third of their gross operational revenue (24% - from reevaluation, 8% - from hard currency market transactions), then for the three quarters of 2000 – less than 10% (including 4% - from reevaluation and 5% - from hard currency market transactions).

PIC. 4.2

Dollar/ruble average monthly exchange rate changes at the MICE in 1999 & 2000, in percentages



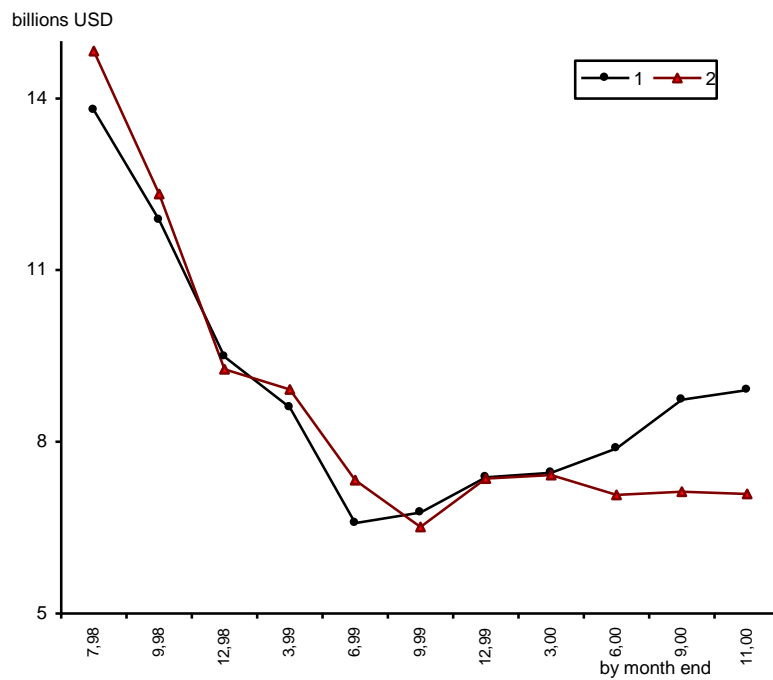
As was the case in 1999 a breaking point according to many indexes fell on the second quarter. During this period a process of reduction of the share of foreign placed assets in the banking aggregate asset base gains momentum. From 22% - the post-crisis maximum – by the end of November it fell down to 19%, however this tendency increased through the accelerated growth of other types of revenue accounts – in absolute expression the foreign placed assets continued growing, however, not as fast as they used to. The index of the share of assets placed in the banking sector demonstrated a similar kind of tendency. From 40% by April 1, 2000 it went down to 37% by December 1, 2000. After the first quarter the lowering of the marginal share of assets represented by loans to a non-banking sector also came to an end. Having gone

down to 35.4% by April 1st, this index by the end of November turned out to be even slightly higher than in the beginning of the year (38.1% by January 1st and 38.3%). But, first and foremost this happened thanks to Sberbank. If the Sberbank contribution is to be excluded, then by the end of the year the share of loans was still a bit lower, than at the year's start (36.0 against 37.7%). Thus it was still premature to talk about a redistribution of assets in favor of crediting the real sector. The banks, as will be demonstrated below, were still trying to inflate their portfolios of exchange notes and securities. However, reproaches to the banks, as it seems, are justified only in part. The Ruble loans in 2000 kept on growing in their total value (by 45% for 11 months in fixed prices), as well as against the aggregate asset base (from 21 to 24%). Even though the hard currency loans have grown during the period under review by 20% in their dollar value, they remained at the level of 40% lower than on the eve of the crisis. Such a situation, as it seems to us, is one of the manifestations of a banking crisis – and specifically the trust in the Russian banking system among non-residents was not redeemed. In the pre-crisis period those were the resources of non-residents, which mainly acted as the sources for hard currency loans. As is shown in pic. 3 the amounts of loans to resident borrowers and obligations to non-residents in hard currency are very similar. A correlation analysis also demonstrated a stable positive connection between the share of loans to enterprises in hard currency in the asset base and the share of foreign obligations in the banks' liabilities in the pre-crisis period (65% in the middle of 1998). The crisis cut the banks from this market. The reduction of claims by non-residents to the Russian banks was accompanied by a lowering of the total amounts of loans in hard currency, which were being extended by banks. Neither the deposits, nor the transaction accounts in hard currency were able to substitute this source

of hard currency loans, whereas the potential for their growth was exhausted by 2000 (see pic. 4). The remaining hard currency balances in the corporate accounts in percentage to assets demonstrated a tendency towards a decrease in 2000, and the growth of the share of deposits of corporate entities in hard currencies in the liabilities during the period under review constituted a mere 5%.

PIC.4.3

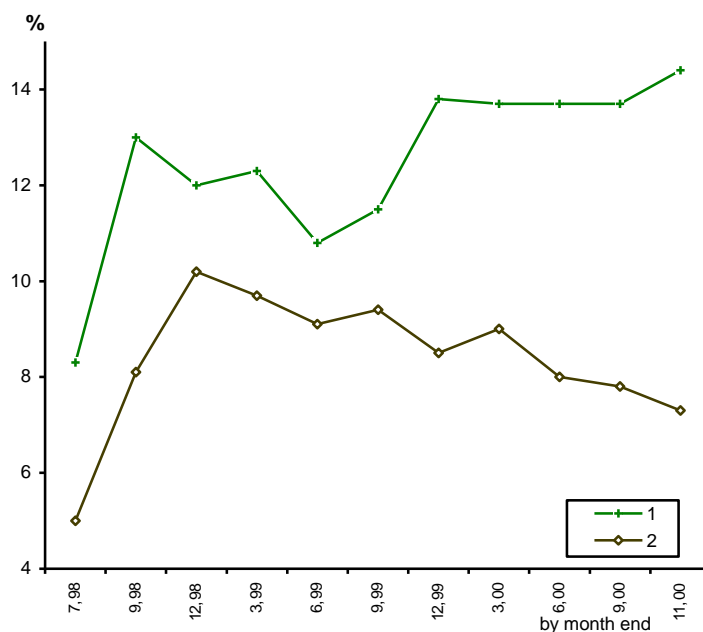
Hard currency loans to resident corporations and Russian banking liabilities with non-residents



1 – loans to resident corporations
2 – liabilities with non-residents

PIC. 4.4

Share of remaining hard currency balances in the accounts and deposit accounts in the liabilities of operating banks



1 – deposit and savings accounts

2 – transaction accounts

All of this points to the unresolved problems with foreign creditors not being the exclusive problem of the banking sector, least of some separate banks. Without reviving the trust in the banking system, the latter is unable to resurrect the function of a financial intermediary between owners of the savings and the real sector even at the level of activity it used to have before the crisis. To say nothing of the inability to resolve this problems through measures aimed at further limitations of the rights of creditors like a limita-

tion of the right of a depositor to withdraw his/her money before the expirations of the term of a deposit, which is being lobbied by the banks.

So far hard currency loans growth has been lagging far behind the asset growth. Its increase in 2000 apart from the Sberbank, was provided by the banks, which at the start of the year, were even smaller than on average the institutions involved in crediting the non-banking sector. At the same time the banks, which were reducing their foreign currency loans portfolios (group 1)⁶ at the start of the year had higher NBS credit ratings (51% of assets against the average marker of 38%, without Sberbank data). With that not only the amount of foreign currency loans went down within this particular group, but generally speaking the share of loans from NBS (from 51% down to 41% of assets) along with just a slight growth of the share of assets placed in the banking sector. With a high level of probability one could state that the crediting of the non-banking sector was first widely undertaken by the group of more conservative banking institutions, which considered the macroeconomic backdrop of 1999 too unstable for the implementation of projects in a non-financial sector. An indirect testimony of this assumption are the shorter terms for which the banks are granting loans, the kind of banks, which have broadened their foreign currency loans offer this year. (see table 1). The group of banks, which in 2000 has increased the volume of loans granted to resident corporations in hard currency (group 2)⁷, in the beginning of the year 47% of the assets it had

⁶ This group includes all the banks with foreign currency loans in dollar denomination as of November 1, 2000 lower than by the start of 2000 and with the share of foreign currency loans to resident enterprises of not less than 55 of the assets. The banks placed under RCO management were not included. Total number of banks in the group – 109.

⁷ This group included all the banks with foreign currency loans in dollar denomination as of November 1, 2000 higher than at the start of the year, and

placed in the banking sector, and additional 14% of its assets were in securities. The share of the NBS loans accounted only for 31.5% of the total assets. In the course of the year the share of the funds placed in the banking sector went down to 38% of the assets (by 9 percentage points). To a great extent the resources had been redistributed in favor of NBS with their share growing by 6 percentage points, including the share of loans to resident corporations, which grew from 28% to 34% of the total assets.

TABLE 4.6.

Distribution of foreign currency loans by terms in the groups with the reduction and the growth of loans in hard currency, in percentages

Foreign currency Loan terms	Share of foreign currency NBS loans within the total amount of good loans as of January 10, 2000	
	group 1	Group 2
Up to 90 days	9,6	8,6
From 90 to 180 days	4,2	15,8
From 180 to 365 days	17,5	30,2
For more than a year	68,7	45,3
Number of banks in the groups	109	187

The Ruble loans grew at higher rates. However, the share of the loans in hard currency also grew from 17.8 to 18.6% of the assets. With that the growth of the amount of loans in foreign currency took place against the background of a slight expansion of obligations of foreign currency with non-residents in their absolute ex-

whose share of foreign currency loans to resident enterprises as of December 1, 2000 not less than 5% of their assets. Banks under Arco management were not included. Total number of banks in the group 187.

pression and their drastic reduction against the assets (from 17.5 to 11.2%). One could assume that the main resource for increasing foreign currency loans were the accounts of the companies held in foreign currencies, the share of which in this group at the beginning of the year was twice higher than in the first group (13.6 and 7.6 respectively) and it continued growing. Another peculiar feature of the second group – a relatively low share of loans to non-residents. Whereas in the first group the loans to non-residents in hard currency constituted approximately 15-16% of their loan portfolio, the second one had it at the level of 1-2%.

A regressive analysis of a correlation between the share of loans to resident corporations in hard currencies in their asset structure and different types of liabilities, as well as the capital, which was conducted at several selected dates (July 1, 1998, October 1, 1998, January 1, 1999, January 1, 2000, October 1, 2000) shows that the connection between the loans to resident companies and the obligations with non-residents in hard currencies weakened in 1999-2000. The connection between the private deposits and the loans in hard currencies proved to be statistically significant for all of the dates (negative character of the deposits in Rubles and a positive one with the deposits in hard currencies). The significance of the factor of the deposits of corporate entities was not stable. That is to say that the deposits belonging to no-government entities acted as a significant factor for all of the dates before the beginning of 1999, however, at the start of 2000 the deposits by the state agencies acquired a greater significance, and by October 1, 2000 this role was then played by the government entities. The factor of the share of the Ruble accounts of the companies in their liabilities picture became a negative significance factor from the beginning of 2000. However, the explanatory ability of this model became less prominent.

The growth of the Ruble loans which was noticeable in 2000 could only partially be attributed to the growth of recourses in the banking system. To a greater extent this growth was possible because of the redistribution of resource within the loan portfolios of the banks and the assets placed beforehand in the banking sector. Such a conclusion is made possible by the analysis of changes in the structure of the assets of a group of banks, which during the period under review have grown their share of loans to the real sector in Rubles among their asset structure (see table 2). All in all 231 bank was put into this category (the bank whose relationship of loans against their assets remained less than 5% as of December 1, 2000 were not considered, as well as the banks which at the time were under ARCO management, and also Sberbank). From the data contained in the table it is obvious that on average these banks were bigger than the ones whose share of the Ruble loans to enterprises during the period under review remained the same. At the beginning of 2000 the gap between the average amount of assets was 63%. Their assets had a greater hard currency content and at the same time they had a higher share of the assets place outside the country. Whereas in the group which did not demonstrate any growth of the share of Ruble loans (group 1) at the beginning of the year the share of assets placed abroad constituted a quarter of all the assets, than the group whose share of the Ruble loans was growing (group 2) – their share amounted to 35.7% and during the period under review it went down to 28.9%. The percentage of assets placed in the banking sector at the start of the year was also higher in the second group (49.4 against 44.5 %). However, whereas in the first group this indicator kept on growing, than in the second one it went down to 36.8% including the non-resident banks from 26.3 to 17.7%.

The total share of NBS loans with the banks, which had increased their share of the Ruble loans, was higher by the start of 2000, than in the first group and continued growing throughout the year. Consequently by the end of November the gap between the groups in this particular indicator exceeded 8 percentage points. However, among the second group of banks the loans in hard currency took a greater share of burden and amounted to 80% by the start of the year in their general loan portfolio and along with that a considerable number of loans was granted to non-residents. In the course of the year this figure went down from 25.6 to 18.3%.

The mentioned above changes in the asset structure enable one to conclude that the growth of the Ruble loans to the Russian entities, to a greater extent, was ensured by the return to Russia of a number of resources formerly placed outside the national Russian borders.

TABLE 4.7.

Certain indicators of operations by banks grouped according to the growth of Ruble loans to enterprises in assets and percentages

Indicators	Group of banks with no growth		Group of banks with growth	
	By 12.99	By 11.00	By 12.99	By 11.00
Assets	100	100	100	100
In foreign currency	46,7	45,1	62,8	50,2
Foreign assets	25,3	25,4	37,3	29,9
In foreign currency	24,5	24,2	35,7	28,9
Funds in the banking sector	44,5	45,8	49,4	36,8
In foreign currency	26,3	25,2	29,8	19
In the banks of the Russian Federation	6,3	6,9	9,2	7,4
In foreign currency	2,6	2,1	2,7	1,3
In non-resident banks	22,9	23,3	26,3	17,7

TABLE 4.7 CONTINUED

In foreign currency	22,2	22,2	24,7	16,8
Funds in the Central Banks of Russia (CBR)	11,9	13,4	10,1	10
Correspondent accounts in CBR	7,4	6,8	5,2	4,4
Deposits in CBR	0,5	1,3	0,2	0,3
Mandatory reserve fund	4,1	5,3	4,7	5,3
NBS loans	36,5	32,9	37,6	41,2
In foreign currency	14,5	11,8	30,1	21,8
In Rubles	22	21,1	7,5	19,4
Loans to resident enterprises	32,5	29,6	25	31,1
In foreign currency	12,7	10,5	18,5	12,8
In Rubles	19,7	19,1	6,5	18,3
Loans to resident enterprises / NBS loans	89	89,8	66,5	75,6
In foreign currency	34,9	31,7	49,2	31,2
In Rubles	54,1	58,1	17,4	44,4
Loans to non-resident corporate entities /NBS loans	2,1	2	25,6	18,4
In hard currency	1,9	1,7	25,6	18,3
In Rubles	0,2	0,4	0	0,1
Loans to the treasury and extra-budgetary funds/ NBS loans	3,1	2	1,8	1,3
In foreign currency	0,6	0,4	0,9	0,3
In Rubles	2,5	1,6	0,9	1
Loans to private individuals /NBS loans	5,6	6	5,8	4,6
In foreign currency	2,1	1,9	4,1	3
In Rubles	3,5	4,1	1,7	1,6
Defaulted loans / NBS loans	5,1	3,1	3,3	1,4
In foreign currency	3,5	1,9	2,4	1,1
In Rubles	1,6	1,2	0,9	0,3
Exchange notes (excluding exchange notes of banks)	5,3	6	5	8,1
Debt liabilities and shares	9,6	11,8	6,2	8,2
Including debt liabilities, which also were made up of the debt liabilities of the Government of Russia	6,6	9,4	4,9	5,5

TABLE 4.7 CONTINUED

In foreign currency	4,4	6,7	2,8	3,2
In Rubles	2,3	2,7	2	2,4
The income (loss)	2	1,6*	1,9	2,5*
<i>Brief references:</i>				
Average assets of a bank in current prices in mln.Rubles	648,28	1029,72	1057,41	1714,61
Average assets of a bank in fixed prices, in mln Rubles	648,28	870,9	1057,41	1450,16
share of the group in the total loans to resident enterprises of**	68,3	64,9	19,8	25,7
Number of banks in the group	1022	1022	231	231

* recalculated on an annual basis.

** all the existing credit institutions by December 1, 2000, excluding Sberbank.

Note: the group did not include the banks which were placed under ARCO management, the second group did not include the banks with the share of Ruble loans to entities below 5% as of December 1, 2000.

Such a policy probably helped to increase the profitability of the operations by banks in the second group. Whereas by the results of 1999 the ROA indicator in the considered group was very narrow (2.0 and 1.9%), then by the results of 11 months of 2000 it went down to 1.6% in the first group and in the second group it went up to 2.5%. But the extent to which this is related to the banks' credit policy is hard to define. There is no statistically meaningful connection neither between the share of the Ruble loans within the asset structure and the ROA indicator, nor between the interest income on loans to enterprises in Rubles and ROA. However, the correlation coefficient between the share of the Ruble loans and the interest income by the results of three quarters of 2000 amounted to 60%.

As was noted above within the period under review there occurred a certain redistribution of assets in the banking system (without the Sberbank's data taken into account) in favor of taking into account exchange notes and securities. The latter apparently was not as much as a consequence of an active banking policy as the result of a price growth for these assets. For the three quarters of 2000 the reevaluation of securi-

ties brought 10.55% of the gross operational revenue to the banks, another 8% came from the securities market transactions, and finally 26.6% came from interest derived on income from securities (without Sberbank's data taken into account).

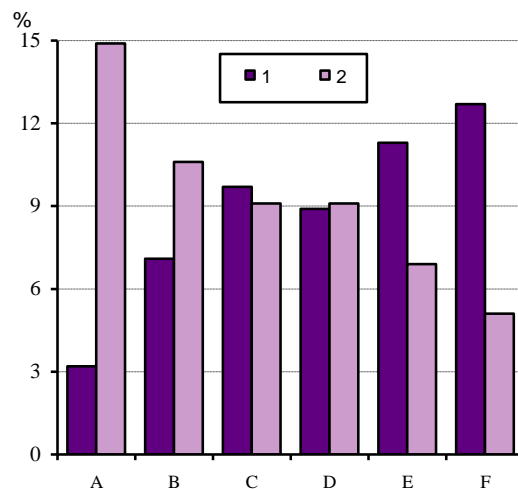
An aggregated securities portfolio denominated in foreign currency grew considerably. Whereas the total value of securities in percentage to the assets grew from 10.2 to 11.4%, i.e. by 1.2 percentage points. The share of the Federal bonds denominated in hard currency by 1.8 percentage points from 4.1 to 5.9%. The portfolio of NBS exchange notes grew in percentage of the asset ration from 5.9 to 6.6%. With that the transactions with exchange notes remained the specialty of smaller banks. Whereas in the asset structure of the ten major banks the exchange notes of the NBS companies on account amounted to 3%, then in the banks, which had the ratings below 200 these exchange notes exceeded 10% of the asset structure. A reverse dependence between the amount of assets and the share of securities in the assets. The highest average amount of securities in the assets could be noted in the group of the major leading banks (15%), in the group of the smallest banks this indicator goes down to 5% (see pic. 4.5).

A concentration of assets in the banking sector in other types of liquid assets at a first glance eliminated the re-capitalization problem – a prevalent majority of banks were able to easily exceed the requirements of the sufficiency of capital established by the Central Banks of Russia (H1). At the same time the growth of capital like in 1999 was lagging behind the growth of assets. The “leap” of the last few months simply narrowed this gap. Whereas by the year's start the relationship between the balance capital and the assets constituted 14.7%, then by April 1, 2000 it went down to 13%. And by December 1, 2000 despite the attempts by the Central bank to increase the charter capital of Vneshtorgbank it still remained one percentage point lower than at the beginning of the year (13.9%). If we are to exclude Vneshtorgbank, then

we could see that the growth of the charter capital in October – November would have been not 12 but only 3%. In under 11 months only the third of the banks operating at the time, was able to increase their charter capital in fixed prices. Gazprombank was the second after Vneshtorgbank in the amount of its charter capital with its 30% of statistical increase and with its contribution of approximately 12%. However this neither produced any serious influence on the relative size of the structure of the banking services market nor did it induce any changes in the charter capitals.

PIC.4.5

The share of exchange notes and securities in the assets of the banks grouped depending upon the size of their assets as of December 1, 2000



1 – share of exchange notes (without bank exchange notes)

2 – share of securities

Groups according to asset size as of December 1, 2000

A- banks rated from 1 to 10

B- banks rated from 11 to 50

C- banks rated from 51 to 1000

D- banks rated from 101 to 2000

E- banks rated from 201 to 5000

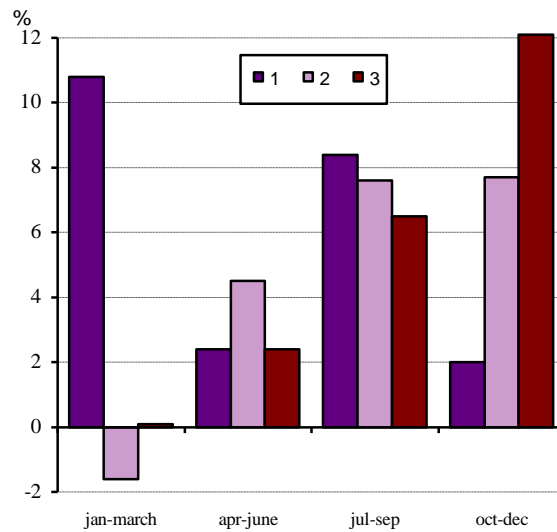
F- banks rated from 501 to 1316

According to our estimations by October 1, 2000 out of a number of banks, which had a positive capital ration and according to the rules established by the Central Bank of Russia 482 could not reach the amount of 1 million Euro. With that in Moscow and the Moscow region less than 30% of the total amount of banks were operating. The remaining 70% were located in 70 different regions including the banks with the capital under 1 million Euro, which in 9 regions constituted 100% of regional banking institutions. Under such circumstances a simple administrative decision to take them out of the market ran the risk of contradicting another not less important area of the government policy - the need to maintain a competitive environment in the banking services market. Particularly, since the less radical economic measures were not entirely exhausted. This and the encouragement for recapitalization, mergers and acquisitions, and the reconsideration of the licensing rules with the introduction of license, which not only limited the list of permitted transactions, but which also introduced territorial limitations on the right of the small credit institutions to engage in banking business.

The process of consolidation through the existing banks merging in 2000 became somewhat more active, which gives us the reason to consider in a greater detail the mergers and acquisitions in the Russian banking sector after the 1998 crisis.

PIC. 4.6

Capital and fixed price asset growth rates in 2000



- 1 – assets
- 2 – balance capital
- 3 – charter capital

The post crisis mergers and acquisitions in the banking sector

During the period after the financial crisis of 1998 and before February 1, 2001 – 22 mergers and acquisitions took place which covered 48 banks. One of them, the most notable, was the merger between UNEXIMBANK and its “bridge” bank registered by CBR in November. Other mergers geographically could be distributed into two major groups – 6 interregional mergers and 15 bank mergers, which happened in a single region (see tables 4.8 and 4.4).

Conditions for restructuring of the obligations of UNEXIMBANK with foreign creditors and a merger of Rosbank with UNEXIMBANK

This merger became the first example of a reverse merger between the 1998 crisis victim bank and its “clone” into which the assets of the problem bank were being funneled. The merger took place after the debts of UNEXIMBANK had been restructured by the non-resident creditors.

In September 1999 the debts of the bank to the Western creditors were estimated by Flemings USB, which acted as a financial consultant to the bank in its restructuring negotiations, approximately at 1.7 billion USD, including its obligations under the forward contract as well as Eurobonds in the amount of 50 million USD placed by the bank in January, 1997 and the eurobonds in the amount 450 million USD, which had been placed in two tranches in August and September of 1997. Both papers were to mature in the beginning of 2000. The banks started negotiations with Western creditors in November 1998. Conditions for restructuring were agreed upon in October 1999. The restructuring plan envisaged payment of monetary resources and a redistribution of restructuring instruments. An official declaration about the end of the restructuring of the UNEXIMBANK was made in the beginning of July 2000.

The agreement to restructuring by holders of Eurobonds and UNEXIMBANK's bonds with FRN was secured in the form which reflected the specialty of these financial instruments, i.e. in the form of acceptance by the prevailing majority of the holders (app. 90%) of extraordinary resolutions, which changed the conditions for Eurobond and FRN trading in accordance with the restructuring plan.

The monetary compensations amount to 10% of the total sum of claims, which while considering the banks' debts under the for-

ward currency contract estimated at the agreed upon exchange rate of 8 Rubles to a dollar constituted 1.4 billion USD. The restructuring instruments include new Eurobonds, quarantined by Rosbank at their nominal value of 130 million USD and the exchange notes, which give the creditors the right to a proportional receipt of the proceeds, generated from the sale of the bank's assets. The greater part of the proceeds would be transferred directly into the creditors ownership through a special company set up in Luxembourg. The assets which potentially can generate a greater amount of proceeds are represented by several credits, extended to the Interros group of companies and securitized by the SIDANCO oil company shares.

Based on the amount of payments and a probable market price for the Eurobonds, Flemings USB evaluates the net present value of these securities as 20% of the amounts claimed of the banks. This figure can be bigger in case of a successful sale of the problem assets of the bank.

AS the result City Bank authorized by the creditors to act as their agent in this redistribution – received 1-5 million USD, 130 million USD were in 12 year bonds for 130 million USD, which entitle the creditors in the equity participation in the Luxembourg trust company.

In September 2000 the shareholders of Rosbank and UNEX-IMBANK at their general meeting approved the reorganization of Rosbank in the form of its merger with UNEXIMBANK, finally on November 23, 2000 CBR revoked UNEXIMBANK's license for conducting banking operations.

TABLE 4.8

Interregional bank mergers

Region	Bank	Merger registration month	Assets and regional asset size rating			
			Before merger amount, mil. Rub.	rating	After merger Amount, mil. Rub.	rating
Vologda region	Severgasbank merged	January 2000	786,2	2	979,8	2
	1.Ustiug-bank		14,8	13	–	–
	2.Vitegorski bank		21,2	11	–	–
	3.Magistral (Komi republic)		37,6	6	–	–
Novosibirsk region	Sibacadembank merged	January 2001	1686 *	1 *	N/a	N/a
	Kuzbass transport bank (Kemerovo)		328,5 *	5 *	–	–
Moscow	Gazprombank merged	March 2000	73027	2	55177	3
	Energoinvestbank (Briansk)		99,7	1	–	–
Tula region	Alpha-bank merged	April 2000	48190	5	49041	5
	Alpha-Bank-Novosibirsk (Novosibirsk)		170,8	7	–	–
Tula region	Tula industrialist merged	March 1999	145,4	1	154,7	1
	Elika bank (Moscow)		52,8	393	–	–
Tiumen region	Diplomat merged	May 1999	96,8	21	99,5	21
	Moscow development bank (Moscow)		10,5	–	–	–

* data as of December 1, 2000

TABLE 4.9

Regional bank mergers

Region	Bank	Merger registration month	Assets and asset size rating in the region			
			Before merger		After merger	
			Amount, mil. Rub.	rating	Amount, mil. Rub.	rating
Archangel region	The First marine banks merged Niandomabank	September 1999	14,6 11	8 9	26,2 –	6 –
Belgorod region	Severinvestbank merged Krasnogvardeiski bank	May 1999	14,1 4,7	4 8	21,3 –	4 –
Irkutsk region	Radian merged Lenakombank	August 1999	83,9 4,6	6 12	78,6 –	6 –
Kemerovo region	Kuzbassugolbanks merged Kemerovo commercial bank	December 2000	888,1 225,5	2 6	N/a –	N/a –
Krasnoyarsk region	Yenisey united bank merged Lesosibirski bank	January 2000	175,6 3,9	5 12	171,8 –	5 –
Mordovia	Mordovpromstroibank merged Siyazher bank	February 1999	141,1 19,7	1 5	147,7 –	1 –
Moscow	MAK-bank merged United regions bank	January 2000	418,4 147,4	209 346	612,3 –	163 –
	Rosbank merged Uneximbank	November 2000	35100 5100	8 40	41300 –	7 –
St.Petersburg and Leningrad region	Inkasbank merged with Anima-bank	October 1998	366,6 114,5	9 17	470,3 –	9 –
Perm region	Permstroibank merged Kredit	August 1999	159,2 519,8	4 1	714,4 –	1 –
Saratov region	Sinegiya merged Rtishevobank	September 1998	25,6 1,3	9 21	28,8 –	7 –
	Volgoinvestbank merged Ligatura	December 2000	277,1 162,9	4 6	Н.д. –	Н.д. –
Northern Osetia Alania Republic	Regional development bank merged banks: 1. IR 2. Osbank 3. Yermolov bank	February 1999	10,3 120,7 47,5 14,1	7 1 2 6	172,6 – – –	1 – – –
		May 2000	5854 164,2	1 17	6542,3 –	1 –
		December 1999	538,9 11,8	11 32	536,4 –	11 –
		February 1999	133 –	2 –	151,2 –	2 –

Note: Sberbank was not taken into account for the estimation of ratings for the Moscow banks

Interregional mergers⁸

Out of six mergers involving 14 banks from different regions only 2 were registered with the participation of the Moscow banks. In two cases the mergers resulted in the expansion of the branch network of the Moscow banks (Gazprombank and Alpha-bank). In 2 other cases Moscow branches were set up by the regional banks from Tula and Tiumen. A peculiar feature of such interregional mergers – assets of the leading banks were several times larger than the average one in the region. The only exception was the merging of the banks Diplomat (Tiumen) and the Moscow development bank (Moscow). In two cases the regional banks from Vologda and Novosibirsk expanded their branch networks by acquiring banks in other regions.

The second peculiarity of the interregional banking mergers was in the different “weight categories” of the merging banks. In such cases when a Moscow bank was acting as the “leading” bank. In such cases the assets of the merging banks differed within the margin of 0.3% from the amount of assets of the Moscow bank. Similar type of correlation was noted during the merging of Komi bank into the Vologda bank, when this correlation amounted to 5%. A large gap between the sizes of the banks made the changes in the balance of the merged banking entities untransparent because the average monthly fluctuations of the balance of a merging bank exceeded the total sum of assets of the merged banking entity. So it is only natural that the fact of a merger did not produce any direct influence over the rating position held by the bank in a list of banks in a respective region as to the size of their assets. As one can see in table 3 in practically all cases except one the banks retained the po-

⁸ Analysis was done on the basis of the reporting status of December 1, 2000 – see table 3 of the current section.

sitions which they held in such rating reports. In two cases when a regional banks was merging a Moscow bank into itself the gap between their assets was considerably smaller (11% and 46%) – the share of assets of the merged bank which led to the growth of the assets of the resulting banking entity by 3% and 11% per month respectively.

*Regional mergers*⁹

The mergers of the banks which operated in one local market can be divided into two types:

- one of the participants of a merger already was a leader in the region as to the size of assets (4 cases – in Mordovia, Northern Osetiya Alaniya, Tatarstan and Perm regions). The merging of the Uralstrustbank with Udmurtunikombank could be categorized by the same type, where a “leading” bank was the second in the region as to its asset size. It is interesting to note that in two out of five cases the merged bank were larger than the merging ones. As the result of such a merger the regional leader was changed, but this change had only a formal character.
- The banks participating in this merger process had assets which were smaller than the average level in the respective region (8 cases). According to financial parameters such mergers could be further divided into two groups.

1. The assets of merged banks constituted 30-75% of the assets of the banks into which they were being merged. This group involved mergers in Moscow, St. Petersburg, Belgorod and Archangel regions with some exceptions. In these cases there took place a unification of loan portfolios, fixed capital, money in customer accounts, balance capital and a number of other accounts. This meant

⁹ The analysis is based on the data received before December 1, 2000 – see table 4 in the current section.

that there occurred a more or less transparent merging of the balances of formerly independent banks into the balance of a new entity. However, the banking mergers neither in Belgorod nor in St.Petersburg resulted in higher ratings of such banks as to the sizes of assets among the banks of the respective regions immediately after these mergers were finalized (they remained respectively the 4th and the 9th as to the size of their assets in the regions), which also remained unchanged by the middle of 2000. Inkasbank for the time that elapsed from the date of the merger with Animabank went down one position lower as to the asset growth rate from the middle of 1998 and until the middle of 2000 received 8th rating in St.Petersburg. The fact that the Belgorod bank retained 4th position was quite natural – too large a handicap from the bigger banks (21 million Rubles of Severinvestbank and 60 million Rubles of Beldorbank by the middle of 1999). At the same time the First marine bank of Archangelsk raised its position from 8th to the 6th. The biggest “leap” was done by MAK-bank (from 209th to 163rd position among the Moscow banks immediately after the merger and 131st position based on the results of the first six months of operation in the current year.

2. The assets of the merged banks were by way smaller than the assets of the banks into which they had been merged. Such a group included the banks in Krasnoyarsk, Irkutsk, Saratov and Tiumen regions. In all of these cases the assets of the merged banks were within the margins of 2.205.5% of the assets of the merging banks. In these cases the average monthly fluctuations in the balances of the merging banks considerably exceeded the total assets of the merged banks and such a merger did not have any noticeable influence on the positions of the banks in the local market (see table 4). As one could see from the data contained in the table there were no changes of positions as to the size of the assets following the mer-

gers in any of the regions, except Saratov region, where Sinergia bank after merging Rtishevo-bank – the smallest one in the region as to its assets – rose from the 9th to the 7th position. But the bank merger was not the most important factor in this process – direct merger of their assets could not enable Sinergiya bank to move up even by one point.

The duo of Volgainvestbank-Ligatura completely falls under the first group. However the lack of sufficient data by the end of 2000 makes the analysis of this particular case impossible. Other mergers form a new type of a group, not only because the assets of the merged banks exceeded an average size of the assets of the banks in the respective regions. The thing was that they took place under the pressure from the local authorities. For example, Kuzbas-sugolbank (Kuzbass coal bank) merged with Kemerovo bank as part of the regional ARCO project. Now. Concluding certain results one could note that the processes of concentration in the banking services market in the post-crisis period became noticeably intensive in their quantitative aspect. Whereas for the two years preceding the crisis six mergers of credit institutions had been registered, than for the past two years – three times more than during that period. However, it is yet premature to speak about qualitative changes.

Government guarantees of bank deposits

One of the most debatable elements of the reform of the banking system – guaranteeing of deposits in banks. A respective legislation again was not passed in 2000. More than that, as the discussion of the issue demonstrated its concept has not been finalized yet. Such a situation at least partially could be explained by internal contradiction contained within the idea of guaranteeing bank deposits itself. It is not accidental that the system of insuring deposits has champions as well as opponents, while the conditions for insurance of deposits in foreign

countries are often subject to frequent changes. Besides, part of the banking system in Russia is already covered by unlimited guarantees for private depositors. And without the resolution of the fate of these guarantees the essence and the idea of adopting the Law about the deposits in non-government banks is being undermined to a great extent.

From the date of the last veto of this draft law by the President in December 1999 noticeable changes took place in the economic conditions for the enactment of such law as well as in the attitudes of the interested agencies. Let us begin with the status of the banking system. What is the extent to which the objectives identified by this draft law are achievable with the kind of norms that are contained therein, and the kind of the status which characterizes the Russian banking system? Could a Federal reserve corporation for guaranteeing bank deposits (hereinafter – Corporation) pay compensations to depositors, if it were to start functioning in the beginning of 2000 and if the depositors had a chance to resort to the Corporation's protection from the banks, whose licenses had been revoked in the first half of the year under the condition that the reserve fund could be formed only by contributions by banks?

Estimations of such a nature because of a possible influence by the available guarantees for the deposits over the behavior by banks and depositors as well as because of the lack of information may only have an approximate character. Our estimations were based on the following assumptions:

- All of the banks operating at the respective dates which attract private deposits with the exception of Sberbank are members of such a Corporation; besides, from the fourth quarter of 1999 the banks which were placed under ARCO management were excluded; In case a license was returned to a bank on a temporary basis, its deposits were not taken into account for the estimation of the amounts of contribution;

- Member banks of the Corporation are paying their dues at the maximum legal rate of the calendar contributions (0.15% from the amount of the private deposits) on a quarterly basis;
- Private deposits in the banks with the revoked licenses are subject to full compensation irrespective of the amount of the deposits. This allowance is related to the lack of information about the average size of a deposit per one individual. This assumption slightly raises potential obligations of the Corporation with the depositors. Information published as the result of the transfer of the depositors' obligations into Sberbank of Russia by individuals who applied for the transfer of their money from MOST bank, Mosbusinessbank, Promstroibank, Incombank, MENATEP and SBS-AGRO banks enables us to estimate an average deposit size as being 15,5 thousand Rubles. With an even distribution of such deposits this could mean the return of 14n thousand Rubles or 91% of deposit compensations in case the liability for this obligations was place on the Corporation. However the absolute size of the deposits since 1998, naturally has grown substantially;
- As a basis for the deposit estimation the Corporation accepted into its reserve a half-sum of the remaining balances in individual deposit accounts in the active banks at the beginning and the end of the quarter;
- In case of a lack of information on the amount of obligations with the banks' depositors at the end of the quarter, and in case a bank's license was revoked the estimation would utilize the data available on the last reporting date;
- The revocation of licenses from Promstroibank of Russia, Mosbusinessbank, Mezhkombank and UNEXIMBANK was postponed until the second quarter of 1999. Possible expenditures by the Corporation were not corrected for the obligations which appeared in the case of a need to pay compensations to the clients of the banks,

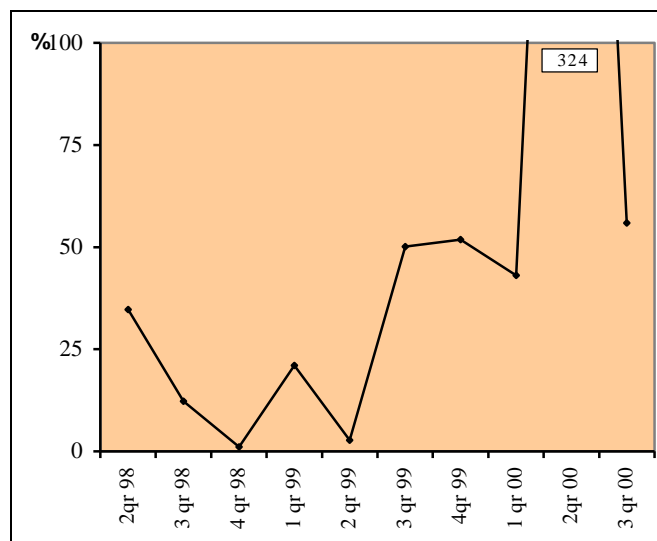
which participated in the program of the transfer of the private deposits into Sberbank;

- The Corporation's reserve was formed exclusively in Rubles and interest income temporarily was not derived;
- Money from the reserve of the Corporation were being expensed exclusively for the payment of compensations. The amount of Corporation's obligations to the depositors was estimated in two way. The maximum amount of obligations was defined based upon the sum of the deposits of private holders in the banks with the revoked license. The second option assumed that the number of deposits were to be returned by the banks themselves at the expense of their liquid assets. Respectively the Corporation's obligations estimated according to the first option were reduced by the amount of the liquid assets remaining in the bank on the same date;
- The money remaining in the bank's cash register, in the mandatory reserve fund, the deposits and correspondent accounts in the Central Bank were included into the composition of the liquid assets for the purpose of this estimation.
- Let us assume that the Corporation utilizes in the course of the first quarter of 2000 the calendar contributions of the banks which attract private deposits, which had been transferred by private individuals in the beginning of 2000 on the basis of compensation of payments in the last quarter of 1999. Roughly speaking, if by October 1, 1999 the amount of the private deposits was 46.6 billion Rubles and by January 1, 2000 – 55.5 billion Rubles, then the average amount would be in the area of 51.1 billion Rubles. At the rate of calendar contributions of 0.15% the amount of contributions does not exceed 77 billion Rubles.
- The amount of private deposits in the banks whose licenses were revoked in the first quarter of 2000 could be estimated in the similar way: the amount of private deposits in these banks by the start

of 2000 amounted to 175 million Rubles, by April 1, 2000 – 182 million Rubles. The average size can be valued at 179 million Rubles. Contributions by operating banks into the Corporation should have been enough to return to the private depositors 43% of these amounts. As is shown by Pic. 7 this was a third quarter in a row when the coefficient of coverage of expenses by the Corporation for the compensation of deposits was at a substantially higher level than on the eve of the banking crisis in August 1998, when under the similar set of assumptions it would have been only 35%.

PIC.4. 7.

Coefficient of coverage of private deposits in the banks with licenses revoked in the respective quarter by the calendar contributions by operating banks



Source: estimations by authors

Estimations for the first quarter of 2000 show that regular contributions by the banks in case of an organization of the Corporation would have been insufficient for a complete coverage of the

current Corporation's expenses for the compensation of private depositors and even the proposed increase of the government contribution in the guarantee fund of up to 5.5 billion Rubles under the existing conditions looked excessive. The reason behind it apparently is the intention to establish a purpose specific amount of the size of the fund at 10% of the amount of deposits. Such purpose specific targets can be seen in some foreign countries and could range from .4% of the deposits in Italy and up to 20% of insured deposits in Kenya. But it is very rare that one can implement these targets. It seems that the financial capabilities of the government could be better suited not by a one time allocation of monetary resources but by an extension of a loan facility or other forms of government guarantees to the Corporation in case it encountered financial difficulties. Probably in this case the officers of the Corporation would have more incentives to insure the return of a part of the resources expensed on payments of compensation through the work with the insolvent banks' assets.

In the second quarter of 2000 the situation both for the Corporation and the depositors would have been more favorable. The contributions by banks could turn out to be three and even more times greater than those necessary to pay compensation amounts. However, it was premature to count on such a tendency becoming stable. The favorable trends in the second quarter appeared not as much as the result of the expansion of the contribution basis by the operating banks as the result of the insignificant deposit amounts by private depositors in those six banks from which the Central Bank revoked licenses during that quarter. The amount of contributions should become greater compared to the first quarter by 16% against the expenses of the Corporation, intended for payment of compensations, going down by 80%. With that, by the middle of 2000 the banks which practically did not have any capital accounted for ap-

proximately 1.5% of private deposits attracted by banks without Sberbank's participation as well as by the banks managed by ARCO under its insolvency programs. If within the Russian prudential oversight there could have been a more active use of the sufficiency of the capital criterion, than the danger of a revocation of license from such banks could have been more real. Their obligations to private depositors were able to engulf dozens of quarterly insurance premiums of the rest of the banks.

Basically, already in the third quarter the coverage coefficient went down to 56%. The number of the banks with revoked licenses increase twofold and the amount of their obligations to private depositors - by 6.5 times.

Government banks and the system of deposit guarantees

On the way of the adoption of the Law on the deposit guarantees, apparently, one will have to deal with the problem of participation of the government banks in the system of guarantees because currently in accordance with the Article 480 of the Civil Code of the Russian Federation the government guarantees obligations to private individuals of those credit institutions, in which the government owned stock exceeds 50% of equity. In this way the depositors in the government banks (and this list is not only limited to Sberbank) already have guarantees for their depositors, which have an unlimited character, while the depositors in the banks that would participate in the proposed system could only enjoy some limited guarantees.

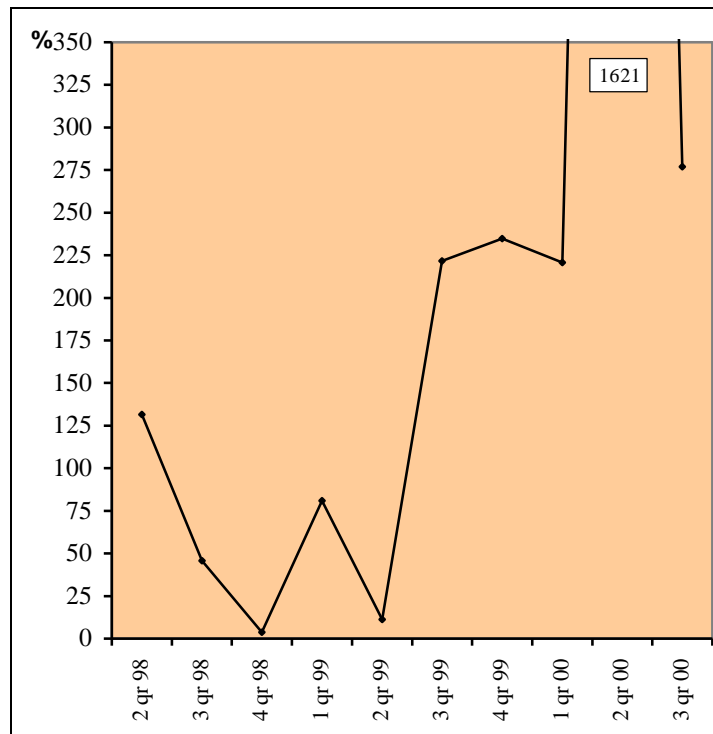
The problem of guaranteeing deposits in Sberbank does not have a straightforward solution. Similar to the law "On guaranteeing the deposits of citizens in the banks" its exclusion from the system of deposit guarantees has its stronger and weaker points. In case it is included into the program the conditions of guarantees to

its depositors would worsen. While the bank due to its status in the private deposit market begins to pay for the problems of other members of the Corporation with its contribution. So in case Sberbank with other banks were to pay contributions to the Corporation from the beginning of 2000 then the Corporation would have had no problem with payment of compensations to the insolvent banks' depositors already in the first quarter. At the same time, as can be seen in pic. 8 the extension of the limited insurance scheme over to Sberbank would not offer any solution to the problems with the sources of compensatory payments during the acute phase of the crisis.

On the other hand if one should keep unlimited guarantees to the depositors in the government banks, which were not covered by any monetary obligations for these banks, at the same time if a system of limited guarantees was introduced for the rest of the banks to be financed by these banks themselves at least on a partial basis, then such rules of the game would hardly helped to improve the competitive environment in the banking services market. The owners of savings would be better attracted by a higher level of protection of their deposits in the government banks, while the costs involved to attract deposits for the government banks would not grow by the size of insurance contributions as would be the case for their non-government competitors. Respectively there will be additional advantages in the interest rate policies. So it would not be appropriate under such circumstance to expect any substantial decrease of the share of Sberbank in the total amount of private deposits and the same applies to the growth of private deposits in the banks in general. But the economic side of the problem of guaranteeing deposits in Sberbank remains anyway – the government eventually in a hidden form undertakes risks related to a fast growing loan portfolio of Sberbank.

PIC. 4.8.

Coefficient of coverage of private deposits in the banks whose license were revoked in a respective quarter, by calendar contributions from banks which retained licenses (including Sberbank)



Source: estimations by authors

One could attempt to make a projection of the way the owners of deposits would behave in case the draft legislation is adopted and in case the unlimited guarantees for Sberbank remain as part of a hypothesis of the rational behavior, which however we do not foresee as the most

probable one. The owners of small deposits would find it economically indifferent, which bank to put their money into. I.e., expectations in the sense of redistribution of the money from Sberbank into the commercial banks would lead to such redistribution if ever taking place, then only in the form of smaller completely or partially guaranteed deposits. It is hardly likely that such a piece of legislation would bring joy to the banks: under existing technology costs to set up a deposit in a bank are high while the amounts deposited are very small. At the same time the owners of larger deposits are strongly recommended to transfer their money into the banks, which are covered by unlimited guarantees.

In case at the current stage of the development of the system of protection of the bank deposits there will be adopted a model with different levels of guarantees for the banks depending upon the ownership structure, it will be necessary to define the list of the government banks and determine the status of the banks in which the government has a controlling share of stock but in which the government will be represented by the Bank of Russia, ARCO, the federal ministries, local authorities, etc. There also appears the need to define the status of the subsidiary banks of these banks particularly taking into account Vneshtorgbank's intention to acquire MOST-bank with its wide, according to the Russian standards, network of offices and the program of restructuring private deposits, which was frozen in this bank in 1998. A similar type of issue appears in relation to the status of the subsidiary banks of the Russian foreign banks, irrespective of who owns their stock – the Central Bank of Russia or Vneshtorgbank.

Problems of guaranteeing foreign currency deposits

Positive things about the new round of discussion of the draft legislation are in the appearance of a provision for investment of a part of the Corporation's assets into hard currency instruments. In case of a financial crisis such a diversification would ease for the Corporation the need to

act on its obligation. But one should bear in mind that apart from the risk of devaluation of the national currency the Corporation will have to deal with the market risk per se. If money is invested into the Russian debt instruments denominated in foreign currency then in case the banking crisis and the hard currency crisis coincide (as was the case in 1998) the Corporation is very likely to see prices for these instruments plummeting in a situation, where the problems of liquidity in this particular market are not a rarity. Respectively, the issue of which specific hard currency instruments should the Corporation invest its reserves into must be formulated with greater detail in the Law, particularly since permitting the Corporation to enter foreign financial markets requires changes in the currency legislation. Whether to insure foreign currency deposits or not – is resolved differently in different countries. Out of 68 countries, which had insurance systems in place and which were included into the IMF review, 20 countries did not offer any guarantees to deposits in foreign currencies.

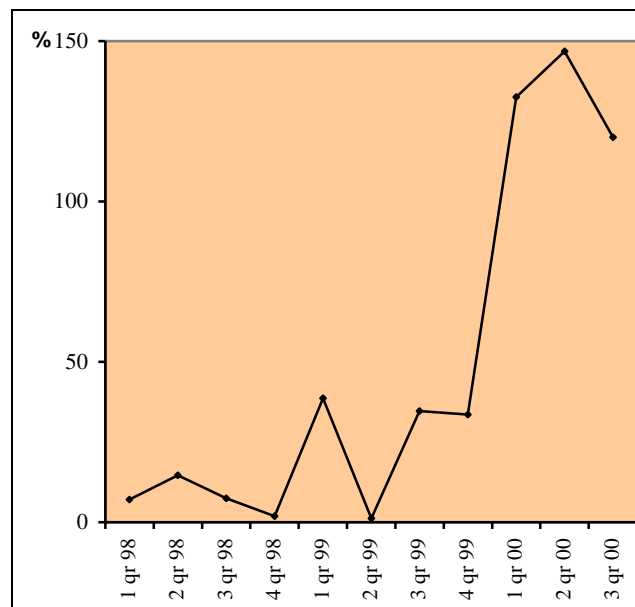
Boundaries of guarantees

Even a smaller number of countries (16) limited themselves to insuring private deposits only and even half of those are the countries of Central and Eastern Europe, which had adopted such a legislation only recently. In other countries, as a rule, the corporate accounts and deposits of small businesses at least are also subject to a certain level of protection. In Russia such an approach to defining the subjects of guarantees not only seems to be well founded but also quite feasible. The estimations show that proliferating insurance over to the resources of corporate entities does not affect the level of burden for the Corporation's budget, if it were to start functioning from the year 2000 (see pic.9). The burden on the assets of banks along with that certainly grows (from 0.01% per quarter, if guarantees extend only to the private deposits and approximately to 0.07% in case current accounts and deposits of the corporate

entities are also subject to such guarantees). However this question can be resolved by reducing the norm of the mandatory reserves which banks are obliged to hold in the Central Banks of Russia. Technical problems related to the separation of the small business accounts do not seem to be insurmountable either.

PIC.4. 9

Coefficient of coverage of non-banking sector resources in the banks, whose license were revoked in the respective quarter by the calendar contribution from the banks who retained licenses



Source: estimations by authors

The upper limit of compensation

The limitation of the insured amounts stipulated in the draft legislation in a combination with the elements of co-insurance logically fall into the flow of modern tendencies related to the insur-

ance policies utilized abroad. As far as setting of the quantity of the upper limit of the insured amount is concerned an optimal one according to foreign experts will be the amount corresponding to the amount of GDP per capita for the period of one or two years. Based on the results of 1999 in Russia the GDP per capita figure was approximately 31 thousand Rubles.

The rejected draft legislation envisaged the following scale of compensation per one depositor: 100% for the deposits not exceeding 20 minimum wages, 90% - not exceeding 250 minimum wages, 50% - not exceeding 1000 minimum wages.

Deposit size	Percentage of compensation	Compensation amount in Rubles under former minimum wage (83 rub. 49 kop.)	Compensation amount in Rubles under minimum wage =300 rub.
Under 20 min.wages	100	Under 1670	Under 6000
From 20 to 250 min.wages	90	Under 18952	Under 68100
From 250 to 1000 min.wages	50	Under 50261	Under 180600

In case the law does not contain any mentioning of a minimum wage then one could expect a simple substitution of the minimum wage term with its value in Rubles. If we are to take the value of the minimum wage as of the middle of 2001 (300 Rubles) then we will reach the sum of 180.6 thousand Rubles which is substantially larger than the estimated one based on the assumptions of the average deposit size.

The system of deposit insurance and the restructuring of the banking system

So far the set of issues requiring regulation of the relationship between the Corporation and the Central Bank remained insufficiently defined. This is the procedure for the introduction of a system of guarantees, the list of the banks participating in this system, their operations, relations between the Corporation and the banking oversight agencies.

At the first glance these are pure technicalities, but the efficiency of the future system very much depends upon them. Should one introduce such a system overnight, or should the list of the participating banks be expanded gradually? Should the banks be accepted into the Corporation based on the results of special inspections into their financial standing, or should one rely on the existing criteria, used to determine the financial status of credit institutions by the Central Bank? Will the Corporation in the future be monitoring the financial status of member banks or will it completely rely upon the Central Bank in passing out such definitions? In any case this must be a different criterion than the currently existing license for the right to attract money from individuals (by the middle of 2000 less than 3% of operating banks did not have licenses for working with individual depositors; their assets constituted 1% of the total amount of assets of all the Russian banks as of April 1, 2000).

In this respect one should definitely note the point of view championed by the experts from the Russian-European center for economic policy (RECEP)¹⁰, that it is necessary to exclude problematic banks from participation in the system of deposit insurance by establishing strict criteria of selection and by establishing a sys-

¹⁰ Enrico Peroti (Amsterdam University, RECEP), Steven Friz (EBRD), Knut Eggenberger (RECEP), Marina Maliutina (RECEP) Guarantees for bank deposits: international practice and the Russian problems, March 2000

tem of a permanent control over banks complying with such criteria. At the initial stage one could limit the number of banks participating in the system with the banks which during the defined period, for example one year, are qualified by the Central Bank as financially stable credit institutions (1st category banks). Each bank which was not included into the first group would be accepted individually after meeting the respective criteria.

Such an approach is not ideal. The system of attributing categories to banks already was the subject of some criticism by the Central Banks management for the facts of distorted reporting from locations. Besides the public acceptance of the fact that this or that banks was not able to become a member of the Corporation may turn into the factor of further deterioration of the banks' financial standing. But on the other hand the government at this point in time is not looking to maintain at a certain acceptable level the quantity of operating banks. And the banks will have sufficient lead time between the enactment of the draft legislation and the start of the functioning of the Corporation to encourage their shareholders to undertake recapitalization measures or join more successful institutions, in case internal reserves for the improvement of financial results are already exhausted.

What kind of financial resources for the Corporation in case it will have to conduct monitoring of financial statuses of the member banks, and what kind of relationships it will have with the Central Bank, if in time it is to turn into a center for the banking oversight? In case the oversight functions remain an exclusive authority if the Central Bank, then what will be the measure of its financial responsibility to the Corporation for the lack of timely decisions or an untimely provision of information? Irrespective of the way this last dilemma is resolved, trying to make this dependent upon "insurance" cases the Corporation's obligations to pay compensation – an

in the event of a revocation of a license and not the fact of a completion of the obligations to an insured party - do not seem to be the best of solutions. An introduction of a differentiation of insurance contributions depending upon the financial status of banks at the regional stage of the system's operation does not seem to be worth the while.

The functions performed by the Corporation in the deposit guarantee system bring about a natural need for the Corporation to have a sufficiently close access to the information about the state of the banks and a control over the processes, which may result in the reduction of the reserve fund. It seems to us that the minimum efficient level of authority for the Corporation is located above (although on a mandatory basis it includes) the ability for a remote analysis of the financial standing of banks (for example, by way of random checks in locations, holding of seminars with representatives of the banks' auditor, launching of an Internet site opened for complaints to bank clients). The maximum level might be envisaged by the Corporation acquiring the function of a prudential banking oversight agency (through transferring these departments from under authority of the Bank of Russia).

The issue of a real status of the Corporation should be resolved upon a specific government strategy for restructuring the banking system, which is a mandatory condition of its stable operation. If the functions of the Corporation were to be limited to that of a money bag, it will be quite probable that it would lead to expenditures that would take place without any serious analysis of the depth of the problems in the banking sector like was the case during the period of stabilization loans issued by the Bank of Russia in 1998-1999. It would be difficult to expect any growth of the authority of the national financial system in such a development. An opposing extreme – concentration inside the Corporation of the pru-

dential oversight functions and the deposit guarantee functions, which could lead to the same kind of consequences because of a deep conflict of interest and the concentration of a monopoly administrative resource in one place. In both extreme cases the most probable development will be a further growing of burden on the budget in case of even a slightly serious problem occurring in the banking system.

Being a part of the system of in-built checks in the banking system (along with the prudential oversight and the functioning of the Central Bank as a creditor of the last resort) – the system of the government deposit guarantees invariably touches upon a number of key elements in the structure of the banking sector. Besides the above mentioned components of this dilemma, which appear during its organizational stage do not finish the list of such problems. This takes us back to the issue of the government strategy in the area of the financial system reform. Unfortunately, as is shown by the draft of “The main guidelines of the social and economic policy of the Government of the Russian Federation for the long term perspective” it is not considered a part of the priority objectives. So one can only hope that the draft legislation “On guaranteeing deposits of citizens in banks” would eventually and finally turn into the Law, which would implement a fragment of the strategy, that has been left undefined at this point in time.

4.5. Russian real estate market in 2000: from depressive stability towards growth¹¹

The main tendencies of the housing market development in 2000

The analysis of the development of the real estate market in Russia conducted last year after the August crisis of 1998 makes it possible to conclude that the market by the of 1999 passed the stage of decline and went into the stage of *depressive stabilization*. The data received about the results of 2000 confirms this conclusion: out of 20 cities represented in the analysis the level of prices in December 2000 in 19 cities was either equal or higher than the level of prices in December 1999. Only in 1 city it was below that historical level.

¹¹ The current section uses the information from the housing market monitoring in 2000 which was conducted by PAH CABA, RMLS, "Contact-Estate" Agency, "MIEL" Agency (all located in Moscow), Information Publishing group "Real estate bulletin" (St.Petersburg), "DOM" real estate agency (Barnaul), Real estate information center of the Urals Chamber of Real Estate (Yekaterinburg), "Real Estate of Kaliningrad" Agency (Kaliningrad), the Siberian Real Estate Agency (Novosibirsk), the Perm League of Realtors and Evaluators, "Kamsk Valley" joint stock company, "Perm Real Estate Trading House" Agency (all located in Perm), TITAN Agency (Tver), "Real Estate Center" Agency (Ulyanovsk), "Institute of Housing Investments" Center(Krasnoyarsk), "BEST Realty" Real estate agency (Omsk), "Privat-Estate" real estate agency (Tomsk), North-Western Realtor Company (Yakutsk).

TABLE 4.10

Changes of average residential real estate supply in 1997-2000

City	Price denomination	Average price, \$/sq. m				Index			
		12.97	12.98	12.99	12.2000	1998/1997	1999/1998	2000/1999	2000/1997
Moscow*	USD	950	890	656	670/720**	0,94	0,74	1,02	0,71
St.-Petersburg*	USD	560	565	370	370	1,01	0,65	1,00	0,66
Yekaterinburg*	USD (mix)	535	335	220	336	0,63	0,66	1,53	0,63
Kaliningrad*	USD	620	470	330	323	0,76	0,70	0,98	0,52
N. Novgorod	USD	538	450	265	280	0,84	0,59	1,06	0,52
Khabarovsk	USD	390	240	200	220	0,62	0,83	1,10	0,56
Tver*	USD	355	265	186	203	0,75	0,70	1,09	0,57
Russia-1	USD	535	475	311	332	0,89	0,65	1,07	0,62
Perm*	Rub.	505	165	182	287	0,33	1,10	1,58	0,57
Yakutia	Rub.	660	230	155	282	0,35	0,67	1,82	0,43
Krasnoyarsk	Rub.	510	220	195	270	0,43	0,89	1,38	0,53
Novosibirsk*	Rub.	490	280	210	263	0,57	0,75	1,25	0,54
Tomsk	Rub.	400	147	136	210	0,37	0,93	1,54	0,53
Barnaul*	Rub.	380	175	163	170	0,46	0,93	1,04	0,45
Tiumen	Rub.	470	180	146	160	0,38	0,81	1,10	0,34
Kemerovo	Rub.	365	150	140	160	0,41	0,93	1,14	0,44
Ulianovsk*	Rub.	340	135	134	158	0,40	0,99	1,18	0,46
Omsk	Rub.	375	170	130	152	0,45	0,76	1,17	0,41
Petrosavodsk	Rub.	435	180	140	150	0,41	0,78	1,07	0,34
Astrakhan	Rub.	320	150	145	150	0,47	0,97	1,03	0,47
Lipetsk	Rub.	375	140	135	145	0,37	0,96	1,07	0,39
Russia-2	Rub.	432	187	162	205	0,43	0,87	1,26	0,47
Russia (regional centers)	-	650	533	387	13/431**	0,82	0,73	1,07	0,64

Notes:

* - the marked cities are represented by data which was calculated by a certified Russian Realtors Guild (RRG), the real estate market analysts according to a uniform method and also processed by the authors. The information about other cities was compiled from mass media reports, internet and are approximate.

** - the numerator contains estimations according to 1993-1999 method, and denominator – according to the new method.

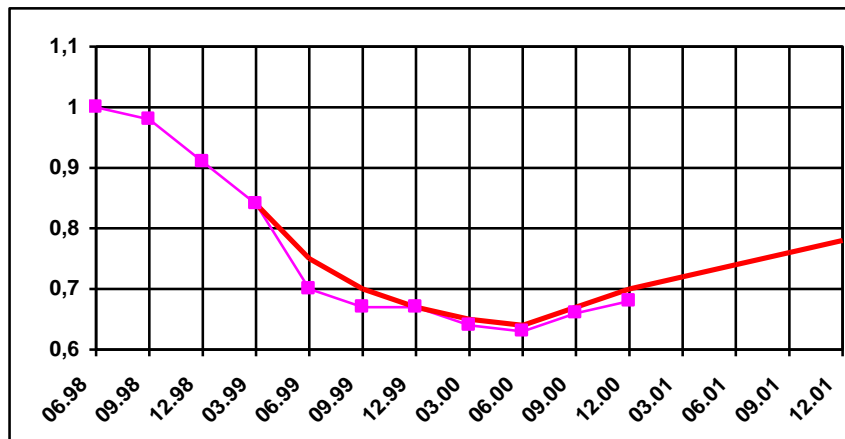
On the basis of the conclusion about stabilization of the residential real estate market and taking into account the factors which

influence prices of external phenomena, with regard to the residential housing market (macroeconomic, political), as well as internal mutual influence of primary and secondary market, state of demand and preferences (a projection of the dynamics of changes was made of an average dollar price index per 1 sq. Meter of a residential real estate in Moscow, the cities, where prices for real estate are denominated in dollars (**Russia-1**) and the cities where prices for real estate are denominated in Rubles (**Russia-2**). In the beginning of the year (before April-May) in Moscow and some other cities a lowering of prices was expected. Then after the summer stabilization a slight growth was forecasted towards the end of the year.

The real data on the cities in Russia which permanently monitor residential real estate and their comparison with the projection is given in table 4.10 and pictures 4.10-4.12.

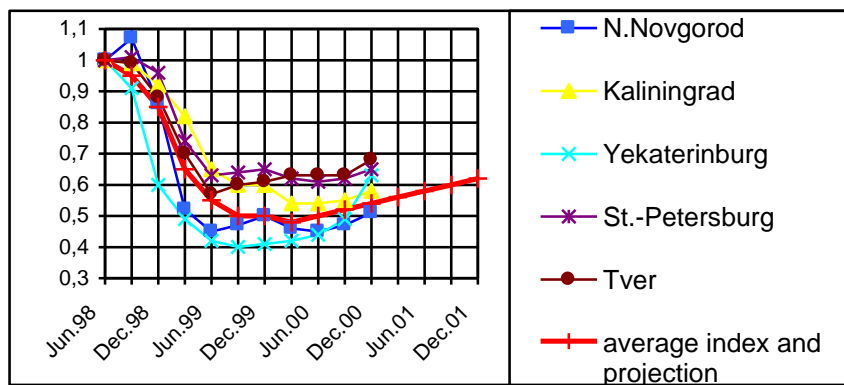
PICTURE 4.10

Projected and real change of dollar price index in Moscow



PICTURE 4.11

Average value (before 12.2000) and projection (after 12.2000) of real changes of indexes of dollar prices for residential real estate in the cities of Russia -1



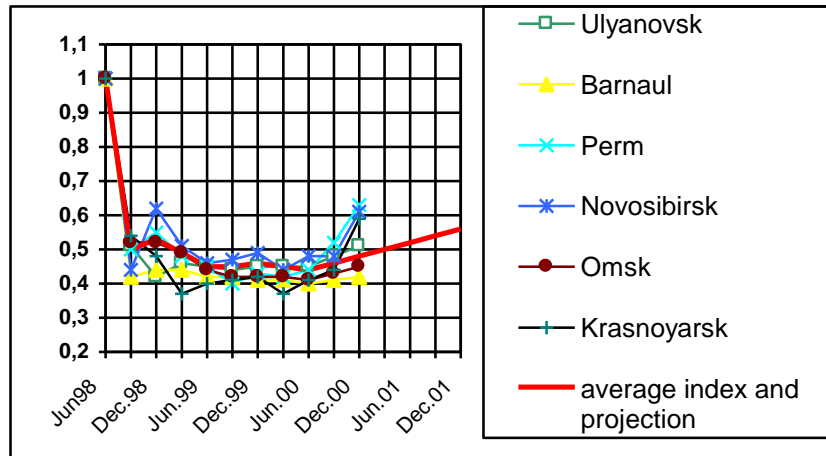
The information contained in the tables and pictures demonstrates that this projection was basically confirmed. Based on the results of 2000 one can not only acknowledge a stabilization of prices in the housing market, but also register an obvious tendency towards growth (separate issue is to what extent this growth will be stable). The reason for this transition from one stage to another was the change in general economic situation in Russia based on a certain revival of economic growth. The primary issue now is the issue of the quality of this growth, its influence on the level of life of the people, who in their term will determine to a great extent the tendencies in the housing market.

During the previous stages of *decline and depressive stabilization* changes in the housing market occurred simultaneously within the three groups of cities (Moscow, Russia-1, and Russia-2), and between the groups themselves they differed substantially. In the

second half of 2000 the stage of *growth*, individual peculiarities of situations in the Russian cities became important.

PICTURE 4.12

Average value (before 12.2000) and projection (after 12.2000) of real changes of indexes of dollar prices for residential real estate in the cities of Russia 2



Practically in all of the cities which were considered and which were located in the Asian part of Russia (including the Urals), prices for housing grew at rates which exceeded an average growth rate in the country (7%). Barnaul was the only exception. The maximum growth of prices for housing in dollar value in 2000 was noted in Perm (by 58%), Tomsk (by 54%), Yekaterinbug (by 53%), Nizhnevartovsk (by 43%), Krasnoyarsk (by 38%), and Novosibirsk (by 25%). One should especially note the growth of prices by 82% in Yakutsk: the direction of migration flow changed, people previously relocated to the northern territories started coming back together with demobilized military personnel, who previously also resided in Yakutsk.

On the contrary almost in all of the European part of Russia (including the Volga river area) prices for housing grew at rates which did not exceed the average indicator. Only Ulyanovsk was an exception, where prices in one year grew by 18%. The lowest growth rate of prices was noted in Moscow (2%). In St.-Petersburg they remained at the level of 1999, and in Kaliningrad they fell by 2%.

Differentiation of the pricing dynamics in the housing market is related to both the specific features of previous stages of crisis in the development of the cities, and the situation which evolved in this or other region during the stage of economic revival following the devaluation of the national currency in the fall of 1998. In the cities where during the crises prices fell most dramatically (with more favorable economic situation) these prices rebounded more quickly. Cities like Perm, Yekaterinburg, Tomsk and others are the centers of their respective regions, where statistics noted a very intensive growth of industrial production and other businesses for the past year then on average in the country.

At the same time in other cities of the revived market due to a not so favorable economic situation no positive changes took place, while in Moscow and St.-Petersburg prices in the residential real estate during the crisis went down to a much lesser extent, which determined the stability of prices in 2000.

The case of Kaliningrad should be noted separately, there the growth of prices for housing, which started in the summer and followed the tendency in the rest of the cities, was not that notable, in order to compensate for the decline of the first half of the year (annual change - minus 2%). The reason for this is within the political and economic situation. Temporary ban on free economic zones in the fall-winter of 2000-2001, an introduction of customs barriers and the resulting reduction of the flow of goods from the enclave

into Russia, the establishment of many production facilities, and negative diplomatic signals may not only cause the downfall of the rates of growth but also undermine the whole residential real estate market. In case the economic situation improves and the issues of the passport control and visa free travel between Russia and its neighbors are resolved with Russia planning to join the European Union a fast growth of prices for land, housing and other real estate in the cities and regions will start taking place.

Differentiation of the price and cost indicators between the groups of the cities in 1997-2000

Below one can see a generalized data of the dynamics of prices in residential real estate in 11 different cities of Russia (4 cities with Dollar denominated price, 6 cities with the Ruble denominated prices and the city of Moscow) during the period from 1997 to 2000 (table 4.11). In order to characterize the process of revival of the housing market in the post crisis period a very important feature was in the extent to which this decline could reach (the low point) in course of the three year period and the level reached by the start of 2001.

The data contained in table 2 shows that as the result of the index of price changes for residential real estate in December 2000 (December 1997 was taken as a basic point) in Moscow reached 0.71 (grew by 6 p.p. compared to the low point in May 2000) in the cities of the group Russia-1 (excluding Yekaterinburg) – 0.52-0.66 (increase by 4-9 points in relation to the low point), in the cities of Russia-2 group –0.41-0.57 (growth by 8.22 points). I Yekaterinburg, where the level of Dollar mass in the market during the period fluctuated considerably (and that was why it should be noted as the city with a mixed denomination of prices), as to the reached level of prices compared to pre-crisis December 1997 is compara-

ble to the cities of the Dollar group (0.63) and as to the growth from the low point –to the Ruble group (growth by 23 points).

TABLE 4.11

Characteristic points of price dynamics in Russian cities in the period from December 1997 until December 2000

City	Nominal currency	12.97	Low point		Level reached by 01.2001			
		\$/sq. m	Date	\$/sq.m	index	\$/sq.m	index	Index growth
Moscow	Dollar.	950	05.00	620	0,65	670/720	0,71	0,06
Yekaterinburg	Dollar (mixed)	535	09.99	214	0,40	336	0,63	0,23
Kalinin-grad	Dollar	620	04.00	293	0,47	323	0,52	0,05
St.-Petersburg	Dollar	560	06.00	349	0,62	370	0,66	0,04
Tver	Dollar	355	06.99	172	0,48	203	0,57	0,09
Barnaul	Rubles	380	02.00	143	0,38	170	0,45	0,07
Krasnoyarsk	Rubles	510	02.00	157	0,31	270	0,53	0,22
Novosibirsk	Rubles	490	03.00	199	0,41	263	0,54	0,13
Omsk	Rubles	375	05.00	120	0,32	152	0,41	0,09
Perm	Rubles	505	03.00	176	0,35	287	0,57	0,22
Ulyanovsk	Rubles	340	05.00	125	0,37	158	0,46	0,09

TABLE 4.12

Characteristic indicators of price dynamics in groups of cities with different price nomination (in dollar equivalent)

Groups of cities	Price nomination	Strongest decline, %	Growth from the low point of percentage points	December 2000 level against pre-crisis level in December 1997, % %
Moscow	Dollar	35	6	71
Yekaterinburg	Dollar (mixed.)	60	23	63
Russia-1	Dollar	38-53	4-9	52-66
Russia-2	Ruble.	59-69	7-22	41-57

TABLE 4.13

Rating of cities listed by decrease of different indicators of price dynamics of residential real estate (in dollar equivalent)

Cities	Nominal price	Price level in December 1997	Price index at low point	Price level in December 2000	December 2000 price index compared to December 1997	Index growth in December 2000 from low point
Moscow	Dollar.	1	1	1	1	9
Kaliningrad	Dollar.	2	4	4	8	10
St.-Petersburg.	Dollar.	3	2	2	2	11
Yekaterinburg	Dollar (mixed)	4	6	3	3	1
Krasnoyarsk	Ruble.	5	11	6	7	2-3
Perm	Ruble.	6	9	5	4-5	2-3
Novosibirsk	Ruble	7	5	7	6	4
Barnaul	Ruble	8	7	9	9-10	8
Omsk	Ruble	9	10	11	11	5-7
Tver	Dollar	10	3	8	4-5	5-7
Ulyanovsk	Ruble	11	8	10	9-10	5-7

Table 4.13 demonstrates strong leadership by Moscow, St.-Petersburg, Kaliningrad and Yekaterinburg in the housing market as to the absolute level of prices throughout 1997- 2000. These four cities were always in the lead before the crisis and by the start of the current year the situation remained the same although they sometimes changed the leading places among themselves. With that Kaliningrad ended in the group of the cities with the lowest value of price index in December 2000 compared to December 1997, while Yekaterinburg became the leader in the market revival rate towards the end of 2000:price change index for housing compared

to the low point of the price decline grew by 23 percentage points. Cities like Perm, Krasnoyarsk and Novosibirsk also became leaders in this revival keeping 5th-7th places in the absolute level of prices. Here one should note that Perm and Krasnoyarsk (together with Omsk) made a trio of cities with the sharpest decline in prices, based on the indicators at the low point of decline during 1997-2000. And by the end of 2000 it was Omsk which became the city with the most drastic decline in prices, where apart from this an absolute minimal price per housing was registered throughout the whole group of above mentioned cities.

A relative price for a residential real estate in prices of the basic period, which was December of 1997 might be considered as an important indicator of tendencies in the real estate market based on the analysis of 20 cities represented in table 1.

If we are to recalculate nominal Dollar and Ruble index price changes into comparable ones (taking into account both Dollar and Ruble inflation) of the prices of the basic period, then **IGS**¹² index (indicating change in the residential real estate prices with respect to December 1997) in December 1998 in Moscow had the value of 1.71, in Russia-1 cities – 1.62, Russia-2 – 0.79, and on the whole in the cities selected – 1.50 (table 5). In other words total cost of residential real estate in the selected cities grew as the result of the crisis 1.5 times (because of their increase in Moscow and Russia-1 cities).

¹².Calculation of IGS index is done according to the following formula: $IGS = I_{цр} / I_{ир} = I_{цд} / I_{ид}$, where $I_{цр}$ – housing price index in Rubles, $I_{ир}$ – consumer price index, $I_{цд}$ – housing price index in Dollars, $I_{ид} = I_{ир} / I_{дрд}$ – Dollar inflation index in Russia (with respect to the consumer price dynamics), $I_{дрд}$ – Ruble/Dollar devaluation index.

TABLE 4.14

**Indexes of changes in relative price for residential real estate
in comparable prices in the cities of Russia in 1997-2000**

	IGS		
	Dec.98/97	Dec.99/97	Dec.00/97
Moscow	1,71	1,24	1,10
St.-Petersburg	1,84	1,18	1,03
Kaliningrad	1,38	0,95	0,81
Nizhni Novgorod	1,53	0,88	0,81
Yekaterinburg	1,14	0,74	0,98
Tver	1,36	0,94	0,89
Khabarovsk	1,12	0,92	0,88
Russia-1	1,62	1,04	0,97
Novosibirsk	1,04	0,77	0,84
Yakutsk	0,64	0,42	0,66
Tiumen	0,70	0,56	0,53
Petrozavodsk	0,76	0,58	0,54
Omsk	0,83	0,62	0,63
Perm	0,60	0,65	0,88
Astrakhan	0,86	0,81	0,73
Kemerovo	0,75	0,69	0,68
Krasnoyarsk	0,79	0,69	0,82
Tomsk	0,67	0,61	0,82
Lipetsk	0,68	0,65	0,60
Ulyanovsk	0,72	0,71	0,72
Barnaul	0,84	0,77	0,70
Russia-2	0,79	0,67	0,74
Russia (regional centers)	1,50	1,07	0,99

In the following year of 1999 there occurred an overall decline in the cost of housing in comparable prices: in Moscow – by 47 p.p., in Russia-1 cities by 58, in the cities of Russia-2 group, which already went through the decline – by 1/5, only 12 percentage points. Nevertheless, generally throughout the cities analyzed by

the end of 1999 the relative cost of housing remained at 7 p.p. higher than by the end of 1997.

2000 was characterized by the process of an active revival of the housing market. However, correction of the level of prices reached by the end of 2000 with the account of inflationary factors shows that in comparable prices residential real estate in the cities with Dollar (Russia-1) and Ruble (Russia-2) denomination of prices cost cheaper than in December 1997: in Russia-1 cities – by 3 p.p., in Russia-2 – more than by ¼. Here one should note different directions of tendencies in the cities of these groups in 2000. Whereas in the cities with Ruble denomination of prices in 2000 relative residential real estate cost grew by 7p.p., then in the cities with Dollar denomination –it went down by a similar margin of change. So the return of the cost of the residential real estate in comparable prices to the original level of December 1997 throughout the cities analyzed took place because of a relative increase of the cost of real estate in Moscow by 10 percentage points despite its serious decline in the past year.

So the results of 2000 confirm our previous conclusions about the housing market in Russia having passed through the stage of *depressive stabilization* and now going through the stage of growth. Differences in *the level and rates of decline* between Moscow, Russia-1 and Russia-2 cities with insignificant variations within the groups now turned into the differences between the growth rates with the substantial variations within separate groups depending upon specific economic situations in the cities, and the regions. Despite substantially higher rates of growth in cities of Russia-2 group, the level of prices compared to the pre-crisis period in this group still remains the lowest.

Perspectives for 2001

The projection for the change of prices in the cities of Russia for 2001 was calculated in accordance with the Russian Realtors Guild methodology for forecasting prices for residential real estate, as an average in the group of the cities (individual features and peculiarities of these cities in the group were not taken into account) and as the middle term (monthly, seasonal fluctuations were not calculated),

The following factors were taken into account:

- the reached stage of market development (the start of the growth stage);
- the forecast of the general economic situation in the country (slowing down of the rates of growth compared to 2000: GDP – from 7.6 to 3-4%, real income – from 8.5% to 2-4%, savings in real terms – from 17.2% to 8-19%);
- the forecast of macroeconomic parameters (lower inflation from 20.5% to 12-14%, higher index of Ruble devaluation against the Dollar from 1.04 to 1.07. As the result the purchasing capacity of the Dollar in Russia which went down in 2000 15% will further go down in 2001 by additional 6%);
- further continuation of the pressure by the growth of the cost of the housing construction (in Moscow in the first place where this value grew by 40-45%), which might lead to the growth in sale prices in the primary market and later on in the secondary one.

Summarizing forecast: in 2001 in Moscow and other Russian cities a slight growth of prices for residential housing is expected – 0.5-1.0% per month, 8-10 percentage points per year. Much higher rates of growth will be seen in the cities of **Russia-2** group (the Ruble group) with a favorable political and economic situation in the regions (this does not relate to Ulyanovsk, but quite possible in

Barnaul). Slower rates will be seen in **Russia-1** (the Dollar group), with the exception of Kaliningrad, where it is not yet possible to project the results of the solutions of the current crisis situation and both scenarios are possible – both of the price downfall and its turbulent growth.

Activities in the Russian real estate market in the second half of the 90-s and its institutional structure

During the past year the State Statistics Committee of Russia for the first time published an official data describing activities and institutional aspect of the real estate market in Russia (tables 6-8).

TABLE 4.15

Number of intermediary transactions with real estate in 1995-1999

	1995		1996		1997		1998		1999	
	Thou- sands	In % Of results	Thou- sands	In % Of result	thou- sands	In % Of results	thou- sands	In % Of result	thou- sand	In % Of result
Transac- tions – total out of those	783,9	100,0	862,3	100,0	371,3	100,0	171,5	100,0	201,0	100,0
- with residential content	772,8	98,6	846,1	98,1	333,7	89,9	164,1	95,7	192,3	95,7
- with commer- cial con- tent	4,3	0,5	7,2	0,9	7,2	1,9	6,8	4,0	6,4	3,2
- with land (land lots)	6,8	0,9	9,0	1,0	30,4	8,2	0,6	0,3	2,3	1,1

Source: Russian annual statistical bulletin: Stat. coll./ M., Goskomstat of Russia, 2000, p. 475.

The official statistical data demonstrates that throughout the whole period of 1995-1999 transactions with residential housing were dominant in the general structure of intermediary transactions in the real estate market constituting 96-99% of their total number.

- A turbulent growth of activity according to Goskomstat data surprisingly happened in 1996 which was considered the year of an acute political instability of the 90-s in the country. The total number of the registered intermediary transactions grew by 10%, the number of transactions with commercial real estate was far in the lead in its growth (by 67%) and transactions with land (by 32%). The next year in 1997 statistic noted more than twofold reduction of the total number of transactions because of the residential segment, where it was reduced approximately by 2.5 times. The number of transaction with commercial real estate remained the same and those involving land grew drastically (3.4 times).
- The decline of activity in the real estate market in the year of financial crisis (1998) was approximately similar to 1997 compared to 1996. This time it touched upon all of the market segments, however very unevenly: in residential market – 2 times, in commercial real estate – only by 6%, and land – 50 times (!!!). Certain revival of the market in 1999 resulted from greater number of transactions with residential real estate (by 17%), and land (3.8 times). The number of transactions with commercial real estate, on the contrary slightly diminished.
- As the result the structure of the real estate market in 1999 compared to 1995 saw the growth of the share of transactions with commercial real estate more than by 6 times (from 0.5% to 3.2%) because of the lower share of transactions with residential real estate. The share of transactions with land practically remained unchanged at the level of 1%.

It is interesting to compare this data with the one collected by the Russian Guild of Realtors, which covers residential real estate market in several cities (table 4.16).

TABLE 4.16

Indicators of residential real estate market volatility in some cities in Russia in 1992-1999 (total number of transaction (purchasing-selling, changing, pledging) for one year, in thousand units).

City	1992	1993	1994	1995	1996	1997	1998	1999
Moscow	12	55	70	88	80	90	82	85
St.PetersburgP	2	11	12	23	55	56	60	58
N. Novgorod	1	4	3,5	5	11	20	18	19
Yekaterinburg	0,4	7,0	12,3	15,6	18,5	21,9	20	22
Tver	0,1	0,3	5,3	3,9	3,7	3,2	3	3,5
Total	15,5	77,3	103,1	135,5	168,2	191,1	183,0	187,5

Source: Russian Guild of Realtors, 2001.

Based on the above data it is clear that in 1996 the major cities contained therein (the basis is constituted by Moscow and major cities with over a million in population with Dollar denominated price) demonstrated a growth of activity in the residential real estate market. Total volume of transaction in this group of cities in 1995 amounted to 135.5 thousand (according to Goskomstat of Russia) in the country in general – 772.8 thousand), in 1996 – 168.2 thousand (according to Goskomstat data 846 thousand in Russia in general), These tendencies were of a single direction, although the cities analyzed by the Russian Guild of Realtors the rate of growth of the number of transaction 2.3 times exceeded a similar indicator, provided by the official statistics. With that according to Russian Realtors Guild data in the Moscow residential real estate market the number of transaction slightly went down (from 88 to 80 thousand).

But starting with next year 1997 the tendencies traced from the data from Russian Guild of Realtors and the Russian Committee for Statistics were different. In the Guild's data the volume of transactions grew from 191.1 thousand (by 14%) and in the Goskomstat's – fell down to 333.7 thousand (by 60%). In the crisis

year of 1998 these indicators amounted to 183 thousand (decline by 4%) and 164.1 thousand (decline 2 times) respectively, i.e. according to official data throughout the country fewer transactions were registered than the Guild was able to track in selected 5 cities.

Finally in 1999 according to the Guild's data activities in the real estate markets in the cities it covered revived to almost of the level of 1997 (187.5 thousand worth of transactions), and in Moscow this marker was exceeded. While according to Goskomstat this figure amounted only to 55% of the pre-crisis level (192.3 thousand worth of transactions). At the same time according to official data this revival was going in a much more intensive fashion (growth of 17.2%) if compared to the Guild's selection (growth – 2.6%).

So it seems that the data from Goskomstat does not completely conform to the data from the Russian Guild of Realtors received from the agencies registering transactions with real estate and the expert data from realtors supplied from 56 Russian regions, who are members of the Russian Guild of Realtors. The most vivid feature of this is the fact of exceeding in 1998 of a number of transactions in residential real estate according to the Guild's data which consisted only out of 5 cities (183 thousand) over the number of transactions registered by official statistics from the whole country (164.1 thousand). In 1999 these figures were very close to each other (187.5 and 192.3 thousand).

Along with the real estate market its infrastructure was also being developed. According to Goskomstat in 1999 compared to 1995 the number of organizations engaged in intermediary activities in real estate market grew 2.2 times, and the quantity of employees involved in this sector 2.6.times.

TABLE 4.17

Main indicators of infrastructure of intermediary activities related to transactions with real estate in 1995-1999

	1995	1996	1997	1998	1999
Number of entities (by the end of the year)					
- total	730	906	1090	1156	1628
- in % of previous year		124	120	106	141
Average number of employees (without outside vendor representatives and workers of non-budget financial).					
- total	6155	8242	10438	11425	15976
- in % of previous year		134	127	109	140
- estimated per one organization	8	9	10	9	10

Source: Russian annual statistical bulletin: Stat. coll./ M., Goskomstat of Russia, 2000, p. 475.

This information contradicts the data from the Russian Guild of Realtors, according to which in Moscow only the number of licensed realtors reached 1100-1200, in St.-Petersburg –600, in ten major cities (Nizhni Novgorod, Samara, Yekaterinburg, Rostov-on-Don and others) – 100-300, in twenty medium sized regional centers – 50-100, and in almost 50 smaller cities – 10-30, in nine hundred of the remaining cities – 1-5, in townships – 0-1. The total number of realtor companies operating in all of the cities (1087 in 2000) and in townships and settlements (1872 in 2000) of Russia. Russian Guild of Realtors estimates this number to be 11-12 thousand. Such a significant discrepancy also requires research analysis. Nevertheless even according to official data, it is obvious that in the crisis year of 1998 intermediary activities in real estate transactions as a sphere of business and employment continued to grow, although the rate of its growth were the lowest in the whole five year period (1995-1999).