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Introduction

Economic and Political Results for 2001 and Prospects for Strengthening Economic Growth

Results of the first decade of post-Communist reform

The year 2001 concluded the first decade of post-Communist transformation, Russia's development in a regime of market democracy. The period witnessed difficult and complex processes of the transformation of Soviet socialism into a new society. A tortuous and contradictory path gave rise to acrimonious debate about the very nature of reform, its effectiveness and appropriateness, about whether there were alternative ways of meeting the challenges that the country was facing.

One of the key points of the debate of the 90s was to what extent the Russian problems were unique to this country, whether they were inherent in the historical experience as well as national and cultural features of Russia's development, and, accordingly, to what extent universal approaches and the experience of other countries were applicable in developing and implementing the program of post-Communist restructuring. This is all the more important because an answer to these questions makes it possible to summarise the results of the first post-Communist decade and formulate some important problems of Russia's further progress towards the market and democracy.

At the end of the 80s Russia (rather, the USSR) encountered four formidable challenges associated with four different transformation processes. It was those processes that determined the country's development throughout the 90s. While not necessarily inter-related per se, they proved to be intertwined in Russia, substantially

affecting each other, and, more importantly, the economic and political development of the country.

First, Russia was faced with the challenges of the post-industrial epoch. Transition from an industrial to a post-industrial society is accompanied by severe structural and macroeconomic crises, such as those the Western countries experienced from the 70s onwards. Thanks to the favourable conditions of world markets, the USSR could delay the beginning of structural adjustment, only to experience even more painful adjustment when there was no longer any escaping it. The structural crisis of the Soviet economic system, at the height of which came a drastic decline of the now Russian economy, resulted from the same processes, which with reference to Western countries in the 70s were described as «stagflation».¹

Intense discussions about the nature of structural transformation continued throughout the 90s. Some authors described the output drop in certain conventional sectors of the economy as deindustrialization, although a more in-depth analysis of the ongoing processes allows the nucleus of a new, post-industrial structure to be discerned in the structural change that is going on currently (see Table 1). Telecommunications and electronic industries are booming² (since 1998 the latter has been growing by as much as one

¹ Description of the Russian crisis as the crisis of an industrial society is found in a number of papers (see: Bauman Z. *A Post-Modern Revolution? // From a One-Party State to Democracy*. Amsterdam : Rodopi, 1993; Rosser J.B., Rosser M.V. *Schumpeterian Evolutionary Dynamics and the Collapse of Soviet-Block Socialism // Review of Political Economy*. 1997. Vol. 9. № 2).

² In the 90s the electronic industry introduced about 700 new state-of-the-art products and started manufacturing 800 new consumer products. In 1999 output growth was 46%, in 2000 – 37,7%. Exports of electronic products have grown dramatically over recent years to \$70 mln–\$80 mln annually, mainly to non-CIS countries.

third annually). Change to more advanced products is going on in the chemical and metallurgical industries. The number of educational institutions is increasing markedly, as are the numbers of undergraduate and post graduate students. Of course, this trend is not absolutely predominant, and whether it will be sustained or not will greatly depend on the efficiency of economic policy and on the government's ability to promote favourable change.

Table 1. Some indicators of social and economic development in the 90s (1991 = 100% unless stated otherwise), %

	1992 год	1998 год	1999 год	2000 год
Education				
Number of universities	103,3	176,1	180,8	185,9
Number of university students	95,5	130,3	147,5	171,6
Number of university graduates	104,4	123	136,3	156
Number of faculty members	1993 г. = 100%	115,4	121,7	125,5

Table 1 (cont'd)

	1992 год	1998 год	1999 год	2000 год
Production				
Video-cassettes	107,7	1157	944	807,5
Share of sophisticated products in the paint and varnish industry	72	82	85	86
Share of electric arc steel and oxygen-converter steel in total steel production, %	50	72	72	73
Share of continuous casting steel products, %	28	52	50	40
Production of nonferrous metals	99,4	111,4	117	120,6
Transport				
Cars per 1,000 population	107,9	192,1	201,7	208,5
Metalled roads per 1,000 square meters of territory	103,3	111,1	111,3	111,6

Tele-communications				
Number of general access telephone lines	101,6	123,8	130,7	135,2
Number of household telephone lines per 100 households	105	137,6	147,6	155,5
Total length of long-distance telephone channels	106,3	252,8	351,1	509,1
Share of digital telephone channels in total long-distance telephone channels, %	1,5	56,9	69,1	76,9
Number of registered fax-machines	206,2	1706 (1997 г.)		
Number of pagers	100	3838	4118	5065
Number of cellular phones	100	12695	23600	55524

Source: Goskomstat

Second: there was post-Communist transformation as such going on in Russian society. Of course, the most difficult was transformation of ownership, i.e. privatization on a national scale. However, this sort of transition did not constitute a unique Russian experience. Post-Communist change was simultaneously going on in about 25 countries, and Russia was not a pioneer in this respect: a number of countries had embarked on such transition two or three years earlier, which provided the post-Soviet republics with some, although not very rich, experience.

Third: Russia was faced with a huge macroeconomic crisis resulting from populist economic policies (beginning in the second half of the 80s), which led to the collapse of the fiscal and monetary systems, extremely high inflation and output decline. It has to be mentioned, however, that the phenomenon of macroeconomic crisis and ways of handling it had been thoroughly studied by the end of the twentieth century. In the post-war period many European, Asian and Latin American countries had to grapple with similar problems. Moreover, Russia itself had a certain positive experience of pulling out of a macroeconomic crisis in 1922—1923.

Fourth and last, the politico-economic, macroeconomic and structural changes that Russia faced at the turn of the 90s were accompanied by a full-scale social revolution. Systemic transformation, which changed the social set-up of the country radically, was being brought about in a situation of a weak state, which in fact is one defining characteristic of a revolution.³ By the time the post-Communist transformation was launched, practically every institution of the state had been all but in ruins, and their restoration was essentially the central political objective of the first post-Communist decade. Moreover, economic reform advanced only to the extent that the institutions of the state were restored, which made the pace of reform much slower than in most other post-Communist countries. Among the countries undergoing post-Communist transition revolutionary transformation was a unique Russian feature, though it was not entirely new in European history.

So, Russia's development in the last decade was indeed quite peculiar. But this specificity was due not so much to cultural and historical factors as to the very fact that the above four processes were simultaneous. In view of other countries' or Russia's own historic experience, there was nothing unique or unknown about each of those processes. What was unique was their combination in the same country at the same time. It is this combination that gave rise to the peculiar processes which determined the specificity of Russian transformation and puzzled many scholars dealing with issues of post-Communism.

At the end of the nineties signs emerged that at least three of the four transformation processes had run their course.

First of all, *macroeconomic stabilization had been achieved*. The crisis was quite protracted (lasting about ten years) but not un-

³ For more detail see Mau and V.A. Starodubrovskaya I.V., *The Challenge of Revolution*, OUP, 2001.

precedented in economic history. Stabilization was brought about through an array of standard measures (liberalization, fiscal and monetary restraint), and its success paved the way for renewal of economic growth.

Of course, stabilization does not appear granted once and for all. An economic system is not guaranteed against the authorities' misdeeds or their unsound and populist decisions. In 1999–2000 the government successfully passed its first serious macroeconomic test, i.e. coping with favorable prices for Russian exports.

The processes of revolutionary transformation appeared practically exhausted. The restoration of the state is very much in evidence. Macroeconomic stabilization has gone in step with political stabilization. In 1999, the analysis of political parties' pre-election programs showed the reference points of the main political groups to be converging⁴, however, important the differences between them. A common system of fundamental political values, which are above political dispute, is emerging. Specifically, no one calls into question private property as the basis of economic and political life (although appraisal of the outcome of privatization still arouses controversy); no one calls for an end to tight monetary and fiscal policies. (Until quite recently inflationary financing of the budget deficit was widely thought to be acceptable); all groups (even the leftist ones) support the policy of alleviating the tax burden, everyone accepts the need to shift the emphasis of policy to implementation of deep institutional reform. Of course, practical recommendations of political groups still differ substantially but those differences are no longer so deep as to constitute a threat to political stability. The ability of the authorities to secure basic macroe-

⁴ IET. Rossiyskaya ekonomika v 1999 godu: Tendentsii i perspektivy. V.: IEPP, 2000, pp. 313–319; Dmitriyev M. Evolutsiya ekonomicheskikh program veduschikh politicheskikh partiy i blokov // Voprosy ekonomiki. 2000. No 1.

conomic stability is the most important politico-economic characteristic suggesting that the crisis has been overcome.⁵

The year 2001 brought new elements to the pattern of post-revolutionary politico-economic stabilization currently taking shape in Russia. While 2000 saw the emergence of *de facto* domination of the Duma by the executive branch, which could rely on support of either the right or the left (depending on the nature of proposed legislation), now a steady pro-government majority is being formed in the Lower House. Now practically every new bill sponsored by the government can rely on support in parliament, which is very important for further operation of the political regime. On the one hand, there is less political haggling over each specific bill, hence more consistent pursuit of the government's chosen course. On the other hand, a system of relations between the government (relying on its parliamentary majority) and the opposition (the parliamentary minority) is assuming the form typical of stable democratic societies.

One could further claim that *the goals of post-Communist transformation have been successfully accomplished*. This conclusion tends to provoke especially strong objections and, therefore, needs to be clarified. The Communist system was distinguished by three main political characteristics: a totalitarian political regime, absolute domination of state ownership in the economy, and short-

⁵ High inflation is not only an economic but also a political indicator. Indeed, inability of the authorities to implement a variety of macroeconomic stabilization measures results from their weakness and resulting dependence on the balance of various interest groups seeking soft monetary and fiscal policies. This is exactly why macroeconomic stabilization hinges on a strengthening of political institutions, and hence is one of the most important criteria of political stabilization.

age of goods as a basic constituent of economic and political life.⁶ By the end of the 90s three main features of Communism had been eliminated in Russia. Of course, this does not at all mean that Russia had fully overcome the crisis that ushered it into the nineties. However, severe structural and macroeconomic problems which Russia is still facing and which make it vulnerable to external shocks, are not, strictly speaking, a legacy of the Communist system. They reflect rather the development and crisis of the industrial system, and it is no accident that practically all countries which have had to cope with transition from an industrial to a post-industrial society have faced similar problems and challenges.

So, the dominant socio-economic problem confronting the present-day Russia is the crisis of the industrial system and establishment of the socio-economic basis of a post-industrial society. This process defines the main challenges that the country will need to meet in the coming decade.

Politico-economic results of 2001

Institutional changes have become the focus of the current stage of economic reform, coming to the fore now that the task of microeconomic stabilization has been successfully accomplished. Strictly speaking, during the first post-Communist decade issues concerned with establishment of a new system of institutions also played an important role (since privatization is one of the most sig-

⁶ The inseparable link between Communism system and shortage of goods was shown at the very start of the Communist experiment (see Brutskus B.D. Problemy narodnogo khozaystava pri sotsialisticheskom stroye // Ekonomist. 1922. No 1–3; Novozhilov V.V. Nedostatok tovarov // Vestnik finansov. 1926 No 2). Curiously, it was in fact acknowledged by J. Stalin. In “Economic Fundamentals of Socialism in the USSR” “the law of the faster growth of needs compared to ability to meet them” is referred to as one of the fundamental laws of society built under his guidance. (Stalin J. Works. Volume 16.: Pisatel, 1997).

nificant institutional changes).⁷ However, institutional change could not have become more purpose-oriented and consistent before the goals of economic and political stabilization had been achieved. This is only natural, since social and economic instability tends to undermine the normal working of economic institutions, primarily that of private property.

2001 saw the first steps towards implementation of the Strategic Program, whose development was initiated by V. Putin in 2000 and which has become known as the Gref Program. The 10-year program is supposed to be detailed in documents covering a shorter period and containing the list of laws to be developed and adopted year by year. Accordingly, in the summer of 2000 a package of measures for 2000–2001 was approved. These were implemented in 2001 (following some revision). In the spring of 2001 a program of measures for implementation in 2002–2004 was approved.⁸

The objectives covered hitherto include tax reform, fiscal reform, the Land Code, the labour legislation, pensions reform, deregulation (streamlining of red tape), reform of natural monopolies,

⁷ Hence one cannot help wondering at repeated accusations by the critics of Russian reform that the reformers of the 90s underestimated the importance of institutional change.

⁸ The main documents were as follows:

- Principal directions of short-term socio-economic policy of the RF Government (approved at the meeting of the RF Government on June 28 2000);
- Plan of the RF Government's activities in 2000–2001 with regard to social policy and modernization of the economy (approved by the RF Government order No 1072-r of July 26, 2000), amended by the RF Government order No 933-r of July 14, 2001);
- Strategy of Russia's socio-economic development for the period up to 2010 (discussed by the RF Government and submitted to the RF President in May 2001);
- Program of medium-term socio-economic development 2002–2004 (approved by the order of the RF Government No 910-r of July 10 2001).

banking reform, reform of customs legislation, development of financial markets and moves towards WTO accession. Unification of legislation across the country (elimination of regional separatism), judicial reform and reform of government machinery were to become important political components of economic reform. All these changes aimed to *establish a favorable investment and business climate, thereby providing the basis for sustainable economic growth.*

The sheer scope of the agenda threatened practical implementation of the program, dispersing efforts and preventing concentration on specific economic and political problems to be addressed. Even without this the dilemmas of implementation were severe enough.

On the one hand, the fastest possible implementation (or at least the beginning of implementation) of the bulk of planned changes had to be secured, both because of the political cycle (initial confidence and goodwill available to President Putin) and a kind of «revolution of rising expectations» affecting the general public along with investors. *On the other hand*, institutional reform is much more individualized and country-specific and, therefore, requires much more extensive technical (economic and legal) groundwork than financial stabilization (where practically universal international experience is available); hence, it took much longer to prepare. At the same time, identification of priorities and concentration of efforts on their practical (political) translation into at least draft laws turned out to be a problem with no theoretical solution.

All this was reflected in a peculiar sequence of events around implementation of the 2000-2001 program. Immediately after the appointment of Mr. Putin's administration and M. Kasyanov's government in May 2000, important steps to restructure federal relations and change the tax system were undertaken. Reform of the Federation Council and establishment of the institution of the Pres-

ident's authorized representatives in the federal *okrugs* (larger regions) were to promote unification of law across the country. A drastic cut in the personal income tax rate and introduction of a regressive payroll tax showed the willingness of the authorities to take resolute steps to improve the economic climate.

However, after these first two steps had been taken, the pace of reform implementation slowed. What followed was protracted coordination of draft documents between government agencies and interest groups represented in parliament. The above-mentioned technical difficulties of developing and drafting laws and regulations, many of them without precedent in the practices of other countries, also played a part. Deregulation, reform of natural monopolies, banking reform, etc., required not only declarations of general principles but also a host of concrete documents explicitly interpreted and built into the Russian legal framework.

None of this was surprising. However, political consequences of such a slow-down in the pace of reform could have been quite detrimental. Investors, although they welcomed the Strategic Program, from the very start doubted the government's ability to put it into practice. Those doubts seemed to have been confirmed. Out of more than one hundred items in the Program planned for implementation in 2000–2001, little more than a dozen were fully implemented.⁹ Many had only just been approved by the government after lengthy coordination and were unlikely to be accepted by the

⁹ To be more specific, out of 119 items in the Government action plan 78 items were to have been implemented by March 15, 2001. Actually only 51 measures had been implemented in full or in part by that time. In practice this meant that most of the documents that were to have been issued, were still being refined or coordinated within the government itself. At the same time, many of them were draft laws that were subject to passage through the Federal Assembly (Monitoring of the progress of the Program implementation was conducted by the Russian European Centre for Economic Policy (RECEP)).

Duma deputies, since some government agencies intended to oppose their adoption on their admission to the Duma.

The package of deregulation laws was making its way through the Government with difficulty, as it affected the interests of most of the agencies who were unwilling to cede any of their powers. The new sections of the Tax Code (primarily the corporate profits tax) were languishing in the Duma committees, which launched a practically endless process of reconciling interests of individual industries and sectors of the economy, all of them with powerful lobbying potential and seeking to secure the maximum number of tax breaks by referring to the peculiarities of their respective industries and the need to boost investment there. Taxation of mineral resources hit similar snags; demands to allow for innumerable special factors in relation to mineral deposits made the taxation system cumbersome and susceptible to corruption. Pensions and labour legislation was also bogged down in coordination and reconciliation procedures. Three versions of the new Labour Code collided in the Duma. Reform of the electricity monopoly UES stirred up fierce infighting within the executive branch itself, with regional governors summoned by the authorities as possible umpires. The new system of customs tariffs developed and approved by the government failed to be put into effect.

True, the concept of railway reform was approved, but the transformation model selected was based on the ideas originally put forward by the Railway Ministry (establishment of a super-monopoly called The Russian Joint-Stock Company Railway as the starting point of reform), which raised doubts about the transparency and effectiveness of further steps.

Finally, the row at the beginning of 2001 over the repayment of debt to the Paris Club did nothing to enhance the image of the new wave of Russian reform. Everything pointed to poor judgment here:

an attempted unilateral refusal to pay the debt and a bitter debate within the executive branch (between the Government and Presidential Administration) that was conducted publicly, followed by reversal of the initial decision. Even though the final decision to comply with the debt repayment schedule was plainly sensible, such vacillation by the authorities always harms their image in the eyes of the public.

So, by the spring of 2001 it had become evident that swift action was wanted to improve the outlook drastically. And before long signs emerged of a new phase of consolidation of power being carried out in two directions.

On one side, political institutions were reconfigured. The Federation Council was transformed into a standing body. A semi-formal association named *Federation* was established, made up of members of the Upper House, committed to consistent support for the initiatives of the executive branch and effectively holding a majority stake in the Federation Council. Thus the tacit rule that the Upper House is non-partisan and focused only on the interests of the regions was set aside.

Parallel processes were in progress in the State Duma. The consolidation of *Yedinstvo* (Unity), *Otechestvo* (Fatherland) and *Vsya Rossiya* (All Russia) into a national party meant the establishment of a pro-presidential majority in the Lower House. Earlier, in 2000, this majority had been secured *de facto* – pro-presidential factions could always form alliances with the right or the left; but to secure support for government initiatives, agreement had to be sought and majority formed for each individual bill. By contrast, in the new situation any initiative of the executive branch automatically gets support. So for the first time in recent Russian history a majority government holds office in the country.

Of course, this substantially simplifies implementation of government policy. However, the responsibility of the Cabinet for the quality of bills put forward by government agencies has been drastically increased, for now the introduction of bills in the Duma is likely to switch on «the voting machine». Especially, because, strictly speaking, the parliamentary majority supports the government as a proxy for the President. This support is to a large extent personal and non-ideological. Therefore, thorough evaluation of proposed bills in parliament becomes much less likely; the source of the bill being more important to the parliamentary majority than its substance. Hence it is with the Government that the real decision making as regards economic policy will now rest.

On the other side, the progress of amendment and passage in the Duma of socio-economic bills has been considerably streamlined. The government agencies were urged to agree and approve documents speedily. Draft laws on deregulation and pensions reform were laid before the Duma. The executive branch agreed in some measure to meet the legislators halfway. This primarily concerned the Land Code, from which the section on the sale of agricultural land was deleted. With regard to the Labour Code the compromise was more formal than real – it was based on a draft elaborated by some Duma deputies but very close to the Government approach.

Finally, there was a breakthrough in the area of tax legislation comparable with the achievements of 2000. After protracted and fruitless debate over the profit tax rates and a variety of tax breaks the Government and the Duma ventured upon a decisive step: the corporate profits tax was cut drastically to 24% with practically all tax breaks, including investment credits, abolished. Similar decisions were made with regard to mineral taxes, which were consolidated in a single tax, with its administration radically simplified.

Some progress was also achieved in the reform of natural monopolies. The Government approved the outline of the railway and UES (electricity monopoly) reform and replaced the top management of Gazprom. Of course, this is only the beginning, and the outline proposals themselves draw sharp criticism from various political and economic groups. So far, however, only the preliminary stage of reform is being implemented, involving the drafting of the laws, to be submitted to the Government and introduced into the Duma. What kind transformation is really intended will become apparent after the drafts have been produced and presented to legislators for debate.

Thus, work to establish the legal framework of proposed institutional reform is in full swing. While it has made noticeable progress, a real breakthrough has yet to be achieved. A number of aspects of legislative work, their successful development or, *au contraire*, obstruction, can be regarded as a touchstone of the effective advance of reform. Those aspects include:

- adoption of the law on the sale of agricultural land. The main issue here is, of course, whether the executive branch will be willing to insist that the clause in the Constitution on private ownership of real estate should be applied to agricultural land;
- prospects for the adoption of the Civil Code. The principal issues in this respect are the approval of the third part of the Civil Code and amendments reducing the statute of limitation as regards privatizations from ten years to three;
- further steps to adopt the Tax Code;
- adoption of the pensions legislation, which is under consideration by the Duma. Especially important is the issue concerning schemes for private pension funds, operation, their competitive operation and stability on the market;

- prospects for further progress in deregulation. Approval of laws on registration, licensing and inspections and audits is only the first step. These laws need to be made effectual by amending laws and regulations governing the operation of the police, sanitary inspectorate and other agencies, and also by adopting a further package of laws on the regulation of entrepreneurship (certification and standardization, self-regulated organizations).

Achievement of these goals will be an important step towards establishment in Russia of an institutional system consistent with the idea of market democracy in a post-industrial era. However, important as those goals are, they do not exhaust the list of top priorities, which the country will have to address in 2002 and which will dominate the agenda of the executive authorities in the run-up to the elections.

Current strategic priorities of Russia's socio-economic policy

The focus of Russia's current and medium-term economic policy is the creation of conditions for fast economic growth in parallel with structural transformation of the economy in the spirit of post-industrialism. This implies addressing the problems of «catching-up». Russia faced problems of this nature about a century ago but that was in relation to challenges of the industrial era. The problem of catching-up development is a matter for separate study, going far beyond the scope of this article. Here we consider only those elements of policy, which have clearly come to the forefront.

There has been a new turn in the debate on mechanisms for achieving sustainable growth. When the Strategic Program was being prepared in 2000, three key alternative strategies were put forward: a dirigiste one (involving enhancement of the regulatory and redistributive role of the government, through its direct participa-

tion in investment); a liberal one involving drastic reduction in the government budget's share of the economy) and an institutional one (development and enforcement of »rules of the game«, encouraging businesses and investors to operate in Russia).¹⁰ In its Strategic Program the Government opted for the third of these approaches. However, actual developments in the sphere both of economic policy and business have placed further questions on the agenda.

A need to choose between three options resurfaced. Whilst the first option is active industrial policy by the government; the second one implies enhancement of the role of major conglomerate enterprises of the biggest companies (financial-industrial groups or vertically integrated companies) in investment (and organization in general), and third – development and strengthening of institutions of a modern market democracy. The three approaches are genetically related to at least two of the above three strategy options. The main difference is that whereas the debate in 2000 was somewhat speculative and mostly based on economists' ideas of the best way to develop, the focus now is on actual current developments in Russia's economy.

Two specific trends are discernible. First, the government is determinedly pursuing institutional transformation in an effort to improve the business climate. Second, establishment of vertically integrated companies has been stepped up. Such enterprises made up of an assortment of businesses and banks, are starting to pursue active investment policies. A more favourable investment climate is believed to be prevalent within such agglomerations, since investment within a corporate organization avoids the heavy transaction costs caused by the government's inability to secure contract en-

¹⁰ For details see: IEPP. Rossiyskaya ekonomika v 2000 godu: tendentsii i perspektivy. M., IEPP, 2001, p. 18.

forcement.¹¹ It is only natural that a public debate should have begun on ways of boosting economic growth and overcoming constraints (or negative trends) of the two policy approaches.

Active government industrial policy implies identification of structural priorities (primarily sectors) and promotion of investment; substantial expansion of government demand and its use as a major factor in enhancing business activity; real appreciation of the rouble to encourage imports of machinery and components and possibly support for import substituting industries through measures of tariff policy. Reliance on integrated business groups is inseparable from this model, since they can be regarded as instruments and vehicles of government industrial policy.¹² The main drawbacks of this model are first, that in a post-industrial economy it is impossible in principle to select industries as priority targets for support; and, secondly, the high cost of mistakes in making such a choice, plus the low efficiency of government investment, which has been proved repeatedly in practice. In addition, industrial-financial conglomerates tend to impose their interests on society both by «nationalizing losses» and by persuading the authorities to substantially restrict competition from foreign companies as much as possible.

¹¹ For details see: Dynkin A.A., Sokolov A.A. *Integrirovannyye biznes-gruppy – proryv k modernizatsii strany*. M., 2001, p. 13

¹² A. Belousov offers probably the most accurate and balanced description of such a model; “This approach requires clear economic policy seeking encouragement of consumption and investment, and, of course, it rules out any rouble devaluation. The main constraint here is poor competitiveness of the domestically oriented sector, which is unlikely to be improved rapidly without a consistent government industrial policy”. (*Ekonomicheskaya konyunktura v oktyabre-noyabre: Obzor makroekonomicheskikh tendentsiy No 32/ Tsentri makroekonomicheskogo analiza I kratkosrochnogo prognozirovaniya*. M., 2001).

Under the alternative strategy, the government intensifies efforts to attract private investment in both export-oriented and import-substituting industries. This should be pursued through macroeconomic, institutional and foreign (diplomatic) policies. Unlike the first model, macroeconomic policy seeks to curtail real appreciation of the rouble and lower the share of the budget in the economy (but with the budget expanding in absolute terms). Efforts are stepped up to provide investor incentives – both general (lowering of the tax burden, removal of bureaucratic barriers to business, improvement of the judicial system efficiency, etc.) and specific (free economic zones, production sharing agreements, etc.). Finally, activities are undertaken to extend Russia's involvement in the relevant international organizations and harmonize national business legislation with that of other market economies.

In real life the two economic policy models are not entirely incompatible.¹³ They are, of course, alternatives, but political practice can to a certain degree combine them, neutralising certain drawbacks and making the most of their respective merits. For example, under certain circumstances government demand could be used as a tool for economic growth, so long as this demand is not founded on fiscal populism or dependent on provision by the monetary authorities of credit to the budget. It goes without saying that the course of events does not depend exclusively on government decisions, which are themselves limited by national economic conditions.

¹³ Incidentally, this is where the current situation differs from most of the 90s. At the first stage of post-Communist change different interest and political groups put forward absolutely incompatible demands with respect to economic policies: inflationary injections of money into the economy versus stabilization based on a tight monetary policy, a zero-deficit budget versus budget-funded support for domestic producers, liberalization of foreign trade versus tough protectionist measures. The list could be extended almost *ad infinitum*.

It may be accepted as highly probable that expansion of vertically integrated companies will be a feature of Russia's development in the years ahead and that they will likely play an important role both in investment and on the political scene. This means that the government should accompany these developments with measures of macroeconomic and institutional policy designed to support investment by financial-industrial groups while at the same time curbing their monopoly powers. The authorities have enough levers to deal with the problem.

If developments follow such a scenario (as seems likely), three areas of policy decision for the authorities will acquire a particular significance.

The first is consistent implementation of liberal foreign trade policy. The key element here is WTO accession. Openness of the Russian market to competition from foreign producers is one of the principal ways to counteract monopoly tendencies of major domestic companies. It is not accidental that in 2001 some of those companies stepped up their efforts to oppose Russia's WTO accession. At the same time, progress toward this goal does not mean rejection of any kind of protection of domestic producers, for instance protection offered through measures of exchange rate policy.

Second, what becomes extremely relevant is implementation of deep reforms in the realms which go beyond the economy as such but which have a substantial (sometimes even decisive) impact on economic activity. Those are reform of the judicial system, reform of government machinery (including law enforcement) and military reform. Positive change in these areas affects the overall business climate in the country (first of all, reduction of transaction costs) as well as forestalling attempts by major companies to acquire control over government institutions.

The third area is encouragement to business enterprises. Central to this area is anti-trust policy and promotion of competition. De-regulation issues (lowering of administrative barriers to business), as well as stimulus to innovation and to small businesses, are especially important. All these are factors contributing to the creation of a favourable institutional market environment for post-industrial society.

The above three target areas define the priorities of government socio-economic policy over the next few years.

European economic institutions as guidelines for medium-term institutional reforms

2001 saw an event which may become crucial for the development of post-Communist Russia: The EU put forward the idea to establish of a Common European Economic Area.

The notion of the EU-RF free trade zone was formulated already in the Partnership and Cooperation Agreement (PCA), which was signed in Corfu on June 24, 1994, and became effective on December 1, 1997. One of the stated goals of the Agreement was «to create the necessary conditions for the future establishment of a free trade area between the Community and Russia covering substantially all trade in goods between them, as well as conditions for bringing about freedom of establishment of companies, of cross-border trade in services and of capital movements». In 1998 it was planned to study the question of whether the time was ripe for beginning talks on the FTA.

The goal of «Russia's integration into a common European economic and social area» was formulated in the Common Strategy of the EU on Russia (3–4 June 1999), which refers to «the future establishment of an *EU-RF free-trade area*» and subsequently of

the *Common European Economic Area* as a result of gradual approximation of legislation and standards.

There are still many points that need to be further spelled out and clarified in these proposals.¹⁴ However, for all the existing vagueness and lack of detail, as well as technical and legal problems, which practical implementation of this idea are bound to encounter, the importance of the declaration on establishing a common economic area can hardly be overestimated. In effect, we are talking about development of key institutional guidelines for the socio-economic transformation of Russia, a sort of key-note of post-Communist reform. For the first time since the collapse of Communism, Russian society may come to recognize and formulate its own long-term development path. If this is truly the case, then Russia will at one and the same time define criteria for appraising politico-economic decisions and results of their implementation.

It is precisely the adaptation to Russian conditions of European institutions that is the aim of the Strategic Program to 2010. The objective can now be detailed and presented in an explicit form. In describing the goals of medium-term development, the criteria of Russia's accession to the European Union may be viewed as strategic targets. They may also be regarded as institutional objectives which Russia intends to achieve within the next 10–15 years. These criteria are rather fully worked out and are in line with the cultural

¹⁴ In fact there is a European Economic Area (EEA) already, incorporating the EU countries, as well as Norway, Iceland and Liechtenstein. The last three countries are also part of the European Free Trade Area. The EEA membership implies not only establishment of "the common market" but also substantial progress towards harmonization of legislation. The EEA membership effectively means adoption by the member states of the EU legislation and standards. At the same time, the EEA does not envisage establishment of supranational bodies (except for the dispute settlement mechanism).

and economic development of present-day Russia. The level of economic development and education, GDP structure, the social structure of population, and for that matter the current political system, make the choice of European standards the most natural and appropriate.

The conclusion that European standards should be used applied, requires, however, some qualification.

First, the use of these parameters as the basic ones should not be identified with the goal of EU accession. The latter is a political issue, and Russian society is not yet ready to discuss it.

Second, the parameters are still quite vague today. Further work is needed to adapt the Maastricht and Copenhagen criteria, as well as special reports by the European Commission (evaluating the degree of preparedness of individual some countries) for more detailed targets to be developed for Russia.

Third, *all* the criteria should be applied to actual Russian realities and practices. As it happens, Russia is already ahead of the EU as regards some socio-economic decisions or institutions. This is true of the tax system, fiscal policy (orientation to a zero-deficit budget), and labour legislation. It should also be recognized that Russia's current agricultural policy (meaning essentially, the principles of relations between the government and the agricultural sector) is more efficiency-oriented than that of the EU. There should also be no formal alignment of Russian institutions with European ones if that were to impair Russia's competitive advantages.

Fourth, we need standards developed in Russia and for Russia. There can be no question of parameters being developed jointly with the EU or under control of European entities. The idea is that Russia should determine its own targets and goals rather than formalize its desire to join the EU.

Remaining within the economic framework, adaptation of European standards should be undertaken primarily in the following areas: 1) existence of a functioning market economy; 2) ability to secure effective competition and operation of market forces (deregulation and establishment of competitive conditions, legislative stability and transparency of fiscal policy); implementation of structural reform with a focus on protection of property rights, effectiveness of bankruptcy legislation, efficiency of the tax system, stability of the banking sector, and of financial markets; 4) monetary and fiscal policies to promote steady growth; 5) establishment of administrative and government institutions in line with European standards. Financial standards are specified by the Maastricht agreements: 1) price stability: annual inflation within 1.5 percentage points of the three best performing EU countries; 2) annual government deficit not to exceed 3% of GDP; 3) debt: total outstanding government debt not to exceed 60% of GDP; 4) exchange rate stability, meaning that for at least 2 years the country concerned has kept within the «normal» fluctuation margins of 2.5% envisaged by the European Exchange Rate Mechanism; 5) average nominal long term interest rate must be within 2 percentage points of the average rate in the three countries with the lowest inflation rates.

Based on the above list of issues, of special importance today is fulfilment of the criteria associated with the establishment of a functioning market economy, ability to secure effective competition and operation of market forces, structural reform and adaptation of standards. Administrative reform is also of interest to the extent that it is not concerned with procedures directly related to EU accession.

The complex of goals relating to macroeconomic conditions have not, of course, ceased to be important; but these problems

have become much less grave in recent years. It is easy to see that with respect to some criteria Russia now looks to much tougher parameters than EU membership requires.

If developments follow a favourable scenario, Russia's position in Europe could, in a strategic perspective, be similar to the current partnership between the EU and Norway (looking here to the precedent rather than to specific forms).

Russia's accession to the WTO and the OECD (formal application to the OECD was filed as long ago as 1996) are natural stations on the way to the European-type institutions.

Economic challenges of the present situation

11 September and the slowdown of the world economy are two key factors that will determine the development of the Russian economy in 2002. However dramatic those developments may be, their impact on the domestic economy is not to be viewed as unequivocally negative. For apart from external factors, there is a conscious reaction of the authorities, a range of tools for alleviating negative consequences, and sometimes even turning them to the country's advantage.

Let us point out that the political circumstances are currently turning in Russia's favour. September 11 gave strong impetus to rapprochement with the West. The drop in oil prices, although painful from the fiscal perspective, may turn out to be an important incentive to step up structural reform.¹⁵ Thus, a lot depends on the

¹⁵ Recent economic literature has argued convincingly that in today's world economic prosperity is achieved mostly by countries poor in natural resources. Lacking in cheap and readily usable resources, those countries and their governments of whatever complexion have to put an emphasis on productivity, productive efficiency and competitiveness, thereby securing growth on a sound basis (See Gaidar E., *Anomalii ekonomicheskogo rosta*. M. Yevraziya, 1996; Gylafson

appropriateness of the government's action, its ability to make effective decisions in responding to the situation.

Given the deterioration of world economic conditions and the resulting drop in prices of major Russian exports, the main problem for the country is not to let the situation develop according to a populist scenario. All the more so because their developments tend to encourage populist decisions in an attempt to support economic growth.

In our view, today's circumstances call for the following principal measures to be taken by the Russian authorities.

In the area of *monetary policy*, it would make sense to allow market forces to bring about gradual real depreciation of the rouble. This is advisable on two grounds. First, this would strengthen the position of domestic producers on the internal market, where real appreciation of the rouble in 2000–2001 has weakened that position substantially. Second, it would prevent a drastic decline in the country's foreign reserves. Third, a low real exchange rate should help to boost investment inflows (the slowdown of the world economy is not the best possible environment for this but given the amount of capital that fled the country previously, the potential for its repatriation remains quite strong). Fourth, such a policy would not provoke speculative attacks on the rouble.

Au contraire, strengthening of the rouble or maintenance of the current exchange rate would place too great a strain on Russia's foreign reserves, requiring tougher customs control (when resources are more than modest in this area). Besides, such a policy would most probably undermine the financial sector's confidence in the monetary authorities, since the available foreign reserves and forthcoming debt payments would not allow the Central Bank to

Th., Zoega G. Natural Resources and Economic Growth: The Role of Investment: CEPR, 2001.

defend the strong rouble for long, thus making attacks on the rouble almost inevitable.

In the area of *fiscal policy* the maneuver needed is, without renouncing the principle of a balanced budget, apply budgetary resources more efficiently in support of economic activity. This will be feasible only in conjunction with if deep reform of the public sector is implemented. The breakthrough in revenue collection (on the tax front) achieved over the last two years now needs to be supplemented by sound decisions on budgetary expenditure. What is meant is not necessarily expenditure cuts but a variety of organizational, political and structural measures to secure substantial improvement in the effectiveness of budget spending. The role and functions of the principal budget beneficiaries, budgeting procedures, etc. need to be revised. This could provide the basis for using budget resources to support the economy through their concentration on areas most conducive to growth.

It should be reiterated that we are not opposed to the idea of using government demand for encouragement of economic activity. We are saying only that this policy cannot be effective with the current structure of budget beneficiaries and the current revenue allocation procedures. That is why budget spending reform is now an important and even crucial priority for the government. Such reform could become the key link in tackling structural transformation of the country and decreasing its dependence on world energy prices.

Implementation of these reforms will increase the importance of changes in the above mentioned extra-economic areas, which are nevertheless closely related to economic: judicial, administrative and military. The first of these constitutes the main institutional prerequisite for development of stable business activity in Russia, supplementing measures of fiscal and monetary policies in the drive

to secure repatriation of the capital that has fled the country. The second and third items are extremely important areas for improving the efficiency of budget spending.

Finally, in a situation of falling oil prices and political rapprochement with the West, all these measures would allow talks on restructuring and perhaps a partial write-off of the Soviet debt to be revitalized. This aspect should be borne in mind as decisions on cooperation with OPEC and oil export cuts are taken.

Overall, the Russian government has successfully passed the test of high oil prices, having resisted populist measures, where consequences are only too familiar. Now, however, Russia faces a new test, that of low prices for its main export commodities. If we pass it successfully, without substantial economic and political destabilization, it will mean that Russia has decisively overcome the crises of transition, that its elite has consolidated and the country is capable of stable operation in the post-industrial world.

Part 1. Monetary and Credit Sphere and Budget Sphere

1.1. Monetary and Credit Policy and International Monetary Policy

Analysing the monetary and credit sphere processes and policies of the Central Bank of the Russian Federation in 2001 one should first of all point out that this sector of the economy is relatively stable compared to the situation of several recent years. The bank of Russia had practically a complete control both of the inflation behaviour (at least in its part that is determined by money supply) and the foreign exchange and money markets. At the same time the range of monetary instruments grew still more narrow: in 2001 the refinance rate remained unchanged, the obligatory export revenues sale rate was reduced from 75% to 50%, the state securities market role remained negligible. The emission of bonds placed on the market by the Bank of Russia in autumn 2001 was rather a pilot project. In particular, the auctions for flotation of two bond issues by the Bank of Russia for 4 billion roubles held on September 6, 2001 showed that these securities were practically unwelcome on the market. Slightly more than 21% of the securities offered with an average 9.8% income were floated. The auctions for floating the Russian Bank's bonds held in the period from December 19 to 21 were declared invalid, as the volume of bonds floated did not exceed 5% of the issue.

The monetary authorities used practically only one instrument, intervention on the foreign exchange market. Though in 2001 the Central Bank of Russia thanks to considerable gold and foreign currency reserves had a possibility to be more flexible, buying and selling dollars as the situation prescribed.

On the whole one can single out the following key features in the monetary and credit sphere and foreign exchange policy typical of year 2001:

- Stabilisation of inflation processes with a concurrent growth of non-monetary factors' influence on the inflation behaviour (advance in regulated prices of natural monopolies);
- Smooth changes in the nominal rouble exchange rate, preservation of the low revaluation tempo of Russia's national currency;
- Accumulation of all-time high gold and foreign currency reserves;
- Foreign exchange control liberalisation start;

- Slower money demand and economy monetization growth rate;
- Bank system capitalization growth and more popular confidence in bank deposits;
- Solving the “redundant liquidity” problem of the banking system by means of promoting investments into foreign assets and accounts of state bodies;
- Wider money supply provided by the banking system by means of bank loans to the private sector, lesser credit rationing.

The above-mentioned issues are discussed in more detail further.

Inflationary Processes

The inflation rate in Russia in 2001 (by the consumer price index) amounted to 18.8% (20.1% in 2000), the second lowest for the whole observation period (11% in 1997). Compared to year 2000 the consumer prices growth rate was lower by 1.3 percentage points. Meanwhile, the CPI fluctuations in 2001 were much wider than in 2000. (See Figure 1)

Consumer prices growth in January 2001 equalled to 2.8% (nearly 40% annualised), which was the highest since June 1999. Quick growth of consumer prices continued also in February (2.3%). The highest growth rate had prices of consumer services (by 4.6% and 4.3% accordingly). In 2001 the seasonal price fluctuations were accompanied by a number of specific factors that contributed to a higher price growth both in January and the following month, which contradicts to the seasonal consumer price index trends registered in 1994 – 2000 that showed quick price reductions already in February after the inflation upsurge in January.

Firstly, the gap between consumer and manufacturers' prices growth rate was getting bigger during 2000 and the beginning of 2001 witnessed a usual attempt to reduce it. Secondly, the seasonal growth of consumer services prices and tariffs of natural monopolies in 2001 was higher than in the preceding years. In the third place, increase of prices and tariffs for services and goods of natural monopolies was performed during a period of several months, which to a great extent explains high inflation rates also in February. In the fourth place, the fact that there was an uncertainty about execution of the federal budget in view of debts servicing and acquittance of foreign loans according to the original schedule of payments, sharpened expectations of devaluation of the rouble and accordingly the inflationary expectations.

Consumer prices growth rate started falling only in the second part of February and in March 2001. Nevertheless, inflation in the first quarter of 2001 reached the level of 7.2% (annualised rate: 30%). For comparison: in the first quarter of 2000 the consumer prices grew by merely 4%. Inflation in the first quarter was distributed by category groups as follows: foodstuffs' index equalled to 7.3%, non-foods' index grew by 4.0% (non-foods' index growth was to a considerable degree connected with introduction of new customs rules and a temporary reduction of TV and radio goods' imports.); services rose by 12.9% (including a 19.6% increase in housing and communal services and a 10.5% increase in passenger traffic prices). A goods price index analysis shows that the major factors for price increase in the first quarter were the seasonal effects (for foodstuffs) and the increase of prices for services of natural monopolies (the housing and communal sector and transport).

In the second quarter the monthly consumer prices increase remained stable at the level of 1.6 – 1.8% (Figure 1). The constraint that kept the inflation at lower rates at that was the stable nominal rouble exchange rate that ensured lower rates for nonstuff prices' increase. In this period the influence of regulated price started growing smaller, while the role of seasonal factors increased. In that way in the first six months in 2001 the inflation reached the level of 12.7% (27% annualised). It is noteworthy that though the individual price indices ratio in 2001 remained practically unchanged compared to 2000, the absolute inflation rate showed to be higher (9.5% in 2000).

Starting in July 2001 there was registered a drastic slowing down of the inflation rate. In June the consumer price index grew by merely 0.5%, in August the consumer goods index growth rate came down to the zero-point, in September the CPI equalled to 0.6%. Lower than these inflation rates were registered in the summer of 1998. Lower inflation rates were greatly influenced by seasonal factors; specifically fruit and vegetables prices came down by 14.8% in August. In that way price growth by the results of the three quarter of 2001 showed to be equal to the same period of the previous year (14.1%).

Inflation started growing again at the end of September 2001. Higher growth rates were caused both by weaker seasonal factors and by a money emission performed in April – July 2001. A reminder: in October 2000 there was registered a local maximum of CPI growth. In October 2001 the consumer index growth equalled to 1.1%. Besides, in the fourth quarter services prices growth rates accelerated (1.9% in October, 1.5% in November).

Summing up the year's results one can single out the following three major features that characterize the inflation processes in the Russian economy of 2001:

- in the first place, the role of nonmonetary factors connected with price administration (price increase) of tariffs and services of natural monopolies for the population have grown. The CPI analysis shows that foodstuffs price index grew by 17.1%, non-foods by 12.7%, while service price index grew by 36.9% (including price index in housing and communal services, which grew by 56.8%). At the same time manufacturers' price index in 2001 grew by merely 10.6%;

- in the second place, the within-year inflation cycle connected with Russia's foreign debt repayment schedule got broken. In particular, foreign currency requirements of the Ministry of Finance of the Russian Federation to repay the debts to the Paris Club became clear already in February – the beginning of March, not in April and May as before. In this way the issuing activity of the Central Bank and “return” to the market of funds from the federal budget accounts with the Central Bank slowed down the inflation reduction in the second quarter;

- in the third place, when inflation rate gets lower seasonal factors acquire greater significance, in particular, lower price increase in summer and the beginning of autumn and higher inflation rates at the end and the beginning of the year. In August 2001 the consumer prices growth rate was equal to 0%, when in October – December 2001 the CPI grew by approximately 1.5% per month, which is higher than the average for the year (1.4%).

Foreign Currency Policy and Rouble Exchange Rate Dynamics

In 2001 the official rouble exchange rate dropped by 7.03% from 28.16 to 30.14 roubles for one US dollar. The exchange rate dynamics during practically the whole of the year was quite smooth. (Figure 2). Foreign currency market speculators' activity was only registered in short periods.

In April 2001 Russia's Bank chose a more active policy in accumulating its gold and foreign currency reserves. This gave commercial banks an opportunity to speculate for the rise hoping that the Central bank playing the role of currency buyer will accelerate rouble depreciation. But the Central Bank managed to repel the aggression and the rouble exchange rate was changing rather smoothly. According to our estimates total dollar intervention by the Bank of Russia to protect rouble in April could amount to 400-500 million dollars. But the Central bank managed to increase its reserves that month by 2 billion dollars.

In June 2001 the rouble exchange rate practically stabilized at the level of 29.1 roubles/\$. It is evident that foreign currency supply on the market grew due to higher export sales revenues thanks to oil prices that rose in May 2001. In particular dollar auctions volumes at SELT that month were tripled compared to April and May 2001.

In July 2001 dollar exchange rate growth continued. The major factor for rouble depreciation that month, as we see it, were the increase of free liquidity in the banking sector (correspondent balances of commercial banks in the Central Bank) and a more active policy of the Central Bank in accumulating gold and foreign currency reserves. Besides, it is necessary to take into consideration the influence of exchange rate expectations and information effects. In particular, the State Duma of the Russian Federation took a decision in July on lower norms for obligatory foreign currency revenues sales from 75% to 50%. This measure didn't have any serious influence on the rouble exchange rate dynamics in the subsequent months, as far as the actual part of export revenues sold at exchanges did not exceed 50% and foreign currency earnings received by the country due to a permanently high level of oil prices exceeded the demand (deducting the demand from monetary administrators). This information in near-term outlook, though, could cause attempts to speculate for a fall of rouble's exchange rate, and with the aim of flattening the exchange rate the Central Bank performed several interventions in July.

The official exchange rate growth tempo slowed down already in August 2001 in spite of the fact that the Ministry of Finance of the Russian Federation and the Bank of Russia needed more foreign currency. Lowered from 75% to 50% norms of obligatory export revenues sales affected mainly the morning sessions on the foreign currency exchange when the turnover was 1.5 times lower, that is proportionate to lowered foreign currency sales norms (total turnover on the foreign currency market remained unchanged).

At the beginning of autumn the foreign currency market went through a period of certain turbulence related to external shocks (after the acts of terrorism in the USA to ensure an undisturbed dollar trade the settlement account of the MMVB in US dollars was transferred to the Chase Manhattan Bank). But the Russian Bank had a complete control of the situation, the main effect of the temporary increase of instability being a reduction of the reserves of the Central Bank, while dollar rates remained practically unchanged (the exchange rate growth didn't exceed 10 kopecks, that is 0.3%) and in a couple of days the dollar exchange rate returned to the level of 29.4 roubles.

However, the nominal rouble to US dollar exchange rate drop speeded up considerably in October and November 2001. Rouble fell in price by 0.4% already in the first week of October and by 0.54% in the period between the 24th and 31st of October. As we see it such a considerable rouble drop is explained both by fundamental macroeconomic changes and changes in economic agents' expectations and seasonal factors: in October – December rouble was getting cheaper to dollar quicker than on average during the year. A possible long-term fall of oil prices to the level of 15 dollars per barrel can prejudice forecast for next year's industrial growth rates, GDP and the balance of payment, this will also give grounds to expectations about lower foreign currency supply on the market. The latter in its turn will promote demand for currency from banks. Should the unfavourable scenario prove to be realistic, there will be a higher probability of rouble devaluation both to support price competitive capacity of Russian goods and help the Bank of Russia to accumulate gold and foreign currency reserves. The latter was indirectly confirmed by statements of the chairman of the Central Bank V.Geraschenko who said that in the present situation the priority task for the bank is building-up of gold and foreign currency reserves as opposed to rouble exchange rate maintenance. The November interventions were mainly aimed at flattening exchange rate fluctuations during the day, rather than at containing the tendency towards a lower nominal exchange rate of Russia's national currency.

Moreover, one can make a supposition that in case of oil prices fall and payment balance deterioration the Central Bank will not prevent the quicker nominal devaluation of rouble hoping for a real devaluation of Russia's currency.

A considerable positive balance of current operations ensured a stable growth of the gold and foreign currency reserves of the Bank of Russia in the past year (Figure 3). At the end of May 2001 by the volume of its gold and foreign currency reserves Russia entered the top-twenty countries of the world. The temporal reduction of the gold and foreign currency reserves was connected mainly with the fact that the Bank of Russia sold foreign currency to the Ministry of Finance of Russia to make payments to service foreign debts. For example, in the second part of August there was registered a reduction of gold and foreign currency reserves by 600 million dollar connected with sale of foreign currency to the Ministry of Finance to make payments to service foreign loans of the Russian Federation. In particular in August 2001 there were made payments for a total sum of 1.3 billion US dollars.

Year 2001 witnessed very important events in foreign currency administration and foreign currency control. In particular, as we have already said, in September the lowered norms for obligatory sale of foreign currency revenues of exporting companies from 75% to 50% entered into force. Moreover, private persons who are Russian residents got their right to make portfolio investments abroad (for sum of up to 75000 US dollars), there was also introduced a new order of informing the Ministry of Taxes and Duties about private accounts opening in foreign banks. These measures are within the framework of the process of liberalization of foreign currency administration and foreign currency control.

It shall be noted that the lower norms for obligatory sale of foreign currency revenues did not have any detrimental effect upon the dynamics of gold and foreign currency reserves. In particular, the third week in September witnessed an increase of the reserves by 700 million dollars. Though the increase of gold and foreign currency reserves of the Bank of Russia in three weeks in October was noticeably smaller (about 300 million US dollars), which is explained by temporary external factors: after the acts terrorism in the USA and failures in the world financial system the Central Bank of the Russian Federation was forced to use up a total of 500 million dollars to support liquidity on the market.

Considerable changes in the diagram of the gold and foreign currency reserves of the Bank of Russia happened only in the second part of October and in November 2001. The gold and foreign currency reserves peaked at the end of October (38.8 billion US dollars) and stopped growing. The situation change in that period was explained by a coincidence of several important factors, sometimes interrelated: lower supply and higher demand for foreign currency on the market and considerable payments to service foreign debts. In particular, in November the Ministry of Finance of the Russian Federation paid out 1.1 billion dollars including retirement of the first tranche of Russian European bonds for a total sum of one billion dollars and 46.25 million dollars of coupon payments on them.

Fall in oil prices both decreased the countries' export revenues (foreign currency supply) and provoked an increase of depreciation expectations and higher foreign currency demand on the part of economic agents. Thus in November 2001 the Bank of Russia in spite of the fact that the dollar exchange rate grew more rapidly used up according to our estimates up to 500 million dollars to stabilize the market. Nevertheless, gold and foreign currency reserves accumulated by the end of the year (36.6 billion dollars) were enough to keep the foreign currency market stabilized and to ensure a monetary base. Gold's share in the total gold and foreign currency reserves by the 1st of January 2002 was approximately 11%.

Tendency of the real rouble exchange rate growth was preserved in 2001 (Figure 4). In the first four month the real rouble to US dollar exchange rate (calculated on the basis of data about the nominal rouble to US dollar exchange rate and consumer price indices in Russia and in the USA) grew by 5.4%, while the real rouble to the German mark exchange rate grew by 10,2%¹.

A quicker inflation in Russia in spring 2001 caused changes of trends in the real rouble exchange rates dynamics to the most important world currencies. The real rouble to US dollar exchange rate of the post-crisis period peaked in June 2001 and went down slightly later. By the end of October the real rouble to US dollar exchange rate equalled 116.0% compared to September 1998. Consequently in ten months of the past year rouble rose in its price by 6.64%.

In the middle of 2001 the real rouble to the German mark exchange rate underwent serious fluctuations connected with fluctuations of the nominal rate of exchange of the European currency to US dollar and, hence, to rouble. The overall trend of changes in the real rouble to the German mark exchange rate though corresponds to the dynamics of the real rouble to US dollar exchange rate: after peaking in June (167.3% compared to September 1998) rouble cheapened in the following months; in November the real rouble/mark exchange rate equalled to 159.1%. In eleven months of 2001 rouble grew compared to European currencies by 12.67%.

The real effective rouble exchange rate curve (calculated considering the export pattern) was in fact moving between the rouble exchange rates to dollar and the German mark. According to this index rouble got stronger in the first three quarters of 2001 by 6.83% (in 2000 the real effective rouble exchange rate grew by 22.0%).

Changes in Money Demand

Changes in money demand in 2001 are characterized by two major trends: 1) slower growth of money demand and the level of monetization of the economy; 2) growth of capitalization of the banking system and return of public faith in bank deposits.

According to the Central Bank of the Russian Federation money stock M_2 by the end of 2001 reached the level of 1602.6 billion roubles, which is 40.05% higher than on the 1st of January 2001 (in 2000 the M_2 growth equalled to

¹ The real rouble to Euro exchange rate grew in fact by the same value. But as far as there is no unified consumer price index value for Euro, we calculate the real rouble exchange rate value compared to the German mark.

62.4%). In real terms by the end of October money stock M_2 equalled to 119.0% of the December 1997 level. Money stock M_1 in 2001 grew by 35.63% (about 14.15% in real terms). Economy monetization (a ratio of M_2 to GDP) by the end of the third quarter of 2001 equalled to 16.6%.

An M_2 pattern analysis (Figure 5) shows a slower growth of balances of rouble accounts that belong to companies, while private bank deposits in commercial banks were growing. By the end of 2001 real balances of rouble accounts that belonged to companies equalled to 163.4% of the December 1997 level (141.6% in December 2000) growing in 2001 by 15.3%. A slower growth of real balances of accounts that belong to companies (real balances of accounts of companies remained at the level of the end of 2000, the December calendar effect excluded) in our opinion can be explained by a supposition that the highest possible level of economy monetization in the present situation is reached. According to results of market polls by IET starting in May 2001 the share of money payments remained practically unchanged or was even lower in certain branches. In this way against the background of a slow development of financial markets and a low level of interaction between the financial and real sectors of economy real money demand on the part of the agents of economy is being stabilized.

At the same time real personal account balances in the same period grew by 22.2% reaching the level of 87.0% of December 1997. This trend can be an evidence of both bigger cash resources accumulated by private persons and return of faith in the banking system. We think that both processes are present. As far as the foreign currency purchase share of expenses in 2000 and 2001 remained permanently low (5.7-7.0% of expenses) and the consumer spendings' share and the share of obligatory payments to the budget diminished, it becomes evident that the share of money accumulated privately and personal savings in form of bank deposits is growing bigger.

An analogous pattern is registered in the economy as a whole. The pattern of commitments in the banking system of Russia (Figure 6) testifies to the effect that the share of foreign commitments was getting smaller (to 10-11%) while the total share of deposits grew to the level of 50%. It is noteworthy that the highest growth is registered in call deposits represented by balances of settlement and current accounts; in 2000-2001 their share grew from 16% to 19-20%. Important factors that promote return of popular faith in the banking system are both the growth of capitalization of banks (share of capital exceeded 20%) and negotiation of aftermath of the banking crisis. In particular, the share of credits with the Central Bank of total commitments of the banking system fell to the level of 8% and the share of deposits with a temporally restricted access (i.e. deposits in problem banks) does not exceed now 1%.

It is noteworthy that in the first hours after news about the acts of terrorism in the USA in the evening of the 11th of September there was registered a growth of sale of foreign cash by citizens through exchange offices and the current purchase rate fell to the level of 20-22 roubles to 1 dollar. Concurrently no growth of demand for any other foreign currency (i.e. the German mark or the British pound) was registered, which attests to a popular faith in the rouble as a better quick asset and a reliable currency (in a short-term outlook) in case of an economic crisis in the USA. There was neither registered a flow-out of money from private foreign currency accounts, in other words, transaction expenses connected with withdrawal and exchange of dollars from bank accounts were assessed higher than gains of a change-over for rouble even in case the situation for dollar would prove to be unfavourable. The next day, though, the foreign currency market stabilized and the purchase/sale rate spread grew narrow.

Payments Settlement Situation for Enterprises and Organizations

The trend of reduction of real accumulated past-due debts in the economy that started in 1998 continued also in 2001 (Figure 7). The new (of 1998) trend and its later continuation were furthered by several factors simultaneously. The first one was connected with devaluation of debts accumulated, which was caused by a higher inflation rate in the post-crisis period. The second one was writing off post-due debts and charging them to financial results of enterprises and organizations. It should be noted that volumes of these writings off compared to the total volume of debts were relatively small, though they are a considerable part of new debts' increase (Table 1).

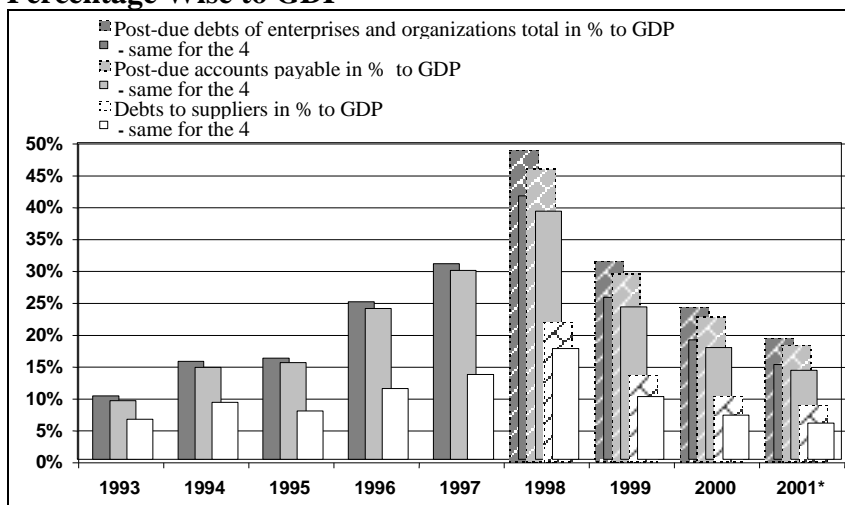
It is noteworthy that writing off accounts receivable is done in comparatively bigger volumes and shares, than accounts payable. Though absolute volumes of accumulated post-due accounts receivable are smaller, than that of accounts payable² (3.3 billion roubles compared to 4.4 billion roubles as of September 2001, Figure 8). It shows that enterprises and organizations rather admit their partners' insolvency³, than

² Volume of accounts payable is naturally bigger than that of accounts receivable due to the fact that the range of financial relations with contracting parties that are referred to in that column is wider; in addition to settlement of suppliers' accounts (buyers are in the column with accounts receivable) the accounts payable also include debts to budgets, non-budget funds, arrears of wages. As per December 1st, 2001 post-due receivable accounts consist 82% of buyers' debts, accounts payable consist 49% of debts to suppliers, by 20% and 19% of debts to budgets of all levels and state non-budget funds accordingly.

³ Note: Writing off a debt charged to loss due insolvency of a debtor is not viewed as a repudiation. This debt shall be shown off-balance for five years since the day it is written off to make it possible to monitor the possibility to collect the debt should the debtor's financial status get better. (Order of the Ministry of Finance of 07.29.98 Nr. 34n., altered on 03.24.00)

their own. Apparently the fact that writing off accounts receivable is performed in a more active way is related to the following: though the tax load is not reduced⁴, at least the volume of accrued taxes does not grow. Accounts payable written off and charged to the financial results do not abate the taxable profit.

Figure 7
Dynamics of Post-Due Debts of Enterprises and Organizations
Percentage Wise to GDP



* - preliminary estimate.

Note: The total of post-due debts of enterprises and organizations include post-due accounts payable and post-due debts to the banking system. The accounts payable in their turn are comprised of debts to suppliers, to budgets of all levels, non-budget funds, arrears of wages and debts to other creditors. Before 1998 the State Statistics Committee of the Russian Federation published non-payment statistics for four major branches of the economy (industry, agriculture, transport, civil construction). Since 1998 the total of post-due debts has been calculated for all branches of the economy.

Source: The State Statistics Committee of Russia, calculations by IET

⁴ Pursuant to the government regulation Nr. 817 of August 18th, 1995 "On measures of ensuring law and order in settlement of payments under contracts of delivery of goods (performance of works or services)", par. 1, written off sums of debts do not decrease the financial result that is taken in account in calculating the taxable profit of the organization-creditor.

The third and, as we see it, the most important factor of decrease of the accumulated debts' level is the lower increase itself, which led to a stabilization of the nominal level of debts⁵ (Figure 8). Starting in 1999 the average nominal debts' increase level has been distinctly diminishing and started more frequently showing negative values (Figure 9).

Another positive effect that continued in 2001 is a decrease of non-money settlements in relations between units of economy (Picture 10). Increase of money transactions implies a greater demand for real cash balances. But the experience of previous years shows that an increase of money stock (even of a real one) is not necessarily accompanied by lower non-payments and non-money contracts. Moreover, right up to the crisis of 1998 the non-payments increment dynamics and cash balance dynamics were codirectional⁶. Non-payments and money grew and fell simultaneously. In the post-crisis period a distinct correlation between these two indices is not traced.

⁵ The growth of the nominal accumulated level of debts is caused by new post-due debts for shipments less debts collected and old debts written off. In this way if new debts are equivalent to writing off old debts and their collection the nominal level gets stabilized.

⁶ Interdependence of money stock and non-payments is multidimensional. One of the mechanisms for this correlation through inflation and percentage was studied in "Development of the Financial Market in Russia and New Instruments to Attract Investments" by R. Antonov, A. Radygin, V. Maou, S. Sinelnikov-Mouryshev and others IET, 1998, p. 96-149. In this article both by means of theoretical and empirical analysis the authors show that higher growth rate of M in a short-term period promotes a lower percentage rate, in a long-term period will add to its growth that will be higher, than the original decrease (the liquidity effect and the price growth effect accordingly), influence of the rate of interest on non-payments is being strictly positive.

It should be added that the codirectional non-payments and money dynamics in the pre-crisis period was in all probability caused by other factors, one of these can be the foreign currency exchange rate policy. The (quasi-) fixed nominal rouble exchange rate (the fixed corridor) diminished the probability of devaluation and inflation, which led to a higher demand for roubles and growth of real money. In other words the real money stock growth was not caused by a money influx to the real sector (the share of non-money settlements was constantly growing in the pre-crisis period), but by the process of de-dollarization. At the same time growth of the real rouble exchange rate that took place in that period promoted non-payments due to aggravation of financial situation of domestic manufacturers (non-payments related to ineffective production, see below).

The situation will develop further under the influence of the following factors. Firstly, the trend of ousting non-money settlements resulting from a favourable economic situation that had been formed earlier and institutional reforms (restructuring of enterprises, strict treatment of non-payers by monopolists, changes in the legislative sphere), is not over yet, and will in all probability continue. It should be noted that strict budget restrictions, establishment of contract enforcement are the necessary conditions to reduce deliberate debts. In conditions when non-payments are possible (cost of non-performance of commitments is minimal), non-performance of commitments can become a rational behaviour strategy for enterprises.⁷

Secondly, accumulation of debts will be influenced by the world markets conditions on the raw material and energy supply markets. Export prices changes have a double effect on accumulation of debts: changing on-budget expenditures and influencing the real rouble exchange rate. Consequently the expected fall in oil prices (see the macroeconomic forecast for 2000), the main component of the Russian raw materials sector on the one hand will reduce budget revenues, on the other hand reduction of the black ink side of the trade balance will promote a fall in the real rouble exchange rate. The effect of the first factor is going to be a considerable one if it leads to non-performance of planned on-budget expenditures. That kind of situation will be possible in case prices will fall below the expected level (planned in the budget). As our previous empirical tests show⁸, non-performance of planned on-budget expenditures is one of the major factors for accumulation of debts.

⁷ See A.Entov, L.Lederman, O.Lugovoi, A.Zolotareva 'Non-payments in the Russian Economy and Regions', CEPRA, 2001. In this work non-payments depending on their source are divided into three groups. The first type are intentional non-payments that can become widespread due to ineffective and underdeveloped institutions of market economy and enforcement of contracts. This type of non-payments involves enterprise's capability to meet its engagements, but nonperformance of its obligations is preferable (more profitable). The second and the third types presuppose a forced performance of commitments. The second one particularly presupposes temporary liquidity problems: the payment will be settled later ("delayed payments"). The third type presupposes accumulation of non-payments due to ineffectiveness (an unprofitable enterprise) and is characterized as "hopeless debts" (can be interpreted as concealed funding of ineffective production).

⁸ See e.g. R. Entov, A. Radygin, V. Maou, S. Sinelnikov-Mouryshev and others. "Developments of the Russian financial market and new instruments of attracting investments", IET, 1998, p. 96-149; O. Lougovoi, D. Semyonov "Non-Payments in the Russian Federation" IET with the help of USAID, 2000; R.Entov, L.Lederman, O. Lugovoi, A.Zolotareva 'Non-payments in the Russian Economy and Regions', CEPRA, 2001.

A possible drop of the real rouble exchange rate⁹ because of fall of oil prices as our calculations show¹⁰, on the contrary promote reduction of non-payments. Mechanism of this influence is probably based on reduction of external competitive influence for home market oriented branches (imports substituting), a better financial situation for them and a better financial situation for exporters.¹¹ A growth of export raw material prices has the reverse influence on the real rouble exchange rate and non-payments.

The ongoing restructuring process (probably not a very active one), extinction of outdated ineffective branches promote a reduction of accumulation of new overdue debts. The political certainty against this background as an indication of stability, no doubt, has a positive influence on the investment situation and can also contribute to a reduction of overdue debts.¹²

Solving the Problem of "Redundant Liquidity", Credit Rationing Degradation

In the annual survey for 2000¹³ we wrote about the problem of "redundant" liquidity and the "enigma" of money multiplier, which become major key-trends in the monetary and credit sphere in 2000. The situation development analysis for 2001 shows that in the past year these two problems were to a certain degree solved.

In 2001 the narrow monetary base increase amounted to 36.35%, the reserve money increased by 28.70%. Thus, money supply as well as demand for it increased at a much slower pace. Monthly fluctuations of money supply increase rates were typical of the past three years and related to seasonal fluctuations of foreign currency export revenues and accumulation of gold and foreign currency reserves by the Bank of Russia on the threshold of foreign debts payments by the Russian Federation.

⁹ One should make a reservation that at present the real rouble exchange rate continues to grow; it is too early to speak about a drastic change of the trend. That is why fall of export prices of raw materials can impede growth of the exchange rate, but not to a rate drop.

¹⁰ See notes above (articles by IET, USAID and CEPRA).

¹¹ A better financial situation of the branches means a simultaneous growth of tax commitments, growth of tax receipts for the budget and everything that goes with it including reduction of non-payments by the state.

¹² In " Developments of the Russian Financial Market and New Instruments of Attracting Investments" (R. Entov, A Radygin, V. Maou, S. Sinelnikov-Mouryshev and others, IET, 1998, p. 96-149), is shown that in periods of political uncertainty increase of non-payments accelerates as distinct from periods of relative political stability.

¹³ See "Russia's Economy in 2000. Trends and Outlooks" (issue 22) – Moscow: IET, 2001.

A money supply structural analysis (“reserve money” aggregates) in 2001 (Figure 11) shows that the negative tendencies of 2000 were mastered. In particular, the share of idle reserves (balances of correspondent and deposit accounts of commercial banks in the Central Bank) by the end of the third quarter was brought to the level of 22.5% of reserve money (compared to 24.6% in June 2001 and about 35% in 2000) . Its growth in the fourth quarter to the level of 24.5% is explained mainly by calendar effects of the end of the year (balance growth of correspondent accounts on the eve of new-year banking holidays). The compulsory reserve fund got stabilized and in the course of 2001 equalled to 14-14.5%. Cash demand changes exert more influence on the monetary base. At present the share of cash in reserve money exceeds 60%, the M_0 to M_2 ratio is 36–37%. In fact, the structure of money aggregates has returned to the pre-crisis level. Taking into consideration the fact that gold and foreign currency reserves of the Bank of Russia have been growing rapidly during the whole of the year, one can say that the sterilization policy of the money administrators has become more effective.

Among possible instruments to solve the problem of “redundant liquidity” used by the Bank of Russian in 2001 one can name stimulation of foreign currency demand using negative real rates for the majority of financial rouble assets, accumulation of funds on budget accounts and a more extensive private crediting by the banking system.

In particular, balances under the general government in the Central Bank of the Russian Federation by the beginning of December 2001 reached the level of nearly 412.1 billion roubles, an increase by 71.4% compared to the beginning of the year (as of the beginning of the year these balances decreased to 295 billion roubles, it was related to the main part of on-budget expenditures during the last month of the year). In other words, money withdrawn from the economy through taxes constitute up to 47-48% of the total amount of the reserve money. It is evident that in order to reach stability in the money sphere one needs, at least, a coordination of actions between money and fiscal administrations. Otherwise, releasing such huge money (e.g. in form of interest-free budget expenditures) means for the market that it can have serious inflationary consequences and put stability of the rouble exchange rate into jeopardy. At the same time it should be noted that the current Government of the Russian Federation keeps strict budget policies, using money to buy foreign currency to pay off foreign debts directly from the Bank of Russia (which is testified by fluctuations of the gold and foreign currency reserves) and prevents in this way shocks on the money and foreign currency markets. Budget account balances used in this way are analogous to an accumulation in some kind of a stabilization fund, but kept on the account in the national currency and, thus, making no profit they are not protected against risks of inflation and exchange rate fluctuations.

Another non-traditional instrument to sterilize the redundant emission caused by purchase of foreign currency by the Central Bank on the market was to induce demand of foreign currency by commercial banks keeping negative percentage rates for liquid financial assets in the national currency. In this way yields of state bonds (GKO and OFZ) during the whole of the past year were between 15% and 18%, annual rates on the inter-bank market and for deposits in the Central Bank were brought down to the level of 2-5% per year. It is evident that with the present inflation rate investing into foreign assets is more profitable even taking the nominal rouble exchange rate growth into consideration. In spite of the fact that in 2001 total share of foreign assets in assets of the banking system fell from 25% to 18% (Figure 12) more and more of foreign assets were transferred to balances of current accounts and deposits in foreign banks (their share in the first half of the year grew from 13.2 to 16.9 billion US dollars, and it was only in the third quarter that it went down to 15.2 billion dollars). In other words, banks preferred just keeping their assets in foreign banks and get a low rent (in foreign currency), than investing them into even less profitable assets in roubles.

At the same time as one can see from Figure 12 in 2001 there was a considerable growth of credits given by banks to the private sector and their share in the total of assets of the banking system increased from 38% to 47%. Accordingly, the multiplier growth trend (Figure 13) was preserved, that is commercial banks were expanding their credit operations increasing money supply to the economy.

By the end of August 2001 the money multiplier (ratio of money stock M_2 to reserve money) grew compared to the beginning of the year approximately by 10% (from 1.55 to 1.70) and by 19.5% compared to the minimal value (July 2000). The level achieved (about 1.7) corresponds to the level of the end of 1998 – the beginning of 1999. At the same time it should be noted that during practically the whole of 2001 (since April) the multiplier remained unchanged. As we view it this is connected with the fact that a certain maximum level of monetization of economy in the present situation was reached, which we mentioned in our August 2001 survey.¹⁴ At the same time the share of idle assets of commercial banks in the monetary base was continuously falling. In the second half of 2001 the share of assets of commercial banks on correspondent and deposit accounts in the Central Bank reduced to the level of 22-23% of reserve money as compared to 27.5-28.5% in the first and second quarters of 2001.

¹⁴ See “Russia’s Economy in August 2001. Trends and Outlooks”, Moscow, IET, 2001. Chapter “Monetary and Credit Policy”.

The ratio of cash money and the volume of the required reserves remains unchanged (cash money is about 80% of the narrow monetary base). Thus, in spite of the increased amount of credits given by banks to the economy they are still to a great extent being turned into cash money (e.g. in form of wages and salaries) and “money multiplication” chains in Russian economy remain short.

* * *

The above analysis of processes in the money sphere of Russian economy in 2001 gives grounds to make the following conclusions that concern the nature and particular features of the money and credit policies:

- Intensity of inflation processes in 2001 continued to reduce, the registered CPI increment was about 18.6%, which is the second annual inflation minimum since the beginning of reforms in Russia. At the same time fluctuation and dispersion of indices for different groups of goods remain, which is explained first of all by the prevailing influence on inflations dynamics of non-monetary factors (rise in regulated prices of natural monopolies).
- Changes in the nominal rouble exchange rate remained smooth during practically the whole of the year (excluding the last 1.5 months), during the year the rouble devaluated by approximately 7%. Consequently, a third year running there are preserved moderate (about 10%) rates of revaluation of Russia’s national currency.
- In 2001 the Bank of Russia accumulated all-time high gold and foreign currency reserves (over 38 billion dollars) in spite of growing payments to settle foreign debts and reduction of the positive balance of the current account and the beginning of the foreign currency liberalization process (in particular the lowered norms for obligatory sale of foreign currency revenues from 75% to 50%, permission to private persons who are Russian residents to open accounts in foreign banks and invest into foreign securities for sums of up to 75000 US dollars).
- In the past year the Central Bank of the Russian Federation solved the problem of “redundant liquidity” in the banking system. Among solution instruments one should mention first of all promotion of investments into foreign assets by supporting negative real interest rates for assets in roubles and accumulation of assets on accounts of state bodies. At the same time one can also mention stabilization of money supply growth rates by the banking sys-

tem by means of private sector crediting and a certain credit rationing degradation.

- In the second half of 2001 a slower growth rate of demand for money and stabilization of the level of economy monetization became obvious. At the same time downtrend for non-monetary settlements and non-payments between enterprises continued. Starting in the second half of 2001 demand for money increased mainly because of capitalization growth in the banking system and return of popular faith in bank deposits, while balance accounts of enterprises remained practically unchanged.

Table 2 (A)

Money and Financial Markets Indicators' dynamics in 2000 – 2001

	Narrow money- base, billion roubles	Narrow money- base growth rate	NDA, billion roubles	NIR, billion roubles	Reserve money, billion roubles	Reserve money growth rate	M ₀ , billion rou- bles	M ₀ growth rate
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%
July 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%
Sept 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%	83,3	436,3	739,2	8,04%	419,3	17,00%
Jan 01	486,4	-6,39%	54,6	431,8	683,6	-7,58%	380,3	-9,33%
Feb 01	493,5	1,46%	52,2	441,3	680,2	-0,51%	388,0	2,06%
Mar 01	499,6	1,24%	10,2	489,4	702,5	3,28%	399,4	2,95%
Apr 01	531,1	6,31%	-11,2	542,3	717,2	2,10%	435,4	9,00%
May 01	550,1	3,58%	-45,6	595,7	741,7	3,41%	438,3	0,68%
Jun 01	583,1	6,00%	-57,4	640,5	773,6	4,31%	474,7	8,30%
Jul 01	609,6	4,54%	-68,1	677,7	784,8	1,45%	490,6	3,35%
Aug 01	621,6	1,97%	-80,4	702,0	808,0	2,95%	507,1	3,37%
Sept 01	649,8	4,54%	-74,8	724,6	838,1	3,72%	531,0	4,71%
Oct 01	663,5	2,11%	-100,9	764,4	863,1	2,98%	531,5	0,10%
Nov 01	651,3	-1,84%	-110,2	761,5	837,0	-3,02%	527,3	-0,79%
Dec 01	708,5	8,78%	-22,5	731,0	951,3	13,66%	584,3	10,82%

Table 2(A) (cont'd)

	Balance of correspondent accounts of commercial banks in the Central Bank, billion roubles	Money (M ₁), billion roubles	M ₁ growth rate	M ₂ , money stock billion roubles	M ₂ growth rate	Broad monetary base, billion roubles	Broad monetary base growth rate	Money multiplier (M ₂ / broad monetary base)
Jan 00	61,4	508,1	-3,55%	695,0	-1,38%	1000,6	1,60%	1,61
Feb 00	64,6	529,9	4,29%	726,6	4,55%	1065,0	6,43%	1,62
Mar 00	72,2	546,4	3,13%	751,4	3,41%	1090,4	2,39%	1,53
Apr 00	72,2	576,4	5,48%	787,9	4,86%	1123,2	3,01%	1,53
May 00	73,2	611,2	6,04%	831,6	5,55%	1170,3	4,19%	1,49
Jun 00	77,7	6620,7	8,42%	892,2	7,29%	1242,8	6,20%	1,48
July 00	83,2	692,4	4,48%	931,2	4,37%	1301,7	4,74%	1,42
Aug 00	81,9	718,0	3,69%	960,1	3,10%	1327,3	1,96%	1,48
Sept 00	90,0	747,4	4,11%	992,4	3,36%	1388,4	4,61%	1,48
Oct 00	77,7	750,7	0,43%	1001,2	0,89%	1415,9	1,98%	1,51
Nov 00	93,9	777,1	3,53%	1036,4	3,52%	1457,3	2,92%	1,51
Dec 00	107,3	879,3	13,15%	1144,3	10,41%	1560,0	7,04%	1,55
Jan 01	79,4	810,5	-7,82%	1079,3	-5,68%	1530,8	-1,87%	1,58
Feb 01	69,1	829,2	2,30%	1109,7	2,82%	1615,8	5,56%	1,63
Mar 01	80,4	858,4	3,52%	1149,5	3,59%	1632,3	1,02%	1,64
Apr 01	78,9	918,2	6,97%	1210,0	5,26%	1683,4	3,13%	1,69
May 01	95,0	938,5	2,21%	1233,7	1,96%	1730,0	2,77%	1,66
Jun 01	79,6	987,9	5,26%	1294,3	4,91%	1798,7	3,97%	1,67
Jul 01	78,7	1015,1	2,75%	1330,2	2,77%	1842,3	2,43%	1,69
Aug 01	90,3	1040,8	2,53%	1365,5	2,65%	1870,4	1,52%	1,69
Sept 01	79,9	1074,9	3,28%	1414,4	3,58%	1925,5	2,95%	1,69
Oct 01	86,4	1084,4	0,88%	1441,2	1,89%	1974,7	2,55%	1,67
Nov 01	79,6	1058,1	-2,42%	1439,1	-0,15%	1984,9	0,52%	1,72
Dec 01	122,9	1192,7	12,71%	1602,6	11,36%	2122,7	6,95%	1,68

Table 2 (B)

Money and Financial Markets Indicators' Dynamics in 2000 – 2001

	CPI (% per month)	Official rouble exchange rate (Rbl./\$)	Rouble rate growth Rbl./\$	Gold and foreign currency reserves (million \$)	Foreign currency reserves (million \$)	Gold (million \$, on the basis of 300\$ / 1 oz tr)
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
July 00	1,8%	27,80	-0,89%	23302	19955	3347
Aug 00	1,0%	27,75	-0,18%	23731	20289	3442
Sept 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
Jan 01	2,8%	28,37	0,75%	29638	25888	3749
Feb 01	2,3%	28,72	1,23%	28345	24591	3754
Mar 01	1,9%	28,74	0,07%	29709	25942	3767
Apr 01	1,8%	28,83	0,31%	31650	27868	3782
May 01	1,8%	29,09	0,90%	33550	29749	3801
Jun 01	1,6%	29,07	-0,07%	35053	31251	3801
Jul 01	0,5%	29,27	0,69%	36502	32694	3807
Aug 01	0,0%	29,37	0,34%	37493	33686	3807
Sept 01	0,6%	29,39	0,07%	37957	34044	3913
Oct 01	1,1%	29,70	1,05%	38002	34016	3986
Nov 01	1,4%	29,93	0,77%	37288	33277	4011
Dec 01	1,6%	30,14	0,70%	36622	32542	4080

Table 2(b) (cont'd)

	RTS-1 index	RTS-1 index growth rate (% per month)	Volume of transactions on RTS (million \$)	GKO and OFZ mean yield (% per year)	GKO and OFZ secondary market turnover (million roubles)	Real rouble to US dollar exchange rate (Dec 1997=100)
Jan 00	172,31	-3,04%	489,51	45,50%	8521,8	95,3
Feb 00	170,93	-0,80%	441,48	33,13%	19457,7	95,3
Mar 00	231,88	35,66%	810,76	30,53%	17914,9	97,1
Apr 00	226,87	-2,16%	499,39	27,71%	14694,9	98,1
May 00	190,21	-16,16%	417,20	27,02%	11221,0	104,3
Jun 00	171,40	-9,89%	411,96	20,78%	20411,1	105,3
July 00	194,09	13,24%	396,46	22,58%	20628,4	109,8
Aug 00	239,99	23,65%	628,95	19,51%	21304,4	114,1
Sept 00	1-,08	-17,05%	443,59	19,76%	16428,7	117,2
Oct 00	189,00	-5,06%	414,07	18,76%	16969,2	120,1
Nov 00	143,42	-24,12%	353,91	20,85%	13003,5	121,8
Dec 00	143,29	-0,09%	247,18	20,94%	10773,6	120,3
Jan 01	173,53	21,10%	339,51	20,12%	11818,9	119,2
Feb 01	164,76	-5,05%	420,53	19,52%	12290,0	121,7
Mar 01	169,46	2,85%	363,49	20,38%	10829,6	124,7
Apr 01	180,68	6,62%	329,14	16,33%	15142,9	127,2
May 01	208,80	15,56%	405,67	17,11%	7979,6	128,8
Jun 01	216,11	3,50%	490,42	17,03%	7923,5	131,8
Jul 01	196,12	-9,25%	436,82	17,19%	11668,6	132,1
Aug 01	205,41	4,74%	231,95	16,13%	7444,2	129,8
Sept 01	180,25	-12,25%	249,87	15,33%	8894,2	128,5
Oct 01	204,04	13,20%	279,00	15,07%	9136,8	-
Nov 01	226,49	11,00%	394,25	14,91%	12560,1	-
Dec 01	260,05	14,82%	277,04	15,84%	10202,4	-

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

Sources: The state Statistics Committee of Russia, The Central Bank, Russian Commodities Exchange (RTS), information agency “FinMarket”, RECEP, International financial statistics.

1.2. Balance of Payment

In this chapter we will examine the status of the balance of payment in 2001 and major change trends for its indices. It should be noted that trends of key items of the balance of payments drastically changed in the past year as compared to 1999 and 2000. First of all current operations payment balance stopped growing, bringing a corresponding growth of deficit of capital and financial instruments operations account. During the year as a whole the balance of current payments reduced practically by half: in the first quarter its figure amounted to 11.5 billion dollars, in the fourth quarter of 2001 according to estimates of the Bank of Russia the balance of current payments was reduced to the level of 5.7 billion dollars. As before the major factor that determined the balance of current payments was the balance of trade, which in its turn was chiefly defined by changes in prices for energy carriers and other major commodities that Russia sells on the world market. Figure 1 shows the dependence of Russia's trade balance on world oil prices that manifested itself in 1995 – 2000 and was clearly visible also in 2001¹⁵.

It should be noted that decrease of the balance of trade happened both because of reduction of Russian exports and due to higher cost of imports to the Russian Federation. The trade balance of Russian in the fourth quarter of 2001 equalled to 9.2 billion dollars, which is 7 billion less than in the analogous period of the previous year. While export of goods went down from 29.5 billion dollars to 24.4 billion dollars, imports increased from 13.4 billion dollars to 15.3 billion dollars.

Besides a reduction of trade balance during 2001 the payment balance of current operations was considerably influenced by the "nonfactorial services" item values. Its negative value (i.e. imports excess over exports) grew by nearly 3 billion dollars and this change was solely caused by the growth of import of services.

¹⁵ The assessments made for 1993-2001 showed that there is a statistically significant relationship between the balance of trade (*TB*) and world oil price index (*P*) at *dummy*-variable, equal to 1 for the third and the fourth quarters of 1998, when the trade balance of the Russian Federation was mainly influenced by other factors .

$$TB = -9.2 + 14.3P + 6.0 \cdot Dummy$$

(-4.8) (9.2) (3.3)

$$R^2=0.77$$

Viewing the payment balance change trends by its different components one may see that in spite of the fact that the black ink part of the balance of trade was being reduced foreign currency assets of residents in 2001 were growing mainly due to exports excess over imports. In other words, it was due to the income side of the trade balance that all payments to non-residents were performed to finance operations that were not connected with imports and exports, as well as changes in foreign assets and commitments of residents. Here we deal first of all with financing the red ink part of payments for labour and capital services (payment of wages and salaries to non-residents and repayment of debts), making portfolio investments abroad, increasing foreign assets of Russian residents and payments to reduce Russian residents' debts to non-residents. Meanwhile, attention should be drawn to flow-out of capital transfers by non-residents of Russia in the third quarter of 2001. As compared to the previous quarters when capital transfers by non-residents varied between 200 and 600 million dollars per quarter, the balance of the above mentioned transfers in July – September 2001 was 10.3 million dollars. According to the Bank of Russia this sum of capital transfers was a result of an irregular operation of a gratuitous writing down (remission) of foreign debts of the world's poorest countries to Russia in part of their commitments to the former USSR within the framework of the Paris Club of Creditors for a total sum of 9.9 billion dollars. The above sum is a cumulative result of a long negotiation process, which was finally legalized in the third quarter of 2001.¹⁶

If we view the aggregated figures of the balance of payment of Russia in 2001 the balance situation of Russian assets can be described in the following terms: due to trade operation with non-residents Russian foreign currency assets grew by 49.5 billion dollars (the balance of trade in January – December of 2001). Besides, sources of Russian foreign assets increment were direct investments in Russian (2.9 billion dollars), portfolio investments attracted by non-financial enterprises (500 million dollars), acquisition of credits by state governmental bodies against their security (960 million dollars), credits acquired by Russian banks and loans taken by non-financial enterprises, deposits and loans (3.7 billion dollars) as well as reinvestment of returns on securities issued by federal state administrative bodies and accumulation by them of past-due debts (3.4 billion dollars).

The abovementioned increment of foreign assets was balanced by changes in the following items: net imports of non-factorial services (10.5 billion dollars),

¹⁶ See "Вестник Банка России" (Russia's Bank Bulletin), Nrs. 7-8 (585-586), February 4, 2002

payment of dividend on direct and portfolio investments to Russia (5 billion dollars), payment of security debts by federal authorities and repurchase of these securities on the secondary market (5.2 billion dollars), repayment of the IMF credit by the Central Bank of the Russian Federation (2.8 billion dollars), direct and portfolio investments abroad (3.1 billion dollars), other investments in foreign assets for a total sum of 10 billion dollars (increment of balance on foreign accounts and deposits, granting of trade credits and advances, increase of post-due debts by non-residents and debts made by non-residents in form of delayed export revenues and existing advances), as well as accumulation of reserve assets (8.2 billion dollars). Besides, in the third quarter 2001 in the "capital transfers" item there were performed transactions for a total sum of 10 billion dollars by non-residents, the red ink side of the "pure mistakes and omissions" item was equal to 8.5 billion dollars.

Thus, in spite of the fact that the black ink side of the balance of trade and current operations was decreasing, 2001 witnessed a ratio of assets and commitments typical of the previous two years: increment of foreign assets due to bigger balance of the balance of trade in the absence of considerable loans was the source of repayment of debts to non-residents that had been accumulated in previous years and the source to increase Russian assets abroad and other forms of capital flow-out.

Among operations that were mainly financed by means of the trade balance sufficiency (surplus) one should not only note a decrease of debts to non-residents, but also an increment of foreign assets of Russian residents which in several years has been actively used for application of funds received as a result of a favourable balance of current operations: when the net decrease of Russian debts to non-residents by results of the year equalled to 1.9 billion dollars, net assets of Russian residents abroad grew by 5.2 billion dollars (at the same time assets of state governmental bodies decreases by 8.1 billion dollars, but foreign assets of banks and non-financial enterprises grew by 13.3 billion dollars). Main types of Russian assets abroad that grew most rapidly in 2001 were balances on current accounts and deposits (increment here reached the level of 2.6 billion dollars), increase of post-due export revenues and existing advances (total of 6.7 billion dollars) and direct and portfolio investments (3.1 billion dollars).

In connection with increase of Russian assets abroad one should also mention the problem of outflow of capital from Russia. As is well known, parts of funds of residents placed abroad in such types of assets as post-due debts, post-due export revenues and outstanding imports advances as well as parts of funds shown in the balance under the item "Pure mistakes and omissions" can be la-

belled as nonregistered export of capital. In this connection one can assume that when the balance of the mentioned items becomes persistently outstanding for a prolonged period of time it can testify to the dynamics of nonregistered export of capital from Russia. In 2001 if one accepts the abovementioned figures, nonregistered export of capital from the country went down slightly: in 2000 the total sum under the "pure mistakes and omissions" item amounted to 10.3 billion dollars, by the results of 2001 the figure was 8.5 billion dollars. An analogous situation is revealed when we analyse totals of pure mistakes and omissions, post-due debts and outstanding export revenues: the figure for 2001 is estimated at the level of -9.9 billion dollars (due to a decrease of post-due debts of non-residents to residents), compared to the previous year when this sum was -21.8 billion dollars. In connections with the above estimates one should accentuate in the first place that the analysed figures can only be viewed as indirect indicators of dynamics, not as absolute volumes of illegal outflow of capital, secondly, that increase of both post-due debts and pure mistakes and omissions could have happened in consequence of a drastic increase of export values which quite naturally could entail a proportional growth of outstanding return of export revenues and higher statistical deviations in making calculations of basic balance figures.

In making an analysis of the balance of payment of Russia in 2001 one should pay attention to the fact that just like in the previous year the favourable balance of trade was that substantial that though big payments to reduce Russian commitments to non-residents were made and Russian assets abroad grew rapidly, reserve assets grew simultaneously: in twelve months of 2001 they grew by 8.2 billion dollars (a maximum increments of 5.2 billion dollars was registered in the second quarter, meanwhile in the fourth quarter the reserve assets decreased by 1.4 billion dollars). Nevertheless, reserve assets turned out to grow practically two times as slow as in the same period of 2000, when gold and foreign currency reserves grew by 16 billion dollars.

Speaking about future trends of the balance of payment, there are grounds to suppose that in 2002 the situation for the Russian balance of payment will be somewhat worse than in year 2000. For the first, judging by the already mentioned interrelation between the balance of trade and world oil prices one can assume that increase of foreign assets by residents from this type of export will be proportionally lower. If we take as a starting point the prognosis according to which world oil prices will be at a level slightly higher than the one in the fourth quarter of 2001, other things being equal, a favourable balance of trade can decrease to the level of 35-40 billion dollars annualised. Though it is

worth noting that the balance of payment will be also influenced by other factors, such as the nominal and real rouble exchange rate, inflation rate, prices on other groups of commodities and goods of Russian export, imports growing rates etc.

Secondly, it is necessary to take in consideration foreign creditors' claims about repayment of Russia's debts. According to the Federal Law on the budget of 2002, expenses of the Russian Federation to cover and service its foreign debts will amount to 14.2 billion dollars. This amount is slightly smaller than the actual payments in 2001, to pay off and to service debts of state the government and the Central Bank of the Russian Federation channelized approximately 17 billion dollars (not counting the 1.8 billion dollars, spent to take out Russian bonds on the secondary market). In this situation one can presuppose that in 2002 Russian authorities like in previous years will be able to settle and service debts due to comparatively high values of the favourable balance of trade. In addition to that one should note that the trend of slower growth of the real rouble exchange rate can have a positive effect on the Russian balance of payment, which will allow just like in the previous year to make forward payments to settle and service Russian foreign state debts.

Table 3

Balance of Payment of the Russian Federation in 2000 – 2001 (in billion US dollars)

	Year 2001					Year 2000 (for reference)
	First quarter	Second quarter	Third quarter	Fourth quarter	Total	
Account of current operations	11,5	9,4	7,6	5,6	34,2	46,3
<i>Balance of trade</i>	14,4	13,2	12,8	9,2	49,5	60,7
Exports	25,5	26,8	25,9	24,4	102,7	105,6
Imports	-11,1	-13,6	-13,2	-15,3	-53,1	-44,9
<i>Balance of nonfactorial services</i>	-2,1	-2,7	-3	-2,7	-10,5	-7,7
Exports	2	2,6	3,1	2,6	10,2	9,7
Imports	-4,1	-5,2	-6,1	-5,2	-20,7	-17,4
<i>Balance of labour payment</i>	0,1	0,1	0	0,1	0,2	0,3

<i>Balance of returns on investments (interests, dividends)</i>	-0,8	-1,2	-2,1	-0,9	-5	-7
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Table 3 (cont'd)

	Year 2001					Year 2000 (for reference)
	First quarter	Second quarter	Third quarter	Fourth quarter	Total	
Receivable incomes	2,6	0,9	0,9	0,8	5,1	4,3
Payable incomes	-3,4	-2,1	-3	-1,7	-10,1	-11,3
<i>Federal administration bodies</i>	-0,8	-0,9	-2,1	-0,9	-4,7	-6,1
Receivable incomes	1,9	0,3	0,3	0,2	2,7	2,3
Payable incomes	-2,7	-1,2	-2,4	-1,1	-7,4	-8,4
<i>Local administrative authorities (payable incomes)</i>	0	0	0	0	-0,1	-0,2
<i>The Central Bank (payable interests on IMF loans)</i>	0	0	0	0	-0,1	-0,2
<i>Banks</i>	0,6	0,5	0,5	0,4	1,9	1,2
Receivable incomes	0,6	0,6	0,5	0,5	2,3	1,7
Payable incomes	-0,1	-0,1	-0,1	-0,1	-0,4	-0,5
<i>Non-financial enterprises</i>	-0,5	-0,7	-0,4	-0,4	-1,9	-1,8
Receivable incomes	0	0	0,1	0,1	0,2	0,3
Payable incomes	-0,6	-0,7	-0,4	-0,4	-2,1	-2
Balance of current transfers	0	0,1	-0,1	0	0	0,1
Account of operations with capital and financial instruments	-7,5	-2,5	-2,8	-4,8	-17,5	-21
Account of operations with capital (capital transfers)	-0,1	-0,2	-10	-0,1	-10,4	11
Financial account (except reserve assets)	-7,4	-2,3	7,2	-4,6	-7,1	-32
Debts	-0,5	1,4	-1,4	-1,4	-1,9	-11,4
<i>Federal administrative bodies</i>	-1,2	-0,5	-2,8	-1,5	-6	-13,9
Portfolio investments (bonds and securities)	0,1	0,1	-1,6	-0,9	-2,2	-10,3

Issue	0,1	0	0	0	0,1	21,5
Retirement (scheduled)	-0,6	-0,5	-0,8	-1,5	-3,4	-32,9

Table 3 (cont'd)

	Year 2001					Year 2000 (for refer- ence)
	First quarter	Second quarter	Third quarter	Fourth quarter	Total	
Reinvestment of interest	0,7	0,7	0,7	0,7	2,9	3,8
Secondary market	-0,1	-0,1	-1,6	0	-1,8	-2,6
Loans and grants	-1,8	-0,7	-1,4	-0,7	-4,6	-2
Usage	0,1	0,1	0,1	0,2	0,5	1,1
Settlement (scheduled)	-1,9	-0,7	-1,6	-1	-5,1	-6,5
Restructuring	0	0	0	0	0	3,4
Post-due debts	0,4	0	0,2	0,2	0,8	-1,6
Other debts	0	0	0	0	0	0
<i>Local administrative bodies</i>	-0,2	-0,5	-0,1	0,5	-0,2	-0,8
<i>The Central bank (operations with IMF credits)</i>	0	0	-0,7	-2,1	-2,8	0
<i>Banks</i>	0,6	1,7	1,2	-0,3	3,3	1,5
Direct investments	0,1	-0,1	0	0	0	0,2
Loans and deposits	0,9	1,7	0,5	0,1	3,1	0,3
Other debts	-0,3	0,1	0,8	-0,4	0,2	0,9
<i>Non-financial enterprises</i>	0,2	0,7	1	1,9	3,7	1,8
Direct Investments	0,5	0,7	0,8	0,9	2,9	2,5
Portfolio investments	-0,1	0,2	0,2	0,2	0,5	0,3
Loans and grants	-0,3	-0,2	0,3	0,7	0,6	-0,9
Other debts	0,1	0	-0,4	0	-0,3	0
Assets, except reserves	-6,9	-3,7	8,7	-3,2	-5,2	-20,6
<i>Federal administrative bodies</i>	-1,9	0,1	9,9	-0,1	8,1	-1,6
Loans and grants	0,9	0,9	-1,3	2	2,4	5,8
Post-due debts	-2,7	-0,9	11	-2,1	5,3	-7,5
Other assets	0	0,2	0,3	0	0,4	0,1

<i>Banks</i>	-3,7	-1,9	1,5	1,3	-2,8	-3,5
Direct Investments	0	0	0	0	0	-0,3

Table 3 (cont'd)

	Year 2001					Year 2000 (for refer- ence)
	First quarter	Second quarter	Third quarter	Fourth quarter	Total	
Loans and grants	-3,7	-2	1,7	1,3	-2,6	-3,6
Other assets	-0,1	0	-0,2	0	-0,3	0,4
Non-financial enterprises and private persons	-1,3	-1,9	-2,8	-4,4	-10,5	-15,5
Direct and portfolio invest- ments	-0,8	-0,7	-0,9	-0,7	-3,1	-3,4
Foreign currency in cash	-0,7	0,6	0,9	-0,6	0,2	-0,3
Trade credits and advances	1,4	-0,9	-0,1	-1,1	-0,6	-4,2
Debts for shipments on the basis of intergovernmental agreements	0,2	0,2	-0,2	0,1	0,3	-0,5
Post-due export revenues and outstanding import advances	-1,6	-0,8	-2,3	-1,9	-6,7	-5,3
Other assets	0,3	-0,3	-0,2	-0,3	-0,6	-1,8
Pure mistakes and omissions	-2,2	-1,6	-2,3	-2,3	-8,5	-9,2
Changes in foreign currency reserves	-1,8	-5,3	-2,4	1,4	-8,2	-16

Source: The Central Bank of the Russian Federation

1.3. Government Finance

1.3.1. State Budget

The year of 2001, just like the previous one, was a successful year for the state budget. One can single out several specific features, though, that are typical of budget execution at all levels in 2001.

For one thing it should be noted that budget revenues growth rates were slower compared to two previous years (Table 4). This can be explained by the fact that market conditions for traditional goods and commodities of Russia's export stabilized and were no longer the only major factor of revenues growth in the budget system. Secondly, tax revenues of the consolidated budget as a whole somewhat

dropped (by 0.2 points of GDP) which reflects major changes in the tax system that entered into force at the beginning of 2001. This fall happened due to changes on the level of local budgets, which showed a decrease in tax receipts compared to the previous year by 1.4 points of GDP (because of centralization of VAT, cancellation of public housing and social amenities upkeep tax and reduction of way-users' tax rate), while federal budget tax revenues grew by 1.2 points of GDP. In the third place, expenditures of the consolidated budget continued to decrease. In 2001 expenditures of the consolidated budget dropped by nearly 2.2 points of GDP (from 26.6 % of GDP to 25.6 of GDP¹⁷), which to a great extent was caused by strict budget policies. In the fourth place, there was a considerable decrease in increment of debts to the budget system; debts to the federal budget in 2001 practically didn't grow. (Table 5). In 2001 increment of balanced tax debts was negligible¹⁸. In particular, increment of balanced debts to the consolidated budget amounted only to 0.5% of GDP, while it didn't even reach 0.1% of GDP for the federal budget.

Table 4

Execution of Receipts and Outlays by the Federal Budget and Budgets of Territories (in % to GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
<i>The Federal Budget</i>										
Tax receipts *	16,6	12,4	11,5	11,6	11,0	10,9	9,6	12,6	15,0	16,2
Revenues	16,8	14,0	13,1	14,3	12,7	12,5	11,2	13,7	16,0	17,5
Expenditures	44,8	23,2	25,2	19,2	20,1	18,5	14,4	14,8	14,5	14,8
Deficit	-28,0	-9,2	-12,1	-4,9	-7,4	-6,0	-3,2	-1,1	1,5	2,7
<i>Budgets of Territories</i>										
Tax receipts *	12,0	13,5	13,5	12,2	11,8	13,0	12,1	12,0	12,2	10,8
Revenues	12,3	16,9	18,2	14,8	14,7	16,0	14,8	14,5	15,2	14,2
Expenditures	12,0	13,1	17,9	15,2	15,6	17,3	15,1	14,5	14,7	14,2
Deficit	0,3	3,8	0,3	-0,4	-0,9	-1,3	-0,3	0,0	0,5	0,0
<i>Consolidated Budget **</i>										
Tax receipts *	18,6	25,9	25,0	23,8	22,8	23,9	21,7	24,6	27,2	27,0
Revenues	29,2	28,4	27,7	27,3	25,1	26,6	24,4	26,8	29,3	29,5
Expenditures	54,7	36,5	39,5	32,1	33,0	32,3	27,9	28,0	26,6	25,6

¹⁷ Without federal budget aid to regions and territories.

¹⁸ Balanced debts are tax debts minus tax overpayments. Before 1999 The Ministry of Taxes and Duties provided statistics that contained only balanced debts.

Deficit	-25,6	-8,1	-11,8	-4,8	-7,8	-5,6	-3,6	-1,2	2,7	3,9
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Increase of non-balanced debts to the budget system in 2001 was appreciably lower than in 2000. Its growth rate equalled to 3% (25% in 2000), its increment share in GDP – 0.1% (1.2% in 2000).

Table 5

Tax Debts to the Consolidated and the Federal budgets

	1996	1997	1998	1999	2000	2001
<i>Debts to consolidated budget (in billion roubles)</i>	120	181	259	290	326	283
Balanced debts growth rate	100%	46%	24%	9%	10%	-11%
Balanced debts growth rate in points of GDP	3,0%	2,4%	2,9%	0,7%	0,5%	-0,5%
<i>Debts to the federal budget (in billion roubles)</i>	70,5	103,6	160	198,7	204,0	206,9*
Balanced debts growth rate	41%	42%	30%	18%	2%	1%
Balanced debts growth rate in points of GDP	1,1%	1,3%	2,1%	0,8%	0,1%	0,0%

* Estimate

Source: The Ministry of Taxes and Duties of the Russian Federation, calculations by IET.

Analysis of Major Tax Receipts

As may be seen from Table 3 receipts of major taxes, except taxes in foreign trade and assessments to off-budget funds, had similar dynamics: lower receipts in 2000 and growth in 2001. Flexibility of major taxes in relation to GDP is shown in Table 7. It follows from it that GDP growth was accompanied by a smaller comparative growth of revenues from four taxes. Drops were registered also in real terms only for VAT and excise-duties.

Table 6

Receipts of Major Taxes in the Budget System of the Russian Federation

	In % of GDP	In real terms
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	1999	2000	2001	2000 κ 1999	2001 κ 2000
Profit tax	6,6%	5,7%	5,7%	109%	132%
Income tax	3,0%	2,5%	2,8%	105%	149%
VAT	11,2%	6,5%	7,1%	74%	143%
Excise-duties	4,2%	2,4%	2,7%	72%	148%
Foreign trade taxes	1,9%	3,3%	3,6%	221%	146%
Assessments to off-budget social funds	7,6%	7,7%	6,4%	129%	110%
Total taxes	33,9%	37,6%	34,5%	141%	121%

Table 7

Flexibility of Major Taxes in Relation to GDP

	Nominal figures		Real figures	
	2000	2001	2000	2001
Profit tax	0,85	1,00	1,00	1,26
Income tax	0,83	1,13	0,97	1,42
VAT	0,58	1,08	0,69	1,36
Excise-duties	0,56	1,12	0,66	1,41
Foreign trade taxes	1,74	1,10	2,04	1,39
Assessments to off-budget social funds	1,01	0,83	1,19	1,04
Total taxes	1,11	0,92	1,30	1,15

Profit tax. Receipts of profit taxes grew in real terms in 2001 compared to 2000 by 32%. The financial result balance of enterprises and organizations at that according to the statistics of The State Statistics Committee as of December 1, 2001 in 2001 compared to 2000 decreased by 10% and net profit by 7%. Moreover, the share of money settlements in the economy grew by 4%.

Profit tax receipts growth against a background of the 2001 profit dynamics is in many ways connected with the 5% municipal profit tax introduced to compensate for the abolished tax for upkeep of housing and communal services. In this connection the share of the profit tax in GDP remained unchanged as compared to 2000: 5.7% of GDP.

Income tax. Income tax receipts in 2001 grew in real terms nearly by half. At the same time it should be taken into consideration that in 2000 nearly 90% of

taxpayers paid their income tax based on the lowest rate (12%), that is why increase of the tax rate for them by 1 point led to income tax receipts growth by 0.1% of GDP. Reduction of the marginal tax rate for taxpayers that were paying their taxes at higher rates in 2000 led according to our estimates to a decrease in revenues by nearly 0.05% of GDP. Moreover, taxpayers' number was extended by the military, which provided an increase in income tax receipts by nearly 0.06%. In this connection an approximate 0.2% GDP increase of income tax receipts in 2001 compared to 2000 happened due to augmentation of the tax base.

The elasticity value of net remuneration in real GDP is quite low (0.13)¹⁹. In this connection growth of real GDP in 2001 by 5-5.5% could lead to an increase of tax receipts by 0.02% of GDP. In this way more than 1.5% of GDP of income tax receipts increment according to our assessments happened in all probability due to legalization of incomes.

It should be noted that in 2002 income tax rate will be changed due to the use of social and property deductions, while extra tax charges because of the single tax rate will not be charged. In this connection one can expect a "lapse" of income tax receipts of 2001 due in the middle of 2002 which nevertheless shall be counted as receipts of 2002.

VAT. According to the data provided by The State Statistics Committee retail trade turnover increased compared to the previous year by 10%. Moreover, there happened considerable changes in the legislation on the value added tax in connection with adoption of the corresponding chapter of the Internal Tax Code. In particular on the 1st of July there was made a transition to payment of VAT according to the "destination country" principle in relations with CIS-countries, some of preferences were reduced. In aggregate all these factors caused an increase of VAT revenues in real terms by 43% compared to 2000. At the same time it should be noted that compensations of VAT in 2001 grew by 0.9 points of

¹⁹ Tax statistics differentiate between income tax collected by fiscal agents and income tax collected by rating authorities. The latter refers to a greater extent to the self-employed, lawyers and public notaries and in the period before 2002 also referred to taxpayers that had more than one place of work. Taxes collected by rating authorities constituted less than 5% of total income tax receipts, though incomes declared by all categories of taxpayers referred to this group constituted nearly 15% of total declared taxable incomes of all taxpayers. Moreover, after all the necessary deductions were made (expenses of the self-employed etc.) this group's tax base was reduced to about 7% of the taxable income base of all taxpayers. Taking into consideration that the self-employed are allowed to pay taxes on imputed earnings instead of the income tax their share of receipts gets even smaller.

GDP (from 1.4% GDP to 2.5% GDP), which in its turn had a negative effect on the level of VAT revenues.

Excise-duties. It should be noted that a considerable increase of excise-duties in real terms by 48% happened mainly due to introduction of new excises (on diesel oil and motor oils) and increase of excises on petrol (approximately 3 times). In aggregate these measures helped to increase excise-duties revenues in 2001 as compared to 2000 by more than 0.25 points of GDP.

Changes in the alcohol excise collection order (establishment of excise-warehouses since July 1, 2001) helped to inconsiderably increase this type of excise revenues calculated in GDP shares.

Foreign trade taxes. Foreign trade taxes receipts of 2001 exceeded the level of 2000 by 46%; the previous year's import duties revenues were exceeded by 62%, export duties revenues by 36%. Increase of import duties revenues was connected with a better collection situation, measures against smuggling and underdeclaration of prices, growth of imports and new higher customs tariffs on imports introduced by Governmental Regulation Nr. 866 of November 27, 2000. Analogous reasons caused a growth of export duties: following the increase of oil prices customs oil export duties were being adjusted accordingly through the year.

Social tax. Social tax revenues in real terms compared to other taxes in 2001 grew to a lower extent in comparison with year 2000, only by 10%, in shares of GDP they decreased by 1.3 points. One should always take the following fact into account: about 7% of revenues were settlement of debts to social budget funds that had accumulated before 2001.

This kind of dynamics is in many ways explained by a reduction of the total rate of payments to state social off-budget funds used before 2001 from 38.5% paid by employers and 1% paid by employees to 35.6% (i.e. by 10%) and to 22.8%²⁰ for self-employed (by 43%). Concurrently The State Employment Fund was desegregated with the federal budget and stopped its independent existence.

As follows from table 8 the share of receipts in each of the off-budget funds corresponds on the whole to the share of payments to this fund in total payments. It should be pointed out that the provided data don't take into account differences in shares of debts paid-out to corresponding funds in sum total of paid-out debts, which leads to considerable distortions in the pattern of receipts.

²⁰ Previously total payments to state social off-budget funds were a block deduction: 38.5% +1%. The social tax was fixed at the level of 26.1% for agricultural enterprises and 17.6% for lawyers.

Moreover, one should take the following into consideration: starting in 2001 there exists, firstly, a regressive tax schedule, secondly, for self-employed in agriculture and lawyers there is a lowered tax rate. According to the data for the first six months the social tax paid by employers that don't belong to categories that lower tax rates are applied to (that is to self-employed, agricultural enterprises and lawyers) made up 95% of the whole of the social tax base. At the same time more than 10% of this tax base were taxed using the regression (that is at rates of 20%, 10% and 2% of amounts exceeding 100,000 roubles, 300,000 roubles and 600,000 roubles of the tax base correspondingly).

Table 8

	Rate in 2000	Share in the total rate	Pattern of receipts in 2000	Rate in 2001	Share in the total rate	Pattern of receipts in 2001
The Pension Fund	28%+1%	71,1%	71,2%	28%	78,7%	75,7%
The Social Security fund	5,4%	13,2%	15,7%	4%	11,2%	14,4%
The State Employment Fund	1,5%	6,9%	4,0%	—	—	—
The Compulsory Medical Insurance Fund and territorial funds of compulsory medical insurance	3,6%	8,8%	9,5%	3,6%	10,1%	9,9%

The 2001 Budget Act Execution Analysis

In 2001 the income side of the 2001 budget was exceeded by more than 30%. The foreign trade receipts level planned by the budget was surpassed by 70%. Among taxes the smallest execution share belongs to indirect taxes, in particular, the VAT control figures were surpassed by 24%, the excise-duty figures by no more than 8%. An important role at that is played by the fact that compensation of the VAT paid to suppliers of material resources used for production of export goods exceeded the figures stated in the budget almost twice.

According to estimates made by the Ministry of Finance the fact that income side of the federal budget exceeded the planned figures was caused by several reasons. Firstly, the exceed of the GDP volume, inflation rate and foreign trade turnover brought to income increase in comparison with planned figures by 0.7 points of GDP. Secondly, the favourable world export prices situation and intro-

duction of higher tariffs also brought about a considerable exceed of planned figures (0.6 points of GDP). A third substantial factor that caused tax receipts increase is a better tax collection situation, also due to restructuring of debts and new customs duties thanks to the effective measures against underdeclared customs prices and smuggling (0.4 points of GDP).

The share of execution of the expenditure side of the federal budget is traditionally smaller and doesn't exceed 111% of cash balance values, planned in the budget. Among the biggest budget expenditures one should single out transport expenditures that were overfulfilled compared to the voted budget figures for 2001 by 21%, international activities expenditures by 34% and media expenses by 21%. Defence, agricultural and law-enforcement expenditures were overfulfilled by nearly 15%, educational expenditures by 11%.

It should be noted that all social expenditures of 2001 were financed in full and funds assigned by the Ministry of Finance of the Russian Federation to budget disponents and further budget funds' receivers corresponded to fixed budget quotas. Federal educational institutions got a full coverage of bills payable for public utilities. Moreover, a considerable expenditures excess against the ones planned in the budget for educational purposes is explained by revenues received from letting out of immovables that belong to educational institutions.

Table 9

Execution of the Federal Law "On the Federal Budget for 2001"

	Budget Act for 2001	Execution in the first six months	Execution in three quarters	Year Execution	Execution in the first six months	Execution in three quarters	Year Execution

	Cash performance				By actual financing	Cash Execution	By actual financing	Cash Execution	By actual financing	Cash performance
	In % of GDP				In % of the Budget Act for 2001					
1	2	3	4	5	6	7	8	9	10	11
Tax receipts	4,39 ¹	6,54	5,57	6,07		9,3		1,9		1,0 ¹³
Profit (income) tax, increase of capital	,26 ²	,61	,48	,40		59,6		93,3		124,5
Taxes on goods and services. License and registration taxes.	9,13	9,26	8,62	9,30		52,4		80,3		119,5

Table 9 (cont'd)

1	2	3	4	5	6	7	8	9	10	11
Total return taxes	0,04	0,05	0,05	0,05		71,1		110,1		157,8
Property taxes	0,01	0,01	0,02	0,02		116,6		284,8		374,8
Natural resources duties	0,48	0,50	0,50	0,55		53,7		88,7		133,7
Foreign trade and foreign-economic operations duties	2,46	3,95	3,77	3,65		82,9		130,2		173,9
Other taxes, duties and tallage	0,02	0,16	0,13	0,11		369,5		507,8		597,4
Non-tax incomes	0,83	1,08	1,11	1,24		67,6		113,9		175,1
Returns on state or municipal property or state or municipal activities	0,35	0,56	0,60	0,66		84,3		147,0		224,0
Returns on sales of land or intangible assets	0,00	0,00	0,00	0,00		66,4		244,8		363,7
Administrative payments and duties	0,01	0,01	0,01	0,01		53,6		79,0		103,9
Punitive damages, and reparation of damages	0,02	0,02	0,02	0,02		38,6		55,8		85,0

Foreign-economic activity revenues	0,00	0,45	0,43	0,49						
Other non-tax revenues	0,04	0,04	0,05	0,06		53,7		107,0		153,4
Funds received by reciprocal settlements	0,00	0,00	0,00	0,03						
Receipts of budget fund-in-trusts	0,18	0,14	0,15	0,16		41,0		69,9		104,4
The fund of the Ministry of Nuclear Power of the Russian Federation	0,18	0,14	0,15	0,16		41,0		69,9		104,5
TOTAL INCOME	15,40	17,76	16,84	17,50		59,6		92,9		133,3
Public administration and local self-government	0,53	0,39	0,38	0,46	53,1	38,7	83,3	61,8	108,6	103,1

Table 9 (cont'd)

1	2	3	4	5	6	7	8	9	10	11
Judicial authorities	0,15	0,10	0,10	0,13	48,1	36,7	79,9	60,1	107,3	104,2
International activities	0,29	0,22	0,23	0,33	40,8	39,4	69,0	67,5	135,0	133,8
National Defence	2,77	2,67	2,57	2,71	54,0	49,7	89,0	78,9	121,4	114,9
Law-enforcement activities and national security	1,70	1,43	1,38	1,64	54,2	43,4	83,6	69,1	114,4	113,0
Internal affairs' authorities	0,46	0,42	0,39		57,4	46,8	83,9	71,6	110,0	109,3
Internal troops	0,13	0,15	0,14		77,3	59,4	117,4	93,9	160,0	156,8
Criminal punishment system	0,31	0,24	0,24		48,4	40,7	74,1	64,6	110,5	109,9
Tax police bodies	0,05	0,04	0,03		49,9	37,8	75,8	60,8	100,9	100,1
State security bodies	0,27	0,23	0,22		53,1	43,6	84,0	69,8	117,4	115,0
Frontier bodies	0,15	0,12	0,12		50,3	38,8	87,9	66,3	117,5	116,6

Customs bodies	0,13	0,09	0,10		49,3	36,3	76,6	63,3	100,4	98,7
Public Prosecutor's bodies	0,08	0,06	0,06		48,9	38,3	77,8	62,5	108,8	108,5
The State fire fighting service	0,07	0,05	0,05		49,3	40,0	73,3	60,7	100,7	98,2
Justice bodies	0,04	0,02	0,02		49,3	32,8	84,7	55,8	110,0	104,8
The state special messengers' service	0,00	0,00	0,00		48,1	39,2	72,4	58,4	97,3	96,2
Basic research and promotion of scientific and technological advance	0,29	0,21	0,22	0,26	50,3	38,7	80,1	65,9	108,0	107,2
Industry, power and civil engineering	0,58	0,37	0,38	0,49	43,6	32,9	72,4	55,7	106,1	98,9
Fuel and energy complex	0,10	0,06	0,06		41,5	29,9	64,4	51,3	101,0	84,9

Table 9 (cont'd)

1	2	3	4	5	6	7	8	9	10	11
Extractive industry (excluding fuel industry)	0,00	0,00	0,00							
Civil engineering and architecture	0,38	0,24	0,25		43,9	33,2	74,2	55,6	0,2	0,2
Mineral and raw-material reproduction	0,07	0,04	0,05		42,0	30,3	73,3	57,9	9,0	8,9
Agriculture and fisheries	0,27	0,17	0,18	0,26	42,1	32,8	66,8	55,8	132,4	114,0
Agricultural production (including the Fund of preferential crediting of the agricultural complex)	0,12	0,04	0,07		25,4	18,2	51,6	44,7	167,7	129,5
Land resources	0,09	0,06	0,06		47,5	35,6	77,5	60,5	102,0	100,7
Fisheries	0,03	0,01	0,02		45,3	26,8	69,4	49,6	103,7	101,0

Other enterprises in agriculture	0,03	0,05	0,03		98,7	98,3	99,4	99,0	100,1	100,1
Preservation of the environment and natural resources, hydro-meteorology, cartography and geodesy	0,06	0,05	0,05	0,05	50,9	42,9	74,1	65,5	104,3	103,5
Transport, public roads, communications and information services	0,39	0,29	0,35	0,41	57,1	38,4	84,5	75,7	124,8	121,3
Motor transport	0,00	0,00	0,00		42,2	42,2	70,0	70,0	100,0	100,0
Railway transport	0,00	0,00	0,00							
Air transport	0,01	0,01	0,01		82,2	75,0	115,6	113,5	376,8	147,3
Water transport	0,02	0,02	0,02		61,7	53,9	87,7	80,5	107,5	107,4
Other means of transport	0,00	0,00	0,00							
Public roads *	0,37	0,26	0,32		56,4	37,0	83,8	74,9	122,0	121,8
Communications	0,00	0,00	0,00		49,0	48,2	79,9	77,3	100,1	100,0

Table 9 (cont'd)

1	2	3	4	5	6	7	8	9	10	11
Information (dataware)	0,00	0,00	0,00		47,6	47,6	76,2	76,2	100,0	100,0
Development of market infrastructure	0,00	0,00	0,00	0,00	50,0	25,0	59,0	25,0	100,4	100,0
Accident control and elimination of extraordinary situations and acts of God	0,08	0,07	0,07	0,08	49,9	44,0	76,2	68,4	110,0	109,5
Education	0,63	0,50	0,49	0,60	62,2	41,3	84,0	66,1	112,9	111,7
Infant education	0,01	0,00	0,00		61,7	28,5	83,6	66,8	115,7	114,5
General education	0,01	0,01	0,01		59,3	33,6	77,9	62,9	104,9	103,4
Primary vocational training	0,14	0,10	0,10		52,5	38,0	76,5	57,8	104,0	103,0
Secondary vocational education	0,09	0,06	0,07		60,5	38,5	84,3	63,5	113,1	110,4

Retraining and additional professional training	0,01	0,01	0,01		59,6	40,4	82,0	60,5	111,9	108,6
Higher professional training	0,37	0,31	0,29		63,2	43,7	82,0	67,2	110,3	109,4
Other expenses of learning	0,01	0,01	0,02		215,2	43,1	322,8	199,8	406,7	405,4
Culture, arts and cinema	0,08	0,06	0,06	0,07	50,8	39,6	84,5	66,5	107,0	105,5
Public mass media	0,08	0,07	0,08	0,08	56,2	48,0	102,5	89,7	120,9	120,8
Public health and sports	0,29	0,21	0,21	0,25	50,9	37,4	77,2	61,5	104,6	104,0
Public health	0,24	0,17	0,17		51,1	37,4	77,4	61,3	104,1	103,4
Sanitary-and-epidemiologic control	0,03	0,03	0,03		50,1	38,2	77,2	66,1	109,4	109,2
Physical culture and sports	0,01	0,01	0,01		47,0	35,5	74,1	52,7	99,1	99,1
Social policies	1,39	1,27	1,19	1,24	52,6	47,1	78,9	72,8	107,9	104,2
Social welfare bodies	0,04	0,03	0,03		69,8	35,6	91,5	59,5	143,5	123,0

Table 9 (cont'd)

1	2	3	4	5	6	7	8	9	10	11
Social aid	0,54	0,52	0,48		50,2	48,9	76,0	74,7	101,5	101,0
Youth politics	0,00	0,00	0,00		50,0	27,5	77,7	45,8	102,5	102,3
Pensions to the military	0,40	0,38	0,34		49,0	49,0	73,6	73,6	97,1	97,1
Pensions to employed in law-enforcement	0,18	0,19	0,17		53,5	53,5	80,1	80,1	107,1	107,0
Other social-political arrangements	0,21	0,15	0,16		63,4	37,2	93,8	64,3	140,3	121,1
State grants to citizens that have children	0,00	0,00	0,00							
Migration politics	0,02	0,01	0,02		36,6	29,8	74,4	59,1	96,6	94,7
State debt servicing	3,09	3,15	3,17	2,54	52,6	52,6	87,0	87,0	96,4	96,4
State domestic debt servicing	0,73	0,55	0,58		39,0	39,0	67,7	67,7	81,9	81,9

State foreign debt servicing	2,36	2,60	2,59		56,8	56,8	93,0	93,0	100,8	100,8
Replenishment of state reserves	0,01	0,00	0,00	0,00	57,1	30,8	82,2	45,5	102,9	68,6
Financial aid to budgets of other levels	2,41	2,74	2,58	2,53	59,9	58,8	92,9	91,0	123,3	123,2
Reclamation and destruction of weapons, including performance of international treaties	0,08	0,07	0,07	0,07	50,1	45,0	78,4	73,4	110,2	108,6
Economy preparedness activity	0,01	0,01	0,01	0,01	50,8	45,3	94,8	86,4	189,0	188,2
Research and use of outer space	0,06	0,07	0,07	0,08	62,5	62,5	105,2	103,4	151,9	151,8
The military reform	0,05	0,07	0,05	0,06	75,2	62,1	88,5	73,4	133,7	130,6
Other expenditures	-0,05	0,14	0,10	0,07	-162,0	-142,5	-171,5	-162,4	-157,9	-156,7

Table 9 (cont'd)

1	2	3	4	5	6	7	8	9	10	11
Reserve funds	0,05	0,00	0,01		6,1	2,4	12,0	9,0	19,1	18,2
Elections and referendum expenses	0,02	0,02	0,01		39,1	39,1	49,6	49,6	30,6	30,6
Budget loans	-0,15	0,10	0,06	0,02	-38,4	-36,0	-35,7	-35,5	-14,0	-14,0
Other expenditures not referred to other expenses	0,02	0,01	0,01	0,05	48,9	30,5	62,6	51,0	173,3	172,9
Road services	0,00	0,00	0,00							
Targeted budget funds	0,18	0,12	0,13	0,16	39,3	35,1	64,1	62,5	104,6	104,6
The fund of the Ministry of Nuclear Power of the Russian Federation	0,18	0,12	0,13		39,3	35,1	64,1	62,5		104,5
TOTAL EXPENDITURES	15,40	14,46	14,12	14,58	54,5	48,5	85,8	77,9	113,8	111,1

Table 10**Execution of the Federal Law “On the Federal Budget for 2001” by Expenditures Including Distribution of Extra Receipts**

	Total expenditures by corresponding expense items of the budget for 2001 including distributed extra receipts	Execution of the budget in 2001	Execution to planned figures ratio, %
State government and local self-government	40816	41971	102,8
Judicial authorities	11867	11807	99,5
International activities	23148	29688	128,3
National defence	234582	246712	105,2
Law enforcement and state security	145833	148705	102,0
Basic research and promotion of scientific and technological advance	22820	23689	103,8

Table 9 (cont'd)

	Total expenditures by corresponding expense items of the budget for 2001 including distributed extra receipts	Execution of the budget in 2001	Execution to planned figures ratio, %
Industry, power and civil engineering	49695	44154	88,8
Agriculture and fisheries	25136	23712	94,3
Environmental and natural resources control, hydrometeorology, cartography and land-	4933	4941	100,2

surveying			
Transport, road industry, telecommunications and information services	31625	37122	117,4
Accidental control and elimination of extraordinary situations and Acts of God	6806	6934	101,9
Education	52389	54498	104,0
Culture, arts and cinema	6537	6734	103,0
Mass media	6234	7526	120,7
Public health and sports	22757	23086	101,4
Social politics	110665	112281	101,5
Replenishment of state stocks and reserves	440	298	67,6
Financial aid to budgets of other levels	204546	229989	112,4
Research and use of outer space	5691	6970	122,5
Military reform	5937	5533	93,2

Execution of the budget's expenditures side in 2001 exceeded the figures in the budget even taking into consideration distribution of extra receipts that were stated in article 120 of the law on the budget. The excess figures were getting lower, but nevertheless were still considerable for mass media and international activities. At the same time defence expenditures were exceeded by only 5%, law enforcement expenditures by 2%, educational expenditures by 4%.

Dynamics of Execution of the Consolidated and State Budget

Federal budget tax receipts peaked in May and equalled to 16.6% of GDP, at the beginning of the year and in October tax receipts amounted to 15.5% of GDP. Federal budget receipts as a whole also peaked in May and equalled to

17.8% GDP. Situation with tax receipts of the consolidated budget was analogous: in May they mounted to 26.4% GDP, revenues as a whole equalled to 30.5% GDP. These dynamics are in many ways connected to changes in profit tax receipts that reached their peak exactly in the middle of the year (2.6% GDP for the federal budget and 6.1% GDP for the consolidated budget).

Federal budget revenues varied in 2001 between 16.2% GDP in January and 17.8% GDP in May – June. The end of the year was characterized by a high receipts level of 17.5% GDP. The consolidated budget receipts varied between 25.9 GDP in January and 30.5 GDP in the middle of the year. Expenditure dispersal both of the federal and consolidated budget was much narrower. Not counting January the minimal expenditure level of the federal budget was registered in October – November at 13.9% GDP, the highest level in December (14.6% GDP). The lowest expenditure level of the consolidated budget (not counting January) was 22.5% GDP in February, the highest level of 25.6% GDP in June.

Table 11

Execution of the Federal Budget of the Russian Federation in 2001 (in % of the GDP)

	January	February	March	April	May	June	July	August	September	October	November	December
Profit tax	1,4	1,5	1,9	2,4	2,6	2,6	2,5	2,6	2,5	2,4	2,4	2,4
Income tax of natural persons	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Value added tax	6,7	6,8	6,7	6,7	6,7	6,7	6,7	6,5	6,4	6,5	6,7	7,0

Table 11 (cont'd)

	January	February	March	April	May	June	July	August	September	October	November	December
Excise-duties	2,3	2,4	2,2	2,4	2,5	2,5	2,4	2,2	2,1	2,1	2,1	2,2
Natural resources duties	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,5

Taxes in foreign trade and foreign economic operations	3,6	4,1	4,1	4,0	3,9	3,9	3,9	3,9	3,8	3,7	3,7	3,6
TOTAL OF TAXES AND DUTIES	15,2	15,7	15,7	16,3	16,6	16,5	16,4	16,0	15,6	15,5	15,8	16,1
TOTAL OF NON-TAX RECEIPTS	1,0	1,1	1,1	1,2	1,3	1,2	1,3	1,3	1,3	1,3	1,3	1,4
TOTAL INCOME	16,2	16,9	16,9	17,5	17,8	17,8	17,7	17,3	16,8	16,8	17,1	17,5
State government	0,1	0,2	0,3	0,3	0,4	0,4	0,4	0,4	0,4	0,4	0,4	0,5
Judicial authorities	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
International activities	0,3	0,3	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,3
National defence	1,3	2,0	2,2	2,5	2,7	2,7	2,7	2,6	2,6	2,6	2,6	2,7
Law enforcement and security	0,7	1,1	1,3	1,4	1,4	1,4	1,4	1,4	1,4	1,4	1,5	1,6
Basic research and promotion of scientific and technological advance	0,0	0,1	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,3
Industry, power and civil engineering	0,1	0,1	0,2	0,2	0,3	0,4	0,4	0,4	0,4	0,4	0,4	0,5
Agriculture and fisheries	0,0	0,0	0,1	0,1	0,1	0,2	0,2	0,2	0,2	0,2	0,2	0,3
Environmental and natural resources controls, hydro-meteorology, cartography and land-surveying	0,0	0,0	0,0	0,0	0,0	0,1	0,1	0,0	0,0	0,0	0,0	0,1
Transport, public roads, telecommunications and information services	0,0	0,1	0,2	0,2	0,3	0,3	0,4	0,4	0,4	0,4	0,4	0,4
Development of market infrastructure	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Accidental control and elimination of extraordinary situations and Acts of God	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1

Table 11 (cont'd)

	January	February	March	April	May	June	July	August	September	October	November	December
Education	0,1	0,3	0,4	0,4	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,6

Culture and arts	0,0	0,0	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Mass media	0,0	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Public health and sports	0,0	0,1	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,3
Social politics	1,1	1,2	1,2	1,4	1,3	1,3	1,2	1,2	1,2	1,2	1,2	1,2
Expenditures of targeted budget funds	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,2	0,2	0,2
Financial aid to authorities of other levels	3,2	2,8	2,6	2,6	2,7	2,7	2,6	2,6	2,6	2,5	2,5	2,5
Other expenses	3,3	5,7	4,9	3,9	3,6	3,5	3,3	3,5	3,5	3,2	3,0	2,8
EXPENDITURES AND LOANS EXCLUDING REPAYMENT OF DEBTS	10,4	14,4	14,2	14,2	14,2	14,5	14,2	14,2	14,1	13,9	13,9	14,6
RECEIPTS' EXCESS OVER EXPENDITURES AND LOANS EXCEPT REPAYMENTS OF DEBTS	5,8	2,5	2,6	3,4	3,7	3,3	3,5	3,1	2,7	2,9	3,2	2,9
TOTAL OF INTERNAL FINANCING	-3,7	-0,8	-0,6	-1,1	-1,7	-1,3	-1,1	-1,2	-0,9	-0,6	-0,9	-0,1
TOTAL OF EXTERNAL FINANCING	-2,1	-1,7	-2,1	-2,3	-2,0	-2,0	-2,4	-1,9	-1,8	-2,3	-2,3	-2,8
<i>TOTAL OF FINANCING</i>	-5,8	-2,5	-2,6	-3,4	-3,7	-3,4	-3,5	-3,1	-2,7	-2,9	-3,2	-2,9

Table 12

Execution of the Consolidated Budget (in % of the GDP)

	January	February	March	April	May	June	July	August	September	October	November	December
Profit tax	3,6	3,6	4,4	5,3	6,1	6,0	5,8	6,1	5,8	5,6	5,8	5,7
Income tax of natural persons	2,4	2,6	2,6	2,6	2,7	2,7	2,8	2,7	2,7	2,7	2,7	2,8

Table 12 (cont'd)

	January	February	March	April	May	June	July	August	September	October	November	December
Value added tax	6,8	6,8	6,7	6,7	6,7	6,7	6,7	6,5	6,4	6,6	6,7	7,1
Excise-duties	2,7	2,8	2,6	2,8	2,9	2,9	2,8	2,7	2,5	2,5	2,6	2,6
Natural resources duties	1,2	1,3	1,3	1,3	1,3	1,3	1,3	1,3	1,3	1,3	1,4	1,4
Taxes in foreign trade and foreign economic operations	3,6	4,1	4,1	4,0	3,9	3,9	3,9	3,9	3,8	3,7	3,7	3,6
TOTAL OF TAXES AND DUTIES	22,7	23,3	23,8	25,3	26,4	26,3	26,0	25,8	25,0	24,8	25,4	25,7
TOTAL OF NON-TAX RECEIPTS	3,2	6,2	3,5	3,9	4,0	3,8	3,8	3,8	3,4	3,4	3,4	3,5
TOTAL INCOME	25,9	26,7	27,3	29,3	30,5	30,1	29,8	29,6	28,3	28,2	28,8	29,1
EXPENDITURES												
State government	0,6	0,9	1,0	1,1	1,1	1,1	1,1	1,1	1,1	1,1	1,1	0,1
Judicial authorities	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
International activities	0,3	0,3	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,3
National defence	1,3	2,0	2,2	2,5	2,7	2,7	2,7	2,6	2,6	2,6	2,6	2,7
Law enforcement and security	1,0	1,5	1,7	1,7	1,8	1,8	1,8	1,8	1,8	1,8	1,8	2,0
Basic research and promotion of scientific and technological advance	0,1	0,1	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,3	0,3
Industry, power and civil engineering	0,3	0,4	0,6	0,8	1,0	1,3	1,3	1,4	1,4	1,5	1,5	1,8
Agriculture and fisheries	0,1	0,3	0,5	0,5	0,6	0,6	0,6	0,6	0,6	0,6	0,6	0,8
Environmental and natural resources controls, hydrometeorology, cartography and land-surveying	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Transport, public roads, telecommunications and information services	0,5	0,6	0,7	0,8	0,8	0,8	0,9	0,9	0,9	1,0	1,0	1,1
Development of market infrastructure	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0

Table 12 (cont'd)

	January	February	March	April	May	June	July	August	September	October	November	December
Housing and communal services	2,3	2,3	2,5	2,6	2,5	2,5	2,5	2,5	2,4	2,4	2,5	2,6
Accidental control and elimination of extraordinary situations and Acts of God	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Education	1,9	2,4	2,7	2,8	2,9	3,2	3,2	3,0	2,9	2,9	3,0	3,1
Culture and arts	0,2	0,3	0,3	0,3	0,4	0,4	0,4	0,4	0,4	0,4	0,4	0,4
Mass media	0,0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,2	0,1	0,2	0,2
Public health and sports	1,4	1,6	1,8	1,9	1,9	2,0	2,0	2,0	1,9	1,9	2,0	2,1
Social politics	1,8	2,0	2,1	2,3	2,2	2,3	2,3	2,3	2,2	2,2	2,3	2,4
Financial aid to authorities of other levels	0,8	1,1	1,2	1,4	1,5	1,3	1,3	1,3	1,3	1,3	1,3	1,3
Other expenses	4,0	6,4	5,7	5,0	4,8	4,6	4,5	4,6	4,4	4,1	3,9	3,6
EXPENDITURES AND LOANS MINUS REPAID DEBTS	16,8	22,5	23,6	24,6	25,1	25,6	25,5	25,5	24,9	24,7	25,0	25,2
RECEIPTS' EXCESS OVER EXPENDITURES AND LOANS EXCEPT REPAYMENTS OF DEBTS	9,1	4,2	3,7	4,6	5,4	4,4	4,4	4,1	3,5	3,5	3,8	4,0

Budget of the General Government

Analysis of execution of the budget of the general government for 2001 gives grounds to point out several major features.

Firstly, the volume of tax receipts by budgets of territories in 2001 equalled to 10.8% of GDP, which is appreciably lower than in 2000, when it reached 12.2% of GDP. Meanwhile, the amount of financial aid to regions redistributed through the federal budget grew essentially from 1.4% of GDP in the previous

year to 2.7% of GDP²¹ – in 2001. Total level of receipts by territorial budgets in this connection slightly reduced from 14.6% of GDP in 2000 to 14.2% GDP in 2001.

Secondly, total amount of expenditures of the general government in 2001 equalled to 37.1 of GDP, which is higher than in 2000 (36%). Taking into consideration that the amount of receipts of the general government as of November 1, 2001 equalled to 31.9% of GDP, the trend of considerable changes in these figures during the last quarter of the year got once again confirmed. In this way execution both of the federal budget as of November 1, 2000 (15.3% of GDP) and of territorial budgets (12.2% of GDP) was considerably different from final results (16% GDP and 15.2% GDP correspondingly).

Thirdly, payments to social off-budget funds (the Pension Fund of the Russian Federation, the Social Security Fund of the Russian Federation, the Fund of Compulsory Medical Insurance and territorial funds of compulsory medical insurance) dropped from 7.5% GDP in 2000 to 6.4%²². At the same time social expenses of these funds (not taking their administrative and other expenses into consideration) remained practically unchanged (6.5% in 2001) as compared to 6.7% of GDP in 2000.

Fourthly, both receipts and expenditures of territorial off-budget road funds dropped appreciably from 2.4% of GDP (of which taxes entered to territorial road funds equalled to 2.2% of GDP) in 2000 to 1.2% of GDP (1% of GDP were taxes and compulsory duties). Adding them up to territorial targeted budget road funds (i.e. road funds consolidated into the budgets of territories of the Federation) increased the gap: 2.6% GDP in 2000 and 2.2% GDP in 2001. Meanwhile the amount of expenditures of territorial budget funds (the budget and off-budget ones) in 2000 equalled to 3.3% of GDP and with an addition of transport and public roads expenditures of territorial budgets it amounted to 4% of GDP, while in 2001 the level of total transport, public roads and telecommunications expenditures of territorial budgets and budget road funds equalled to 1.6% of GDP.

Fifthly, there were no considerable changes in the budget expenditure pattern of the general government in 2001. Visible changes only dealt with the “State Debt Service” item: expenditures were reduced from 3.7% of GDP in 1999 to 2.7% of GDP in 2001.

²¹ Among receipts of territorial budgets the receipts in form of transferred grants equalled to 2.5% of GDP.

²² Estimates

Sixthly, neither there were any considerable changes in budget receipts, with the exception of a certain increase of receipts from foreign trade taxes (from 3.2 GDP in 2000 to 3.6% GDP in 2001) and from VAT (from 6.4% GDP to 7.2 GDP). Increase of income tax receipts equalled to 0.2 points of GDP (from 2.5% GDP to 2.8% GDP).

Analysis of the budget situation in 2001 allows drawing several major conclusions:

- new tax provisions that entered into force as part of the tax reform in 2001 together with intensified administrative control aimed at a better tax collection had a general positive influence on tax collection situation in 2001 for all levels of the budget system;

- there was a considerable decrease in budget tax debt accumulation rates;

- expenditures of budgets of all levels remained at the level of 1999 and 2000, which allowed keeping a surplus in the federal budget and an absence of deficit in territorial budgets;

- the share of social expenditures in the total volume of expenditures (not counting social expenditures included into other budget items) grew in 2001 by more than 10% compared to 2000 and by 5% compared to 1999.

Table 13

Execution of the Budget of the General Government in 2001

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
Items									
RECEIPTS	217880,7	2,4%	553347,7	6,1%			771228,5	8,5%	22,9%
1. Profit (income) tax, capital growth tax	214284,0	2,4%	299932,2	3,3%			514216,2	5,7%	15,3%

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
1.1. Profit tax	2758,3	0,0%	252845,2	2,8%			255603,5	2,8%	7,6%
1.2 Income tax (natural persons)	838,1	0,0%	570,3	0,0%					
1.3. Gambling registry tax	0,4	0,0%	0,0	0,0%					
1.4. Single social tax	845403,4	9,4%	89362,3	1,0%			934765,7	10,3%	27,8%
2. Taxes on goods and services. License and registration taxes.	638851,5	7,1%	2159,8	0,0%			641011,3	7,1%	19,0%
2.1. Value added tax	200013,2	2,2%	40061,5	0,4%			240074,7	2,7%	7,1%
2.2. Excise-duties on excisable goods and certain types of minerals, produced and extracted on the territory of the Russian Federation									
Oil, including hydrocarbon condensate	3081,7	0,0%					3081,7	0,0%	0,1%
2.2. Excise-duties on excisable goods and certain types of minerals, imported to the territory of the Russian Federation	1720,0	0,0%	843,7	0,0%			2563,7	0,0%	0,1%
2.4. License and registration taxes	1733,5	0,0%	1171,4	0,0%			2904,8	0,0%	0,1%
2.5. Tax on purchase of foreign banknotes and means of payments in foreign currency	0,0	0,0%	45119,9	0,5%			45119,9	0,5%	1,3%
2.6. Sales tax	3,6	0,0%	5,9	0,0%			9,5	0,0%	0,0%
2.7. Other taxes and duties on goods and services	4851,5	0,1%	20497,0	0,2%			25348,5	0,3%	0,8%
3. Total income taxes	1499,4	0,0%	88102,8	1,0%			89602,2	1,0%	2,7%

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
4. Property taxes	49718,0	0,5%	79482,7	0,9%			129200,6	1,4%	3,8%
5. Payments for use of natural resources	16607,6	0,2%	49891,3	0,6%			66499,0	0,7%	2,0%
5.1. Payments for use of mineral resources	0,2	0,0%	636,4	0,0%			636,6	0,0%	0,0%
5.2. Payments for use of continental shelf	1117,9	0,0%	1807,6	0,0%			2925,5	0,0%	0,1%
5.3. Payments for use of forests	1048,9	0,0%	1525,0	0,0%			2573,9	0,0%	0,1%
5.4. Payments for use of water bodies	1443,0	0,0%	0,0	0,0%			1443,0	0,0%	0,0%
5.5. Payments for normative and supernormative discharges and dumping of hazardous substances, deployment of these	4159,5	0,0%	11932,8	0,1%			16092,3	0,2%	0,5%
5.6. Tax on land	38,6	0,0%	59,3	0,0%			98,0	0,0%	0,0%
5.7. Payments for use of animals and living water resources	25302,2	0,3%	13630,2	0,2%			38932,4	0,4%	1,2%
5.8. Other payments for use of natural resources	331494,9	3,7%					331494,9	3,7%	9,8%
6. Taxes on foreign trade and international economic operations	328829,3	3,6%					328829,3	3,6%	9,8%
6.1. Customs duties	2665,6	0,0%					2665,6	0,0%	0,1%
6.3. Other taxes and duties, collected in connection with international economic operations	10100,9	0,1%	40678,5	0,4%			50779,4	0,6%	1,5%
7. Other taxes, duties and payments	1180,8	0,0%	1790,6	0,0%			2971,4	0,0%	0,1%
7.1. State dues	8523,6	0,1%					8523,6	0,1%	0,3%
7.2. Other federal taxes	0,0	0,0%	3126,1	0,0%			3126,1	0,0%	0,1%

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
7.3. Taxes of the territories of the Russian Federation	2,6	0,0%	25708,2	0,3%			25710,8	0,3%	0,8%
7.4. Local taxes and duties	393,9	0,0%	10053,6	0,1%			10447,5	0,1%	0,3%
7.5. Other levied payments and duties					673657,4	7,5%	673657,4	7,5%	20,0%
8. Payments to off-budget funds					578614,2	6,4%	578614,2	6,4%	17,2%
8.1. Payments to off-budget social security funds					438137,0	4,8%	438137,0	4,8%	13,0%
The Pension Fund					83637,7	0,9%	83637,7	0,9%	2,5%
The Social Security Fund									
The Employment Fund					56839,5	0,6%	56839,5	0,6%	1,7%
The Fund of Obligatory Medical Insurance and territorial funds of obligatory medical insurance					89098,6	1,0%	89098,6	1,0%	2,6%
8.2. Payments to territorial road funds					5944,6	0,1%	5944,6	0,1%	0,2%
8.3. Payments to other off-budget funds	14511,5	0,2%	112966,3	1,2%			127477,8	1,4%	3,8%
9. Revenues of targeted budget funds	-2,1	0,0%	91837,1	1,0%			91835,0	1,0%	2,7%
The Federal Road fund, territorial road funds as parts of the budgets of the territories of the Federation			5373,1	0,1%			5373,1	0,1%	0,2%
The Federal Ecology fund, territorial ecology funds as parts of budgets of territories of the Federation			15756,1	0,2%			15756,1	0,2%	0,5%

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
The Fund of reproduction of mineral and raw materials resources	14513,7	0,2%					14513,7	0,2%	0,4%
The targeted fund of the Ministry of atomic energy	1475460,2	16,3%	984437,2	10,9%	673657,4	7,5%	3133555	34,7%	93,0%
TAXES AND DUTIES, TOTAL									
NON-TAX RECEIPTS	60093,0	0,7%	64071,3	0,7%			124164,3	1,4%	3,7%
1. Revenues from state property or activities	0,0	0,0%	0,0	0,0%			0,0	0,0%	0,0%
2. Revenues from sales of state property	0,0	0,0%	0,0	0,0%			0,0	0,0%	0,0%
3. Revenues from sales of government reserves	120,0	0,0%	1065,8	0,0%			1185,9	0,0%	0,0%
4. Revenues from sales of land and intangible assets	808,0	0,0%	2857,3	0,0%			3665,3	0,0%	0,1%
6. Administrative payments	1549,0	0,0%	4872,9	0,1%	1421,0	0,0%	7842,9	0,1%	0,2%
7. Punitive payments, payments of damages	44911,6	0,5%	0,0	0,0%			44911,6	0,5%	1,3%
8. Revenues from foreign-economic activities	5059,5	0,1%	13493,2	0,1%	14225,9	0,2%	32778,6	0,4%	1,0%
9. Other non-tax revenues	2691,3	0,0%	229938,6	2,5%			x	x	x
10. Grants from other administrative levels	0,0	0,0%	143222,6	1,6%			x	x	x
10.1. State subsidies	0,0	0,0%	82199,3	0,9%			x	x	x
10.2. Subventions	2691,3	0,0%	4516,6	0,0%			x	x	x
10.3. Means transferred as mutual payments	0,0	0,0%	0,0	0,0%			x	x	x
10.4. Transfers	0,0	0,0%	0,0	0,0%			x	x	x
10.5. VAT transfers	0,0	0,0%	4402,2	0,0%			4402,2	0,0%	0,1%
11. Other gratuitous revenues	0,0	0,0%	9888,3	0,1%			9888,3	0,1%	0,3%

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
12. From state off-budget funds	0,0	0,0%	5852,6	0,1%			5852,6	0,1%	0,2%
13. Revenues from state organizations					65940,1	0,7%	x	x	x
14. Means transferred to non-budget funds					43581	0,5%	x	x	x
14.1. Federal budget's means					22359,0	0,2%	x	x	x
14.2. Local budgets' means					3254,2	0,0%	x	x	x
14.2. Means belonging to off-budget funds			-27839,1	-0,3%			x	x	x
15. Means transferred to targeted budget funds	115232,5	1,3%	308603,2	3,4%	81587,0	0,9%	234691,7	2,6%	7,0%
NON-TAX REVENUES, TOTAL	1590692,7	17,6%	1293040	14,3%	755244,4	8,4%	3368247	37,3%	100,0%
REVENUES, TOTAL									
EXPENDITURES	41971,2	0,5%	69439,2	0,8%			111410,4	1,2%	3,7%
1. Public administration	11807,0	0,1%	812,5	0,0%			12619,5	0,1%	0,4%
2. Judicial authorities	29687,9	0,3%	0,0	0,0%			29687,9	0,3%	1,0%
3. International activities	246712,1	2,7%	0,0	0,0%			246712,1	2,7%	8,1%
4. National defence	148705,4	1,6%	36025,4	0,4%			184730,7	2,0%	6,1%
5. Law enforcement activities and national security	23689,4	0,3%	1638,2	0,0%	2672	0,0%	27999,4	0,3%	0,9%
6. Basic research and promotion of scientific and technological advance	116954,0	1,3%	471007,6	5,2%	86717,1	1,0%	671683,7	7,4%	22,2%
7. State services to the economy, including:	44154,0	0,5%	115105,5	1,3%			159259,5	1,8%	5,3%
7.1. Industry, energy and civil engineering	23712,2	0,3%	45407,0	0,5%			69119,2	0,8%	2,3%
7.2. Agriculture and	4941,4	0,1%	8434,7	0,1%	1389,8	0,0%	14501,9	0,2%	0,5%

fisheries									
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Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
7.3. Environmental and natural resources controls, hydrometeorology, cartography and land-surveying			264,1	0,0%			x	x	x
means, transferred to territorial ecology funds	37122,4	0,4%	59718,1	0,7%	85327,2	0,9%	180934,3	2,0%	6,0%
7.4. Transport, public roads, telecommunication and information services			1233,4	0,0%			x	x	x
means, transferred to territorial road funds	90,0	0,0%	2436,0	0,0%			2526,1	0,0%	0,1%
7.5. Development of market infrastructure			233343,6	2,6%			233343,6	2,6%	7,7%
7.6. Housing and communal services	6934,0	0,1%	5065,2	0,1%			11999,2	0,1%	0,4%
7.7. Accidental control and elimination of extraordinary situations and Acts of God	204124,4	2,3%	538036,2	6,0%	590804,3	6,5%	1277680	14,1%	42,1%
8. Social services	54498,3	0,6%	230592,9	2,6%	1,8	0,0%	285093,0	3,2%	9,4%
8.1. Education	6734,0	0,1%	29670,9	0,3%			36404,9	0,4%	1,2%
8.2. Culture and arts	7525,7	0,1%	7043,6	0,1%			14569,3	0,2%	0,5%
8.3. Mass media	23085,6	0,3%	166237,6	1,8%	69662,3	0,8%	238124,0	2,6%	7,9%
8.4. Public health and sports			20861,5	0,2%			x	x	x
means, transferred to territorial funds of obligatory medical insurance from budgets					2979,1	0,0%	x	x	x
means, transferred to territorial funds of obligatory medical	112280,9	1,2%	104491,2	1,2%	521140,2	5,8%	703488,8	7,8%	23,2%

insurance from the Federal fund of obligatory medical insurance									
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Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
8.5. Social politics, including:	34423,5	0,4%					x	x	x
means, transferred to The Pension Fund, The Employment Fund and the Social Insurance Fund	14526,7	0,2%	107365,6	1,2%			121892,3	1,3%	4,0%
9. Expenditures of the targeted budget funds	14526,7	0,2%	107365,6	1,2%			121892,3	1,3%	4,0%
The targeted budget fund of the Ministry of atom energy	231085,0	2,6%	12677,4	0,1%			243762,4	2,7%	8,0%
10. Foreign debt service	273115,5	3,0%	60588,0	0,7%			333703,4	3,7%	11,0%
11. Other expenses	248254,0	2,7%	2691,3	0,0%			x	x	x
11.1. Financial aid to administrations of other levels	49012,7	0,5%	0,0	0,0%			x	x	x
- State subsidies	82199,3	0,9%	0,0	0,0%			x	x	x
- Subventions	9157,7	0,1%							
Including state support to road industry	94209,9	1,0%	0,0	0,0%			x	x	x
- Transfers	0,0	0,0%	0,0	0,0%			x	x	x
- VAT transfers	4516,6	0,0%	2691,3	0,0%			x	x	x
- Means transferred as settlement of mutual payments	24861,5	0,3%	57896,7	0,6%	22672,9	0,3%	105431,0	1,2%	3,5%
11.2. Other expenses, not referred to other items	1342378,5	14,8%	1297590,0	14,4%	702866,0	7,8%	3033609,3	33,6%	100,1%
EXPENDITURES, TOTAL	1625,2	0,0%	-1837,7	0,0%			-1837,7	0,0%	-0,1%

CREDITING MINUS REPAYMENTS	1625,2	0,0%	-1837,7	0,0%			-1837,7	0,0%	-0,1%
Loans from the budget	17864,7	0,2%	0,0	0,0%			x	x	x
Loans to budgets	16239,5	0,2%	0,0	0,0%			x	x	x

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
Repayment of loans by budgets	0,0	0,0%	42892,7	0,5%			42892,7	0,5%	1,4%
Loans from the budgets, granted to ministries, departments, enterprises and organisations of state	0,0	0,0%	44730,4	0,5%			44730,4	0,5%	1,5%
Repayment of loans by ministries, departments, enterprises and organisations of state	1344003,6	14,9%	1294254,9	14,3%	702866,0	7,8%	3031771,6	33,5%	100,0%
EXPENDITURES AND LOANS MINUS REPAYMENTS, TOTAL	246689,0	2,7%	-1214,5	0,0%	52378,5	0,6%	336475,0	3,7%	
REVENUES' EXCESS OVER EXPENDITURES MINUS REPAYMENTS									
FINANCING, TOTAL									
1. Internal financing	1797,3	0,0%	-2812,3	0,0%	-52827,7	-0,6%	-53842,7	-0,6%	
1.1. The budget's balance of accounts changes on bank accounts in roubles	89659,8	1,0%	55582,0	0,6%			145241,7	1,6%	
Balances for the beginning of the period	87862,5	1,0%	58394,3	0,6%			146256,8	1,6%	
Balances for the end of the period	15062,5	0,2%	0,0	0,0%			15062,5	0,2%	
1.3. Short-term debts by the State	42446,9	0,5%	0,0	0,0%			42446,9	0,5%	

- Debt means	27384,3	0,3%	0,0	0,0%			27384,3	0,3%	
- Repayment of the major sums of debts	-5,1	0,0%	0,0	0,0%			-5,1	0,0%	
1.4. Federal public bonds – variable return on bonds	-1,2	0,0%	0,0	0,0%			-1,2	0,0%	

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
- Debt means	4,0	0,0%	0,0	0,0%			4,0	0,0%	
- Repayment of the major debt sum	1229,2	0,0%	0,0	0,0%			1229,2	0,0%	
1.5. State nonmarket bonds	11500,0	0,1%	0,0	0,0%			11500,0	0,1%	
- Debt means	10270,8	0,1%	0,0	0,0%			10270,8	0,1%	
- Repayment of the major sums of debts	0,0	0,0%	6601,4	0,1%			6601,4	0,1%	
1.6. State (municipal) securities	0,0	0,0%	15123,8	0,2%			15123,8	0,2%	
- Debt means	0,0	0,0%	8522,3	0,1%			8522,3	0,1%	
- Repayment of the major sums of debts	31,3	0,0%	0,0	0,0%			31,3	0,0%	
1.7. Other state securities	31,3	0,0%	0,0	0,0%			31,3	0,0%	
- Debt means	0,0	0,0%	0,0	0,0%			0,0	0,0%	
- Repayment of the major sums of debts	-40822,0	-0,5%	0,0	0,0%			-40822,0	-0,5%	
1.8. Federal state bonds – permanent coupon rate interest	5759,8	0,1%	0,0	0,0%			5759,8	0,1%	
- Debt means	46581,8	0,5%	0,0	0,0%			46581,8	0,5%	
- Repayment of the major sums of debts	14759,9	0,2%	0,0	0,0%			14759,9	0,2%	
1.9. Federal bonds – permanent coupon rate interest	14759,9	0,2%	0,0	0,0%			14759,9	0,2%	
- Debt means	0,0	0,0%	0,0	0,0%			0,0	0,0%	

- Repayment of the major sums of debts	0,0	0,0%	3985,5	0,0%			3985,5	x	
1.10. Budget loans, granted by budgets of other levels	0,0	0,0%	15697,4	0,2%			15697,4	x	
- Debt means	0,0	0,0%	11711,9	0,1%			11711,9	x	

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
- Repayment of the major sums of debts	-2982,5	0,0%	0,0	0,0%			-2982,5	0,0%	
1.11. State savings-bonds	0,0	0,0%	0,0	0,0%			0,0	0,0%	
- Debt means	2982,5	0,0%	0,0	0,0%			2982,5	0,0%	
- Repayment of the major sums of debts	9744,4	0,1%	7093,5	0,1%			16838,0	0,2%	
1.12. Revenues from sales of state or municipal properties	217,5	0,0%	4461,2	0,0%			4678,8	0,1%	
- Revenues from privatisations	9526,9	0,1%	2632,3	0,0%			12159,2	0,1%	
- Revenues from sales of shares	569,1	0,0%	20,0	0,0%			589,0	0,0%	
1.13. State reserves of precious metals and stones	7786,4	0,1%	20,0	0,0%			7806,4	0,1%	
- Sales revenues	7217,3	0,1%	0,0	0,0%			7217,3	0,1%	
- Expenses of financing	-11517,8	-0,1%	-10868,3	-0,1%			-22386,1	-0,2%	
1.14. Other internal loans	0,0	0,0%	70472,7	0,8%			70472,7	0,8%	
- Debt means	11517,8	0,1%	81341,0	0,9%			92858,8	1,0%	
- Repayment of the major sums of debts	0,0	0,0%	0,0	0,0%	449,2	0,0%	449,2	0,0%	
1.15. Credits and loans to off-budget funds	0,0	0,0%	0,0	0,0%	1540,1	0,0%	1540,1	0,0%	
- Debt means	0,0	0,0%	0,0	0,0%	1090,9	0,0%	1090,9	0,0%	

- Repayment of credits and loans	-12133,6	-0,1%	4019,8	0,0%	-52378,5	-0,6%	-56197,0	-0,6%	
INTERNAL FINANCING, TOTAL									
2. External financing	-29502,9	-0,3%	-610,0	0,0%			-30112,8	-0,3%	
2.1. Credits from international financial organizations	12754,9	0,1%	304,8	0,0%			13059,7	0,1%	

Table 13 (cont'd)

	Federal budget		Local budgets		Off-budget funds		The budget of the general government		
	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	billion roubles	% of GDP	% Receipts/Expenditures
Credits received:	42257,7	0,5%	914,8	0,0%			43172,5	0,5%	
Repayments of the major debt sums:	-138055,1	-1,5%	0,0	0,0%			-138055,1	-1,5%	
2.2. Credits form governments of foreign countries granted to the Russian Federation	6197,6	0,1%	0,0	0,0%			6197,6	0,1%	
Credits received (used)	144252,8	1,6%	0,0	0,0%			144252,8	1,6%	
Repayment of the major debt sums	-32875,1	-0,4%	8720,0	0,1%			-45237,4	-0,5%	
2.3. Credits by foreign commercial banks and companies granted to the Russian Federation	0,0	0,0%	0,0	0,0%			0,0	0,0%	
Credits received (used)	33242,0	0,4%	11995,4	0,1%			45237,4	0,5%	
Repayments of the major debt sums:	-26689,4	-0,3%	-12109,9	-0,1%			-43414,1	-0,5%	
2.4. Other external financing	0,0	0,0%	0,0	0,0%			0,0	0,0%	
Credits received (used)	26689,4	0,3%	16724,6	0,2%			43414,1	0,5%	
Repayment of the major debt sums	-28126,6	-0,3%	-1597,3	0,0%			-29723,9	-0,3%	
2.5. Changes in balances of bank accounts of the budget in foreign currency	77292,4	0,9%	769,5	0,0%			78061,9	0,9%	
Balances for the	105419,0	1,2%	2366,8	0,0%			107785,8	1,2%	

beginning of the period									
Balances for the end of the period	2375,7	0,0%	17,6	0,0%			2393,3	0,0%	
Exchange rate difference	-252873,5	-2,8%	-5579,6	-0,1%	0,0	0,0%	-284150,1	-3,1%	
EXTERNAL FINANCING, TOTAL	-265007,1	-2,9%	-1559,9	0,0%	-52378,5	-0,6%	-340347,1	-3,8%	

1.3.2. Macroeconomic Forecast for 2001 and Comment on the Federal budget for 2002

Comment on the Major Figures of the Macroeconomic Forecast Used for Federal Budgeting for 2002

Analysis of the adjusted Forecast of socio-economic development of the Russian Federation in 2002, the results of which were used to draft the federal budget for 2002, to forecast budget revenues in particular, gives us grounds to make several conclusions that contradict to each other to a certain degree:

- firstly, GDP prognosis for 2002 (10700 – 11000 billion roubles) that exerts major influence on budget revenues assessments are adequately realistic and coincide with our assessments;

- secondly, the Forecast contains certain items (e.g. in parts that concern the prognosis for the balance of payment) that can, as we see it, call into question the correctness of calculations by the government;

- thirdly, an important flaw of the Forecast is a lack of any kind of reference points for the nominal and real roubles exchange rates dynamics. Substituted data (foreign trade figures prognosis) give ground to suppose that an invariable or a dropping (according to the first scenario) roubles exchange rate was used;

- fourthly, the expected character of the inflation process and rouble exchange rate dynamics make assessments of interdependence of major macroeconomic variables in 2002 depending on oil prices less unambiguous, which is practically not studied in the Forecast;

- fifthly, our calculations show that federal budget revenues assessments are close to the upper bound of possible values (taking actual execution of the budget in the first six months of 2001 and most important changes in the tax legislature into account). Thus, predicted revenues can appear to be overestimated (e.g. if market situation for

other, than oil and gas export goods and commodities, i.e. metals, timber etc., becomes worse) and the planned reserve funds will be lower, than the expected.

Further we will look in detail upon the following major items:

1. Forecast by the government;
2. Expected dynamics of oil prices;
3. External factors' influence analysis (using situation with the balance of payment);
4. Inflation processes in the economy'
5. GDP prognosis reasonings;
6. Assessment of tax receipts of the federal budget.

1. Forecast by the government. The 2002 forecast is worked out in two variants. Figures of the conservative (1) and the optimistic (2) variants depend on a combination of internal and external factors. An important point here is a supposition that repayment of foreign debts of the Russian Federation can be made in full, according to the current schedule of payments and the prerequisite about accumulation of reserves for 2003.

Table 14

Basic Factors of the Socio-Economic Forecast for 2002, in % to the Previous Year

	Year 2001r.	Year 2002r.			
		Optimistic Variant 2	Variant 1	Conservative A B	
World oil prices, Urals, dollars/tonne	22,9	23,5	18,5	16,5	14,5
Consumer price index	118,6	112,0-113,0	113,0		
GDP	105,0	104,3	103,5	103,1	102,8
Industry output	104,9	104,0	103,0	102,8	102,6
Agricultural output	106,8	103,0	102,0	102,0	102,0
Retail trade turnover	110,8	106,0	105,2	104,8	104,5
Paid services provided to the public	100,8	103,0	102,5	102,2	102,0
Turnover in transport	103,1	104,0	103,0		
Investments to fixed capital	108,7	108,0	106,0	105,0	104,0
Real money income available to the public	105,9	106,0	105,0	104,7	104,5
Exports	97,3	104,2	91,8	87,8	84,4
Imports	118,9	106,5	104,6	103,0	102,0

Principal differences are caused by external development conditions. The deciding factor was the level and dynamics of world oil prices: the average contract price in the first variant equals to 18.5 dollars per barrel, in the second variant 23.5 dollars. Both variants' calculations were based upon equal suppositions about energy resources (oil and gas) export dynamics and performance of obligations to repay and service foreign debts. In connection with changes in external economic situation in the adjusted forecast within borders of the conservative variant there are studied consequences of a drop of the world oil prices to the level of 16.5 – 14.5 dollar per barrel (Variants A and B). Internal development conditions are determined by a growth of investments and consumer demands.

The GDP growth rate considering the factors and conditions of economic development are defined within the limits of 3.5 – 4.3% by variants. The GDP production pattern is determined on the background of accelerated growth rates in civil construction and services in trade. Industrial output growth is predicted at the level of 3 – 4%. The predominant trend in changes in the pattern of the GDP in use remains the situation when the final domestic demand outruns the external demand in its growth rate.

The domestic demand pattern will be defined by the fact that the investment demand growth rate will outrun that of the final public consumption. In connection with growing expenses to settle foreign debts of the state the domestic gross accumulated resources will slightly diminish, which will tell upon the investment expenditure rate. Fixed capital investment increment in 2002 is predicted at a level of 6.0 - 8.0%, their share in the GDP will equal 18.1% against 17.7% in 2001.

According to the forecast real money income growth in 2002 will be 5 – 6%. Real income of the population, though, will not reach higher than 84.4% of year 1997 (before the crisis).

If one uses figure dynamics for real income provided in the forecast, the growth rate of the final consumption by the population in the GDP will be equal to 103.8 – 104.6% against 107.4% in 2001. The present level of income and spendings of the population and consumer prices growth gives grounds to predict a slower savings growth rate in the private homes sector.

Table 15

GDP In-Use Elements Dynamics, in % to the Previous Year

Year 2001r.	Year 2002r.	
	Variant 1	Variant 2

GDP	105,0	103,5	104,3
Final consumption of goods and services, total expenses including	106,2	103,8	104,6
private homes	108,7	104,7	105,6
Gross savings, total	117,0	106,7	107,4
Including			
fixed capital	106,5	105,9	107,7
Net exports of goods, commodities and services	89,9	97,4	93,3

Consequently, the factor that limits growth of final demand is a lower share of gross savings in the GDP on the one hand, and changes in their use on the other. The share of gross savings in the economy in the GDP will remain according to different variants within the limits of 30.9 – 32.4% compared to 34.8% in 2001. Due to the fact that extra revenues will be used with fiscal aims to increase budget surplus and expenses to repay the state debt, the gross domestic savings growth rate will fall from 17.0% in 2001 to 6.7 – 7.4% in 2002.

In spite of the fact that the positive dynamics of investment growth will remain, due to the present technological, reproduction and age pattern of fixed capital, investments given in the forecast will be inadequate to promote active industrial policies.

A slower industrial growth rate is accompanied by a relative fall in the share of investments to development of this sector of the national economy. Most exposed are the branches that have capacity shortages: oil-refining and chemical industry, ferrous and non-ferrous metallurgy, machine-building, food industry.

Situation in the investments sphere is aggravated by the fact that the economy needs investments on a higher scale; moreover it is also in need of a determined strategy to attract investments to branches that want competitive capacities. If one takes into account a high concentration of revenues within export-oriented branches of the raw material sector and lack of mechanisms of inter-industry capital transfer, one can hardly expect a higher investment rate and drastic changes in the pattern of fixed capital reproduction. Against a background of a slower production growth rates and low revenue increase for enterprises the forecast for 2002 envisages prolongation of existing trends. In the situation when internal funds of the real sector of the economy are limited and there are no possibilities for long-term loans for the Russian economy, the situation that provokes narrowing of investment demand will be reproduced.

2. World oil prices forecasts. World oil prices forecasts are worked out by a number of international organizations. According to the basis variant of the latest (December 2001) forecast by the US Department of Energy world oil price defined as the average price of oil imported by the USA in 2002 will be 18.69 dollars/barrel or 15%

lower, than the average world oil price in 2001.²³ According to the prognosis of the International monetary fund the world oil price in 2002 will average 18.5 dollars/barrel

Table 16

	1998	1999	2000	2001 (estimate)	2002 (prognosis)
Price of oil imported by the USA (dollars per barrel)	12,08	17,22	27,72	21,98	18,69

Source: U.S. Department of Energy/Energy Information Administration.

Prognoses for world oil prices dynamics beyond year 2002 are appreciably different depending on starting points of their authors as for forecasts for world oil production and demands. According to the basis prognosis variant provides by the US Department of Energy world oil price in year 2005 will be equal to 20.83 dollars/barrel. Quite close to this forecast are prognoses by the OECD International Energy Agency (19.83 doll./barrel), Natural Resources Canada (21.24 dollars/barrel) and Standard & Poor's Platt's (19.47 dollars/barrel). A number of organizations give lower forecasts for 2005: WEFA Group – 18.39 dollars/barrel, Gas Research Institute – 18.17 dollars/barrel, Deutsche Banc Alex. Brown – 17.08 dollars/barrel, Petroleum Economics – 15.63 dollars/barrel. It should be noted, though, that the above values are given in 1999 prices and are adjusted for inflation. The nominal oil price by year 2005 will be 1-2 dollars higher.

Thus, one expects that in year 2002 oil price for Urals will not be lower than 18 dollars/barrel, i.e. it will correspond to the forecast price for Russian oil on the world market, used for the expenditures side of the budget. For a period beyond there is a considerable scatter of predicted prices. At the same time the majority of prognoses give prices at the level of 18 – 21 dollars/barrel.

3. Influence of external factors and the balance of payment situation.

The scenarios, suggested in the Forecast are calculated with their starting points in the average oil prices for one barrel Urals \$17 – 18.5 and \$22 – 23.5 correspondingly. In both scenarios oil prices are below the average world level in 2000 – 2001. It is envisaged, though, that the exports as compared to exports in 2000-2001 will be even higher (108.5 against 105.5 billion dollars).

²³ This figure is calculated as an average value for all types of oil that is imported by the USA. In the period of 1996–2000 the average oil price imported to the USA was approximately equal to the price of the Urals oil (excess in different years was between 0.1 and one US dollar), in this way this forecast is comparable to the budget prognosis.

Simple econometric estimates made by our Institute based on data from 1996-2001 give the following export values: for the first variant (17-18.5 dollars/barrel) 82 - 86 billion rubles and for the second variant (22-23.5 dollars/barrel) 95-100 billion rubles accordingly. The 96.1 and 108.5 billion rubles given in the Forecast envisage an industrial growth. Admitting these export values when the assumed oil prices will be lower than the current ones one should bare in mind that mineral raw materials, ferrous and non-ferrous metals and goods made of them correspond to a half of the exports and physical volume of exported commodities and goods changes slowly. All this gives us grounds to suppose that the figures given in the Forecast are very optimistic, that is exports estimates don not quite correspond to the basic values of world oil prices used in the Forecast, export value of 108.5 billion roubles cannot be reached if world oil prices remain approximately on the current level.

In 2000 and the first quarters of 2001 a considerable positive balance of trade and good export revenues together with the condition of obligatory sale of a part of export revenues caused a situation when the Central Bank was forced to increase money supply while its capacity to sterilize it by operations on the open market were next to nothing. All this created monetary preconditions for inflation. In 2002 this problem will be partially smoothed over due to the following:

1. Due to lower oil prices exports (the positive side of the balance of trade) will most likely be lower than is stated in the Forecast;
2. If situation remains favourable (there will no critical fall of oil prices) the nominal exchange rate in 2002 will most likely be slightly lower (by approximately 5-7%), its direct influence on the inflation by means of more expensive imported goods will be small. Should oil prices drop considerably which will shortly after entail export cuts to keep the balance of trade positive there will be a possibility of devaluation of the national currency, the government will be forced to restructure foreign debts and to resort to new loans;
3. Should oil prices remain on the level lower than 18 dollars per barrel, a continuation of the real exchange rate strengthening can be expected, which will promote further increase of imports and decrease of the positive side of the balance of trade, cutting foreign currency revenues of the country (seen together with par. 1 above);
4. Should the nominal rouble exchange rate change slightly strengthening of rouble in real terms will become a major problem, because it worsens positions both of export-oriented extracting industries by lowering their compet-

itive capacities and of a number of other branches that produce traded goods because of higher imports (see under par. 3 above);

5. Reduction of the norm of export revenues sales in September 2001 from 75% to 50% allows to be more flexible in 2002 when fixing volumes of foreign currency bought on the market and to make money supply growth rate by the Central Bank lower.
6. In case of a favourable situation of world oil prices the surplus of the federal budget accumulated in form of financial reserves for repayment of foreign debts will allow the Central Bank to partially sterilize money supply growth by purchase of foreign revenues and use of the financial reserves to settle foreign debts (if payments are made according to the schedule), which will lead to a growth of the debit capital balance and reduction of the credit balance in a favourable situation of the balance of payment;
7. If foreign debts' repayments will be performed using a gradual buying-up of foreign currency by the government through the Central Bank and its agents maintaining the nominal exchange rate constant, this can cause a non-speculative fluctuations of the gold and foreign currency reserves without changes in the monetary base and money stock (buying-up of revenues from foreign trade causes a greater money supply, concurrently tax receipts that are accumulated by the financial reserves on accounts with the Central Bank and later converted into foreign currency sterilize this money supply increase).

4. Factors that can influence inflation in 2002. Foreign policies, exchange rate policies and monetary management are influenced chiefly by the situation of the world market of natural resources and the policy of the Central Bank. The government when providing inflation reference point for the budget can influence price changes by the following:

1. Reforms and changes in tariffs of natural monopolies.

Rise in prices as a result of changes in tariffs of natural monopolies (the maximum allowed increase index approved is 35%) in year 2002 will to a certain degree be more controllable, it is assisted in particular by creation of a common tariffs agency. One of variants of tariffs increase can be a controlled indexation (e.g. using the pattern applied to specific excise-duties). When increasing tariffs one should remember that electric power, gas and railway transport are resources and services that are used by practically all branches of the economy, thus increase of tariffs can lead to higher expenses and changes in the structure of costs reflecting on manufacturers' and consumer prices (according to estimates by IET

elasticity of CPI related to electric power tariffs in 1995-2000 equalled to 0.2, elasticity related to housing and communal services about one).

2. Reforms in housing and communal services.

Prices in the housing and communal services sector largely depend upon tariffs of natural monopolies, chiefly on power and gas prices. Moreover a higher share of payments for housing and communal services by the population can cause an extra increase of consumer price index (statistically inflation can make itself visible, for example, when there will be made a transfer from direct share of payments by the population to targeted subsidies through higher service prices at the same level of effectiveness for the state). Here it is also worth noting that against the background of considerable wear of basic assets in the housing and communal infrastructure the heating season can bring forward unexpected maintenance costs as well as possible rehabilitation expenses.

3. Indexing of pensions, wages of employees of budget institutions, use of extra budget revenues to increase non-interest-bearing expenditures.

When extra budget revenues are not used for repayment of foreign debts but for indexing of pensions and wages it leads not only to a higher money supply but also to a higher demand and consumption (a long-term increase with a shift in assessment of receivers' constant incomes). As far as the number of receivers of pensions and wages according to the tariff scale is quite large, a general increase of demand for consumer goods can cause an increase in consumer prices. In particular, use of extra revenues in 2000 for increase of non-interest-bearing expenditures (principally for social expenses) is often called one of the main reasons for high inflation rates at the beginning of 2001. For year 2002 this problem is less important, as far as extra revenues will in all probability be used to accumulate financial reserves for repayment of foreign debts in 2002-2003. As far as extra revenues of the government to a great degree are rental income, decrease of tax burden for the amount of these revenues will not cause inflation prerequisites by increasing the demand, but will add up to capital outflow.

On the whole it should be noted that the inflation and inflationary anticipations are quite inertial, that is why in the present situation judging by the above mentioned one can hardly expect a considerable decrease of inflation. This is the reason why the guidelines suggested by the government in the Forecast for 2002 can be viewed as understated estimates. Allow us to remind that in the Forecast of socio-economic development according to the first scenario inflation for 2002-2003 remains at a permanent level of 10-13% and in 2004 falls to 8-10%. According to the second scenario, the optimistic one, inflation decreases and in 2002-2003 is equal to 9-12% and 7-9% in 2004.

Taking into consideration the inflationary inertia (in 2001 increase of CPI equalled to 18.8%) and expected institutional changes that can cause at least on a short-term basis (in January 2002 the increase of CPI equalled to 3.1%) a rise in prices of natural monopolists (electric power, gas, railroad transport, housing and communal services), we view an estimate of inflation rate at the level of 15-17% as a more realistic one. In case actual world oil prices will be close to the scenario values, as has it already been said, exports can be lower than planned, and tax receipts will be lower accordingly. In such a situation inflation higher than the given reference points will on the contrary promote an increase in revenues and will allow to partially compensate the decrease.

Here it should also be noted that the Forecast in both variants suggests equal inflationary reference points, monetary inflationary factors being stronger in the second scenario accompanied by higher world oil prices. If actual oil prices will be even higher (at the level of 2000-2001) these factors will have a still stronger influence and the inflation can be even higher.

Nevertheless this kind of inflation forecast also has a positive side, showing a slower development of inflationary processes because its underestimation in the Forecast assists lower inflation expectations both in the current year and in future.

4. **Prognosis for the GDP volume.** In spite of the differences in inflation rate estimates (and the GDP deflator indexes accordingly) estimates of the nominal GDP for 2002 (10950 billion roubles) are viewed by us as realistic. This result is achieved by an overestimated GDP for 2001, as we see it. According to preliminary estimates the nominal GDP in 2001 will reach approximately 9040 billion roubles (against 9130 billion roubles in the Forecast). Thus a slightly overestimated GDP in 2001 (by 1%) allows giving a realistic prognosis for GDP in 2002 using underestimated price growth rates.

6. Estimates of the federal budget tax receipts. To make our estimates of tax receipts of the federal budget in 2002 we proceeded from the following:

- nominal volume of GDP in 2002 will be equal to 10950 billion roubles;
- estimates of tax receipts in 2001 in shares of GDP are calculated on the basis of GDP equalling 9040 billion roubles;
- estimates of tax receipts by types of taxes for 2002 are made in two stages:
 - at the first stage estimates of tax receipts by types of taxes for 2002 are calculated on the basis of the respective effective tax rate to the basis of 2002 (in accordance with the draft budget) adjusted to changes in the GDP pattern;
 - at the second stage results of initial calculations are adjusted according to changes in nominal tax rates.

It should be noted that our assessments are relative in that respect that we are not taking influence of the tax reforms on changes in the tax base for each type of taxes into account and they can deviate from actual values in both directions. In particular, in making calculations for the profit tax we disregarded increment of the tax base due to cancellation of privileges, but took into account the low nominal tax rate. Thus, our estimates of profit tax receipts are in all probability underestimated.

Table 17

	2000	2001	2002 (draft)	2002 (estimates)
	In % to the GDP			
Profit tax	2,53%	2,38%	1,96%	1,82%
Income tax	0,39%	0,03%	–	–
VAT	5,26%	7,07%	7,06%	7,00%
Excise-duties	1,86%	2,25%	2,02%	2,00%
Taxes in foreign trade and foreign-economic operations	3,25%	3,67%	2,99%	2,78%
Payments for use of natural recourses	0,26%	0,55%	1,68%	1,58%
Other taxes, duties, dues and fees	0,12%	0,22%	0,06%	0,10%
<i>Tax receipts, total</i>	13,67%	16,16%	15,77%	15,28%

Nevertheless the results of our calculations proved to be close to the reference points. As we see it, the level of tax receipts estimated by the government as 15.77% is closer to the highest possible level of tax receipts when oil prices are within the range of 17 to 20 dollars per barrel, while our estimates are more likely to be close to the lowest level.

Hence, we estimate the total of federal budget tax receipts in 2002 as equal to 15.5% of GDP or 1700 billion roubles. This is approximately 26 billion roubles less, than planned in the draft budget. Thus, if oil prices will fall to the level of 17-18 dollars per barrel the initial surplus of the federal budget can be lower, though budget revenues will be enough to make all payments concerning foreign debts. The volume of the reserve fund, though, can appear to be appreciably lower than planned. According to our estimates the level of the planned tax receipts (15.77%) and increment of the reserve fund as planned in the draft budget can be reached if the annual average of oil prices for Urals will not be lower than 20 dollars per barrel.

As a result of the third reading of the draft federal budget for 2002 there were made amendments that regulate formation of the financial reserve, investments and spending of its means as well as management and control of the financial reserve means. It is also envisaged that in case of an unfavourable market situation in 2002 financing of a part of federal budget expenditures, a total of 68.6 billion roubles, can be put off to a later period. Introduction of such a mechanism gets the financial reserve of the Government of the Russian Federation closer to the presently discussed idea of establishing a stabilization fund. Mean-

while the adopted mechanism contains a number of drawbacks, the most serious one is that the rules of forming a financial reserve (a stabilization fund) shall be adopted as long-term provisions not as part of a budget law and be ruled by a separate federal law or a Budget code. Moreover, the adopted wording of the rules of formation and spending of the fund's means are inaccurate and need additional definitions and interpretations.

Assessment of expenditures of the federal budget. Federal budget expenditures in 2002 are planned at the level of 17.8% of GDP. Especially expanded in shares of the GDP as compared to budget laws of previous years are social expenses (2.5 times compared to the planned figures for 2001 and more than three times as compared to the plan for year 2000). This increase is explained by inclusion into the expenditures of the federal budget of a part of the social tax receipts that are transferred to the Pension Fund, a total of 257 billion roubles (2.4% of planned GDP).

A certain increase of expenditures is envisaged for public roads expenses (from 0.37% of planned GDP in the 2001 budget to 0.6% of the planned GDP in the 2002 budget).

A decrease in GDP share is envisaged for the servicing of the state debts item (2.6% of planned GDP in the budget of 2002 as compared to 3.1 of planned GDP in the budget of 2001 and the analogous level of actual execution of the budget in the first six months of 2001, as well as 4.3% of planned GDP in the budget for 2000), also for defence and law enforcement (a decrease by 0.2 point and 0.1 points in the budget of 2002 as compared to the budget of 2001). It should be noted that the performed financing (that is means transferred by the Ministry of Finance of the Russian Federation to receivers of budget funds) of expenditures under the last two items in the first six months of 2001 exceed the level, envisaged in the draft budget for 2002 (2.9% of GDP and 1.8% of GDP for the first six months of 2001 accordingly as compared to 2.6% GDP and 1.6% GDP in the draft budget for year 2002).

On the whole without taking the single social tax into account the level of expenditures of the federal budget for 2002 and its pattern did not undergo any considerable changes as compared to reference points in the budget law for year 2001.

In constant prices the expenditures side of the 2002 budget was increased by 41% as compared to the budget of 2001 and 64% as compared to the initial law on the budget of 2000 (38% as compared to the budget adjusted to extra revenues). This increase compared to the budget of 2001 can be traced by such important expenditure items as international activities (by 67%), transport and pub-

lic roads (by 113%), including public roads (by 108%), education (by 41%), culture and arts (by 39%), state administration (by 20%), public health (by 24%). Increase of national defence and law enforcement expenditures as compared to the budget for 2001 was no more than 14%.

TABLE 18

Budget Laws and Execution of the Federal Budget in 1999-2002 in Shares of the GDP

	1999			2000			2001			2002	
	Budget Law *	Execution by financing	Execution by cash	Budget Law *	Budget Law of 12.25.00	Execution by financing	Execution by cash	Budget Law *	Execution by financing in the first six months	Execution by cash in the first six months	Budget Law *
1	2	3	4	5	6	7	8	9	10	11	12
Administration of the state and local governments	0,3%	0,3%	0,3%	0,5%	0,5%	0,4%	0,4%	0,5%	0,5%	0,4%	0,5%
Judicial power	0,1%	0,1%	0,1%	0,2%	0,2%	0,1%	0,1%	0,1%	0,1%	0,1%	0,2%
International activities	0,9%	1,3%	1,3%	1,1%	0,8%	0,2%	0,2%	0,3%	0,2%	0,2%	0,4%
National defence	2,3%	2,6%	2,5%	2,8%	4,1%	3,0%	2,8%	2,8%	2,9%	2,6%	2,6%
Law enforcement and state security	1,3%	1,2%	1,2%	1,6%	2,2%	1,6%	1,5%	1,7%	1,8%	1,4%	1,6%
Basic research and promotion of scientific and technological advance	0,3%	0,3%	0,2%	0,3%	0,3%	0,2%	0,3%	0,3%	0,3%	0,2%	0,3%
Industry, power and civil engineering	0,4%	0,4%	0,4%	0,4%	0,7%	0,5%	0,5%	0,6%	0,5%	0,4%	0,5%
Agriculture and fisheries	0,2%	0,2%	0,2%	0,2%	0,3%	0,2%	0,2%	0,3%	0,2%	0,2%	0,2%
Environmental and natural resources controls, hydro-meteorology, cartography and land-surveying	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%
Transport, public roads, telecommunications and information services	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,4%	0,4%	0,3%	0,1%
Accidental control and elimination of extraordinary	0,2%	0,2%	0,2%	0,2%	0,2%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%

situations and Acts of God											
Education	0,5%	0,5%	0,5%	0,6%	0,7%	0,5%	0,5%	0,6%	0,7%	0,5%	0,7%

Table 18 (cont'd)

	1999			2000			2001			2002	
	Budget Law *	Execution by financing	Execution by cash	Budget Law *	Budget Law of 12.25.00	Execution by financing	Execution by cash	Budget Law *	Execution by financing in the first six months	Execution by cash in the first six months	Budget Law *
1	2	3	4	5	6	7	8	9	10	11	12
Culture, arts and cinema	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%
Mass media	0,1%	0,0%	0,0%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%
Public health and sports	0,3%	0,2%	0,2%	0,3%	0,3%	0,2%	0,2%	0,3%	0,3%	0,2%	0,3%
Social politics	1,0%	1,1%	1,1%	1,2%	1,3%	1,0%	1,0%	1,4%	1,4%	1,3%	3,9%
Servicing of foreign debts	4,2%	3,6%	3,6%	4,3%	3,7%	3,7%	3,7%	3,1%	3,1%	3,1%	2,6%
Financial aid to budgets of other levels	1,1%	1,4%	1,4%	1,4%	1,9%	1,5%	1,5%	2,4%	2,8%	2,7%	2,4%
Salvage and liquidation of weapons, including performance of international treaties	0,0%	0,1%	0,1%	0,0%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%
Research and usage of outer space	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%	0,1%
Military reform								0,1%	0,1%	0,1%	0,2%
Other expenditures	-0,2%	-0,1%	-0,1%	0,1%	0,1%	0,1%	0,1%	-0,1%	0,2%	0,1%	0,0%
Public roads											0,6%
Targeted budget funds	1,1%	1,3%	1,2%	1,2%	1,9%	1,4%	1,4%	0,2%	0,1%	0,1%	0,1%
EXPENDITURES, TOTAL	14,4%	14,8%	14,7%	16,8%	19,9%	15,1%	14,8%	15,4%	16,1%	14,3%	17,8%

* in % of estimated GDP;

** including expenditures for public roads (part 26 of budget expenditures classification)

Table 19

Budget Law for Year 2002 in Percent of Budget Laws and Budget Executions in 1999-2001 (in Constant Prices)

	1999			2000			2001			
	Budget Law	Execution by financing	Execution by cash	Budget Law	Budget Law of 12.25.00	Execution by financing	Execution by cash	Budget Law	Execution by financing	Execution by cash
Administration of the state and local governments	246%	224%	228%	157%	152%	155%	163%	120%	77%	81%
Judicial power	235%	216%	229%	169%	160%	167%	166%	145%	94%	97%
International activities	70%	44%	43%	55%	78%	272%	283%	167%	85%	86%
National defence	181%	146%	147%	145%	97%	98%	107%	114%	65%	69%
Law enforcement and state security	202%	183%	187%	157%	112%	113%	119%	114%	69%	70%
Basic research and promotion of scientific and technological advance	156%	156%	160%	137%	127%	126%	125%	118%	76%	76%
Industry, power and civil engineering	236%	178%	201%	207%	109%	120%	118%	111%	73%	78%
Agriculture and fisheries	172%	182%	181%	167%	125%	127%	144%	111%	58%	68%
Environmental and natural resources controls, hydrometeorology, cartography and land-surveying	201%	201%	201%	188%	172%	170%	171%	176%	117%	118%
Transport, public roads, telecommunications and information services	465%	443%	446%	308%	266%	267%	273%	213%	11%	11%
Development of market infrastructure					29%	29%	29%	19%	13%	13%
Accidental control and elimina-	71%	70%	69%	69%	65%	65%	66%	118%	74%	75%

tion of extraordinary situations and Acts of God										
Education	229%	224%	228%	179%	153%	151%	151%	141%	87%	88%
Culture, arts and cinema	201%	200%	213%	158%	137%	142%	142%	139%	90%	91%

Table 19 (cont'd)

	1999			2000			2001			
	Budget Law	Execution by financing	Execution by cash	Budget Law	Budget Law of 12.25.00	Execution by financing	Execution by cash	Budget Law	Execution by financing	Execution by cash
Mass media	294%	294%	307%	129%	120%	122%	121%	142%	81%	81%
Public health and sports	186%	186%	188%	143%	135%	136%	136%	124%	82%	82%
Social politics	213%	180%	181%	170%	160%	157%	158%	119%	221%	229%
Servicing of state debts	102%	105%	104%	93%	108%	79%	79%	102%	74%	74%
Replenishment of state supplies and reserves	323%	323%	337%	226%	199%	203%	229%	105%	70%	106%
Financial aid to budgets of other levels	365%	252%	252%	276%	196%	188%	189%	123%	69%	69%
Salvage and liquidation of weapons including performance of international treaties	355%	170%	171%	358%	202%	193%	213%	147%	93%	94%
Preparedness activities in the economy	66%	48%	50%	72%	43%	46%	56%	86%	32%	32%
Research and usage of outer space	195%	174%	174%	204%	148%	148%	162%	183%	83%	83%
Military reform								337%	174%	178%
Other expenditures	19%	36%	29%	-45%	-34%	-63%	-32%	68%	-30%	-30%
Public roads										
Targeted budget funds	19%	15%	15%	16%	10%	10%	10%	86%	57%	57%
EXPENDITURES, TOTAL	202%	172%	174%	164%	138%	133%	136%	141%	86%	88%

* including public roads expenditures (part 26 of budget expenditures classification)

** payments made to the Pension Fund of the Russian Federation from single social tax receipts are not taken into account

The draft budget introduced by the government to the State Duma was adjusted. Differences in the federal budget's expenditures in the first and second readings are given in table 20.

Table 20

	Difference In shares of GDP
State administration and local governments	-0.02 points
Judicial power	0.00 points
International activities	-0.04 points
National defence	-0.07 points
Law enforcement and state security	0.02 points
Basic research and promotion of scientific and technological advance	0.00 points
Industry, power and civil engineering	0.06 points
Agriculture and fisheries	0.03 points
Environmental and natural resources controls, hydrometeorology, cartography and land-surveying	0.00 points
Transport, public roads, telecommunications and informational services	0.02 points
Accidental control and elimination of extraordinary situations and Acts of God	0.00 points
Education	-0.02 points
Culture, arts and cinema	0.00 points
Mass media	0.00 points
Public health and sports	0.00 points
Social politics	0.10 points
Servicing of state debts	-0.13 points
Replenishment of state supplies and reserves	0.00 points
Financial aid to budgets of other levels	0.08 points
Salvage and liquidation of weapons, including performance of international treaties	0.00 points
Research and usage of outer space	0.00 points
Military reform	0.00 points
Other expenditures	0.00 points
Public roads	0.11 points
Targeted budget funds	0.00 points

As was said before in the third reading of the draft budget in the State Duma there were made amendments that envisage that in case of an unfavourable market situation and a decrease of federal budget receipts in 2002 financing of some parts of federal budget expenditures in 2002, a total of 68.5 billion roubles, can be put off to a later period. This sum's breakdown into expenditure items is given in corresponding sections of table 8.

Table 21

	Billion roubles	% of the GDP
State administration and local governments	2,8	0,03%
International activities	5	0,05%
National defence	10	0,09%
Law enforcement and state security	5,5	0,05%
Basic research and promotion of scientific and technological advance	1,8	0,02%
Industry, power and civil engineering	5,2	0,05%
Agriculture and fisheries	4,5	0,04%
Environmental and natural resources controls, hydrometeorology, cartography and land-surveying	0,5	0,00%
Transport, telecommunications and informational services	1,4	0,01%
Accidental control and elimination of extraordinary situations and Acts of God	0,6	0,01%
Education	2,6	0,02%
Culture, arts and cinema	0,6	0,01%
Mass media	0,6	0,01%
Public health and sports	1,9	0,02%
Social politics	2	0,02%
Financial aid to budgets of other levels	15,7	0,14%
Salvage and liquidation of weapons, including performance of international treaties	0,7	0,01%
Research and usage of outer space	0,6	0,01%
Public roads	6,5	0,06%

Total	68,5	0,63%
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1.3.3. Inter-Budgetary Relations and Sub-National Finances

The past year as distinct from previous years did not witness any thoroughgoing reforms in the inter-budgetary sphere and regional finances. Though a great number of changes in the current legislation that regulate tax collection and distribution of tax receipts to different levels of the budgetary system, such as the system of distribution of financial aid to subnational budgets, the Programme for development of budgetary federalism in the Russian Federation for the period until year 2005 adopted by the Government shall in the nearest future have a considerable influence both on budget situations of territories of the Federation and municipalities and financial relationships of budgets of different power levels.

In this section we will take a closer look on principal trends of inter-budgetary relationships and sub-national finances in year 2001 and make an analysis of cardinal decision adopted in this period. The matter concerns first of all innovations in the tax and budget legislation and the Programme for development of budgetary federalism in Russia.

Inter-Budgetary Relationship Trends of Budgets of Different Levels in the Russian Federation

To make an analysis of main trends of 2001 in the sphere of relationship of budgets of different levels let us consider the make-up of the consolidated budget of the Russian Federation and changes it underwent recently. Table 22 provides data that describe shares of tax receipts, receipts and expenditures of budgets of territories of the Federation in the consolidated budget of the Russian Federation.

Table 22

Shares of Certain Figures of Budgets of Territories of the Federation in the Consolidated Budget of the Russian Federation in 1992-2000 (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Tax receipts	44,2%	53,1%	53,4%	47,6%	49,5%	53,1%	54,0%	48,9%	43,5%	37,4%

Revenues	44,0%	58,0%	53,9%	52,6%	53,8%	57,5%	56,6%	49,2%	50,6%	48,8%
Expenditures	34,0%	40,3%	37,7%	43,4%	45,4%	48,1%	48,4%	46,9%	54,4%	56,6%

As the table indicates the share of tax receipts of territories of the Federation in the consolidated budget of Russia has been steadily decreasing in the past four years, at the same time the share of amounts of budget revenues of territories (including financial aid from the federal budget) in total revenues of the budget system in 1999 – 2001 remained practically unchanged (about 50%). The expenditures pattern of the consolidated budget in the past two years changed towards increase of the share of expenditures of territorial budgets of the Federation in expenditures of the budget system of Russia.

A lower share of tax receipts of territorial budgets of the Federation in total tax receipts in the budget system is a direct consequence of changes introduced to the Russian budget legislation in 2000, namely transition to the new order when all value-added tax receipts are entered in the federal budget, a lower road-users' tax rate (only 1%), abolished housing, social and cultural establishment upkeep tax, other decisions in the sphere of tax reforms (including a lower tax rate on incomes of natural persons). As a result tax receipts of regional budgets in 2001 decreased by 1 point of GDP as compared to the previous year (from 10.5% GDP in 2000 to 9.6% GDP in 2001). Tax receipts of the federal budget in the same period grew from 13.7% GDP to 16.1% GDP. These reference values show that the share of tax receipts of regional budgets in the consolidated budget of the Russian Federation in 2001 lowered not merely because of redistribution of tax receipts to the federal budget, but also because of increased receipts in the federal budget.

An increased share of expenditures of budgets of territories of the Federation in the consolidated budget is explained first of all by growth of surplus in the federal budget to the level of 3% of GDP while excess of receipts of regional budgets over their expenditures in 2001 remained at the level of the previous year.

An analysis of data about granting federal financial aid to budgets of lower levels in 2001 (see Table 23) shows that trends of changing volumes and patterns for granted means correspond to the proclaimed lines of reforms of inter-budgetary relations in Russia and also follow from the measures adopted in the sphere of tax system and budget reforms policies. First of all one should note a considerable increase of the volume of federal financial aid to territories of the

Federation (by 1 point GDP) which is directly connected with the process of tax receipts centralization in the federal budget (including establishment of the Compensation fund due to centralization of value-added tax receipts and a greater volume of subventions and subsidies for road construction because of the lower rate of the road-users' tax).

At the same time transfers from The Fund of financial support of regions remain the principal source of federal financial aid to the regions: in 2001 through this channel of financial aid there was redistributed more than 1% of GDP. If transfers from this fund are added to subventions and subsidies from the Compensation fund (because of the fact that expenditures financed in this way were previously taken into account when means from The Fund of financial support of regions were granted) one can draw a conclusion that in 2001 about 60% (1.5% of GDP) of the total of federal financial aid was granted through formalized channels.

Among other types of federal financial aid one should also name the means that are granted within the limits of "Subsidies and subventions" item which in 2001 amounted to 0.54% GDP (21% of the total federal financial aid) and showed a considerable growth as compared to the previous year, when means granted from this item equalled to 0.15% GDP. Such growth is explained by the following: in the first place within the framework of settlement of inter-budgetary relations with the republics of Tatarstan and Bashkortostan (among other things transition to the mutually established norms of distribution of federal tax receipts acquired from the territories of these republics) the abovementioned territories of the Federation were granted a total of 18.9 billion roubles of subsidies. Secondly, there was performed a redistribution of subsidies among regions that are envisaged in the federal budget law to compensate for losses in connection with changes in volume and the order of formation of The Compensation fund (8.35 billion roubles) and at the end of the fourth quarter regions were granted subsidies to partially compensate for their expenses in connection with raising salary for the first grade of the Uniform wages tariff scale (2.3 billion roubles). As a result subsidies and subventions in 2001 among sources of federal financial aid to territories of the Federation came second after means originating from The Fund of financial support of regions and the Compensation fund.

The third in size channel of federal means distribution among territories of the Russian Federation in 2001 were subventions, subsidies and grants for construction and maintenance of public highways in the regions of the Federation (0.27% of GDP or 11% of the total of federal financial aid). As mentioned before as the principal reason of higher volumes of federal financial aid in this respect

can be mentioned lower regional budget receipts caused by the reduction of the road-users' tax rate to 1% (maximum tax rate before being 2.75% of a given enterprise's revenues).

Among other trends of changes in distribution of federal financial aid to territories of the Federation in 2001 one should point out lower volumes of means distributed in form of mutual settlements (from 0.28% GDP in 2000 to 0.05% GDP in 2001), bigger amounts of financing of state programmes for regional development and a favourable balance of budget loans to subordinate powers registered by the results of the year.

Should one consider main figures of distribution of federal financial aid to territories of the Federation from the point of view of regions one should note that regional budgets become much more dependant on federal financial aid as compared to previous periods, which is explained by the abovementioned process of centralization of tax receipts in the federal budget. The total share of federal financial aid in revenues of consolidated budgets of territories of the Federation in 2001 equalled to 17% as compared to 9% the year before; the share of expenditures of consolidated regional budgets financed by federal means in the same period grew from 8% to 15%. At the same time the list of regions that have budgets most dependant on federal financial aid (the so called "highly granted regions") as compared to previous years has hardly changed: on that list as before (in addition to the Chechen republic) are The Republic of Tyva, Ust-Ordynsky Buryatsky autonomous okrug, the Republic of Dagestan, Komi-Permyatzky autonomous okrug, the Republic of Ingushetiya, the Jewish autonomous okrug, Aginsky-Buryatsky autonomous okrug, the Karachayev-Cherkesskya Republic, the Koryak autonomous okrug, the Kabardino-Balkarian republic, the Republic of Northern Osetiya, the Republic of Adygeya, Bryansk oblast, the Amur oblast, Ivanovo oblast. Meanwhile, as compared to the previous year when the share of expenditures of the twenty most dependant regions financed by federal means varied between 43% and 87%, the dispersion in 2001 varied in range from 48% to 86%.

On the whole the analysis of quantitative showings in the sphere of inter-budgetary relations and regional finances allows us to make a conclusion that the process of centralization of budget revenues is accompanied by an adequate growth of the size of federal financial aid to the regions, which hightens the role of the federal budget as a mechanism of inter-regional redistribution of budget revenues. In case this tendency is accompanied by a better objectivity in distribution of federal financial support to the regions, that is volumes of granted means correspond to the revenue potential and (or) budget expenditure requirements of

territories of the Federation, the mentioned process shall lead to a higher degree of inter-territorial levelling of abilities of public authorities of the territories of the Federation to provide public benefits on their respective territories.

Tax Reforms and Inter-Budgetary Relations

In 2001 there were adopted a number of changes in the tax and duties legislation which to a considerable degree influence distribution of tax receipts to budgets of different levels and in this way influence inter-budgetary relations in Russia. Among the most important legislative innovations should be mentioned the adopted chapters of the Tax code about profit tax, tax on mining operations and sales tax. Let us take a closer look at the mentioned changes from the point of view of their influence on public finances in regions.

Inter-budgetary distribution of profit tax receipts from organizations.

The procedure of profit tax fixing and distribution of tax receipts among budgets of different levels was established and started functioning on January 1, 1994: the profit tax paid to the republican budget was fixed at the rate of 13%, while it was allowed to the corresponding public authorities to fix the rate of the profit tax paid to the budgets of territories of the Federation at the highest level of 25% for enterprises and organizations and 30% for banks and insurers. New profit tax rates started functioning in the Russian Federation in the second quarter of 1999: the 11% rate for taxes received by the federal budget and a maximum of 19% for taxes paid to the budgets of territories of the Federation. At the same time public authorities of the territories of the Federation were allowed to establish extra profit tax allowance for taxes paid to their respective budgets.

Starting in 2001 pursuant to article 8 of the Federal law "On enactment of the second part of the Tax Code of the Russian Federation and introduction of changes to certain tax legislative acts of the Russian Federation" local governments were given the right to fix profit tax rates for enterprises registered on their territories at a level that does not exceed 5% and legislative (representative) bodies of territories of the Russian Federation and representative bodies of local administrations were allowed to fix extra tax allowances for certain categories of taxpayers in profit tax for organizations within the limits of tax amounts payable to their respective budgets.

In 2001 a new chapter of the Tax Code of the Russian Federation, chapter 25 "On profit tax paid by organizations" was adopted, it will enter into force on January 1, 2002. Pursuant to the new part 1 of article 284 of the Tax Code the procedure of fixing tax rates and tax allowances by public authorities of different levels is changed: regional authorities get their right to fix profit tax rates for organizations within tax amounts credited budgets of territories of the Federation within the limits between 14.5% and 10.5%, the federal budget will receive revenues from this tax collected at the rate of 7.5%, local budgets at the rate of 2%.

At the same time all allowances on this tax will be abolished, disbursements accepted as deductions from the taxable base will be determined in the Tax Code of the Russian Federation. It is evident that such considerable changes of tax rates and conditions of taxation cannot but influence the pattern of distribution of tax receipts among budgets of different levels. Though due to the reason that the changes introduced to the laws are substantial, it will be quite a problem to make forecasts about directions and scopes of changes of tax receipts pattern of distribution.

Inter-budgetary distribution of tax receipts arising from taxation of natural resources. Receipts from all control taxes collected on the territories of autonomous okrugs are entered to their budgets according to fixed norms and are not subject for redistribution among budgets of okrugs and krajs (territories) and oblasts that they are parts of. Payments for use of natural resources are no exception in spite of the fact that several autonomous okrugs (Yamalo-Nenets, Khanty-Mansi and Taimyr in particular) possess stocks of hydrocarbons and other mineral resources of national importance. Payments for extraction of hydrocarbons and other mineral resources are entered into budgets of autonomous okrugs pursuant to a single norm equal for all regions. To avoid conflicts arising from these tremendous income sources between autonomous okrugs and territories (oblast) that they are parts of, federal authorities adopted a decision that okrugs shall transfer to the budgets of corresponding krajs (oblast) half of the share of revenues from mining operations payable to the federal budget.

Thus, pursuant to article 42 of the Law of the Russian Federation “On natural resources” in its wording that was valid until the beginning of 2002 there existed the following pattern of distribution of revenues from mining operations. According to the single rule payments for extraction of hydrocarbons were distributed between budgets in the following way: local budget – 30%, regional budget – 30%, the federal budget – 50%; payments for other mining operations were distributed as follows: local budget – 50%, regional budget – 25%, the federal budget – 25%. But in case of mining operations on the territory of an autonomous okrug that is a part of a krai or an oblast payments for mining operations were entered into budgets of the krai or oblast as a half of revenues received by the federal budget. Reasoning from the above mentioned one can state that equality of budgetary rights of all territories of the Russian Federation in this respect was ensured at the expense of the federal budget.

On January 1, 2002 pursuant to federal law Nr. 126-FZ “On introduction of changes and additions to part two of the Tax Code of the Russian Federation and several other legislative acts of the Russian Federation, on cancellation of several

legislative acts of the Russian Federation” there was introduced a new tax on extraction of natural resources (the tax that substitutes the presently collected payments for mineral resources, oil and gas condensate excise-duties and payments for reproduction of sources of minerals and raw materials). In connection with that there are established new rules for distribution of tax receipts between the Russian Federation, krai (oblast) and autonomous okrug as its part. First of all tax receipts arising from extraction of hydrocarbons will be distributed according to the following proportion: 74.5% to the federal budget, 20% to the budget of the autonomous okrug, 5.5% to the budget of the krai or oblast. 80% of tax receipts generated on a territory of the Federation that is not an autonomous okrug that is a part of an oblast or krai shall be entered into the federal budget, 20% shall be credited the budgets of the territories of the Federation. Secondly, the amount of mining operations tax generated by extraction of generally found natural resources shall be entirely credited budgets of territories of the Federation.

As a result of adopted changes one retains the situation when extra tax revenues of the budget of a territory of the Federation arising from extraction of hydrocarbons on the territory of an autonomous okrug that is a parts of this territory are ensured at the expense of means actually meant to be paid to the federal budget. But in contrast to the situation before 2002 losses of the federal budget that equalled to a half of its share of total revenues are now limited to a sum, which is equivalent to 7% of tax receipts (on the other hand it should be noted that this figure is not completely comparable to previously valid proportions, because the new tax was introduced instead of three taxes that were collected before).

It is also worth noting that tax payments for mining operations to the budget of the krai or oblast of the total sum of tax receipts originating on the territory of an autonomous okrug that is a part of an oblast or krai at the expense of the federal budget’s share are only made in case of extraction of hydrocarbons. In case of other types of mining operations (excluding generally found natural resources tax receipts from which are entirely credited budgets of territories of the Federation) the federal budge since 2002 is credited 40% of receipts from mining operation taxes, budgets of territories of the Federation get 60% of receipts, while the procedure of distribution of tax receipts between budgets of territories of the Federation and budgets of their autonomous okrugs shall be established by agreements between the autonomous okrug and the territory of the Federation.

Revenues of regional budgets and sales tax. As we have already pointed out in our survey “Russian Economy in 2000: Trends and Outlooks” at the beginning of year 2001 the Constitutional court ruled that certain provisions of the

federal law “On the frame of tax system in the Russian Federation” related to the sales tax were inconsistent with the Constitution of the Russian Federation.

In its ruling the Constitutional Court said that starting on the 1st of January 2002²⁴ in case provisions of the law “On the frame of tax system” declared inconsistent with the Constitution they shall be abolished. This provision induced the Government to present a draft of Chapter 27 of the Tax Code “On the sales tax” which didn’t contain the provisions that had been declared invalid by the Constitutional Court. At the same time the law on introduction of this new legislative act envisages that the sales tax shall be abolished as of the 1st of January 2004²⁵. By results of year 2001 sales tax receipts amounted to 5.2% of tax receipts in consolidated regional budgets. Obviously federal authorities in 2002–2003 will face the task of working out means to outweigh revenues lost by regional budgets due to abolition of the sales tax.

Inter-Budgetary Relations: the Law on the Federal Budget for 2002

The law on the federal budget for 2002 envisages a number of changes in the system of financial aid from the federal budget to budgets of territories of the Federation, which don’t have such a decisive character as in previous years. The law envisages allocation of 275.2 billion roubles (3% of GDP) for financial aid to budgets of other levels, which exceeds the amounts of financial aid to budgets of other levels planned for year 2001 (the law on the federal budget for 2001 envisaged total allocations of 210 billion roubles or 2.4% GDP for sub-national budgets). It should be pointed out to a growth of federal financial aid to budgets of other levels in the laws on federal budgets for latest years: in this way the law on the federal budget for 1999 envisaged allocation of means equal to 1.1% GDP to

²⁴ See Ruling of the Constitutional Court of the Russian Federation of January 30, 2001 Nr. 2-P, trial case of constitutional compliance of provisions of Article 20, part 1, item “d” and part 3 of the law of the Russian Federation “On the frame of tax system”, enactment of the federal law of July 31, 1998 “On changes and additions to article 20 of the law of the Russian Federation “On the frame of tax system in the Russian Federation”, provisions of the law of the Republic of Chuvashiya “On the sales tax”, the law of Kirov oblast “On the sales tax” and the law of Chelyabinsk oblast “On the sales tax” in connection with the inquiry by the arbitration tribunal of Chelyabinsk oblast, action brought by a limited liability company “Russkaya Troika” and a number of citizens.

²⁵ See Federal law of November 27, 2001 Nr. 148-FZ “On introduction of changes and additions to part two of the Tax Code of the Russian Federation and article 20 of the law of the Russian Federation “On frame of tax system in the Russian Federation””

budgets of other levels (by the year's results it was financed 1.3% GDP), for year 2000 these spendings were planned at the level of 1.3% GDP and executed in the amount of 1.4% GDP.

It should be pointed out that the planned growth of financial aid in question in the latest laws on the federal budget as compared to previous periods is caused both by a direct increase of amounts of financial aid distributed among regions as a result of centralization in the federal budget of certain types of tax receipts (mainly value-added tax and income receipts) and accumulation under the item "Financial aid to budgets of other levels" in the law on the federal budget of means that had never been planned and distributed among regions in a budget act before.

Under the item "Financial aid to budgets of other levels" the law on the federal budget for 2002 envisages the following types of financial support:

- transfers from the Fund of support of territories of the Russian Federation (including financial support of "Northern deliveries" and subventions to compensate for electric power tariffs for the territories of The Far East and Arkhangelsk oblast;
- subventions and subsidies from the Compensation fund;
- subsidies from the Fund of Co-Financing of Social Expenditures;
- subsidies from the Fund of Reformation of Regional Finances;
- financing of federal programmes of regional development at the expense of the Fund of Regional Development;
- grants and subventions to budgets of closed administrative-territorial units;
- financial support of the resort of the city of Sochi;
- financial development programme for "science cities";
- financing of the National contest "The most comfortable city in Russia";
- financing of works of collection and reclamation of radioactive waste;
- financing of expenditures for upkeep of housing and social utilities transferred under jurisdiction of local governments;
- subsidies to stabilize budget revenue bases of territories of the Russian Federation in connection with adoption of the second part of the Tax Code of the Russian Federation and wage rise for the first class of the Single tariff scale for those employed in organizations of the state budget sphere.

As before the main part of financial aid to budgets of other levels is comprised of subsidies from the Fund of Financial Support of Regions and targeted financial aid from the Compensation Fund. Total amount of means planned to be distributed through these channels in 2002 equals to 68% of the total volume of federal financial aid, which is somewhat higher than the analogous figures of

2001 (the law on the federal budget for 2001 envisaged that in connection with distribution of extra revenues shares of financial aid types in question in the total amount of federal financial aid to sub-national budgets will amount to 66%). This tendency is a positive fact, because means of the mentioned funds in contrast to the majority of other types of financial aid are calculated with the help of methods common to all territories of the Federation in accordance with factors that determine objective requirements of regional budgets for funds.

Considering the law on the federal budget for 2002 and the financial aid allotted as subsidies from the Fund of Financial Support of Regions and means from the Compensation Fund one should point out that in 2001 methods of distribution from these funds were improved. For example the method of assessment of budget tax potential of territories of the Federation was adjusted to take a complete account of composition of industrial branches of territories. Starting in 2002 two extra federal expense commissions are financed from the means of the Compensation Fund: in addition to subventions to implement the law "On state grants to citizens that have children" and subsidies to implement the law "On social protection of the disabled in the Russian Federation" the Compensation fund allots subsidies to budgets of territories of the Russian Federation to compensate for payment allowances in housing and communal services, telecommunication services, use of public transport by citizens who had been exposed to the radioactivity of Chernobyl, the accident on the "Mayak" factory and nuclear tests on the proving ground near Semipalatinsk, also subsidies to compensate for payment allowances in housing and communal services and telecommunication services for the military, militia officers, employed by the internal affairs' authorities, the tax police, customs functionaries. Amounts of the new types of subsidies are calculated on the basis of the number of receivers of the named allowances living on the territories of the Federation, the minimal subsidy per one receiver and federal standards for housing and communal services costs on the given territory of the Federation.

When making an analysis of the 2002 federal budget law item that allots amounts of financial aid to sub-national budgets one should note that in spite of the fact that a number of financial aid allotments to sub-national budgets is viewed as well-grounded in their amounts, aims and distribution criteria (transfers from the Fund of Financial Support of Regions, means from the Compensation fund), other forms of financial aid transfers to budgets of lower levels are a subject of certain controversy.

In this way allotment of subsidies to compensate for electrical power tariffs to the regions of the Far East and Arkhangelsk oblast in the form of targeted sub-

sidies as a separate item cannot be viewed as obviously grounded. In all probability these means should be distributed as parts of transfers from the Fund of Financial Support of Regions in the form of non-targeted subsidies, because objectives of the federal government do not include levelling of electrical power tariffs on the whole of the country's territory, but rather building up of regional authorities' potential to provide state services of unified quality. Including the electrical power tariff factor into the formula of calculation of subsidies from the Fund of financial support to regions will allow regional authorities to compensate for high power expenses charged to private homes by giving targeted grants to low-income groups of the population. On the other hand, if public authorities of a certain territory of the Federation mean that other types of expenses are more preferable compared to compensation of power charges, they will have an opportunity to use the received funds for other purposes. Analogous reasoning can be used for funds allotted as federal support of "Northern supplies". In this connection it should be noted that the Programme of development of budget federalism in the Russian Federation, which will be discussed below, envisages that targeted allocation of funds as part of subsidies from the Fund of Financial Support of Regions will be abandoned.

At present the procedure of subventions distribution from the Fund of Co-Financing of Social Expenses is not completely clear. According to the plans of the Government means from that fund are supposed to be allotted as share subsidies for co-financing of regional authorities' expenses to provide housing allowances for citizens, which shall promote the housing and communal services reform in regions. But the practical side of implementation of this suggestion, the system to control the effectiveness of regional housing subsidies and the procedure of share subsidies allocation itself are not worked out by the Government properly.

As for the means from the Fund of Regional Development it should be noted that financing from this Fund of the Federal target programme "Socio-economic development of the Republic of Tatarstan" is viewed as ineffective. In spite of the fact these means are allotted to compensate for deficient republican budget revenues because the republic is going over to the tax and duties payment procedure envisaged by the federal law (the previous year the budget of the republic, as stated above, due to the same reasons was allotted a total subsidy of 11 billion roubles), it is viewed as inexpedient to give federal means to this territory of the Federation taking its high revenue potential into consideration, the released funds should be rather given to needy regions. On the other hand, it should be admitted

that financing of this programme from the federal budget is a sort of payment for the republic's "return" to the common zone of federal budgetary legislation.

In addition to the above-mentioned one should point out the ineffectiveness of several items of the federal financial aid of sub-national budgets, envisaged by previous years' decisions. It is viewed as inexpedient subsidies to the resorts of the city of Sochi (850 million roubles) as far as untargeted support of separate municipalities that are not "closed" municipalities is not one of the objectives of the federal budget. As an alternative one can suggest that a special federal target programme for development of the resorts of the city of Sochi is established and these expenses are financed by means from the Fund of Regional Development. Also ineffective, as we see it, is the financial aid to the budget of the city of Moscow aimed at a partial compensation of its expenses as the capital of the Russian Federation (this support is given in form of a transfer of stocks belonging to the Federation for a total nominal value of 6 billion roubles). When federal means were allotted to this territory of the Federation as an annual procedure (though in form of stocks and shares in recent years) there were not produced any calculations of expenses and benefits arising from the city's performance of its functions as the capital.

It is still unclear what kind of procedure will be used when distributing subsidies to stabilize revenue bases of territories of the Russian Federation that are allotted to those territorial budgets that sustain heaviest losses due to innovations in the federal legislation and were not envisaged when other types of federal financial aid were distributed. The government shall work out a procedure for distribution of these means. The procedure, as we see it, shall be supported by demands to regional authorities in the sphere of budget policies. In particular, allocation of such subsidies can be accompanied by conclusion of contracts with public authorities of the territories of the Federation – receivers of federal funds – that will oblige the corresponding regional authorities to take measures to improve and reform their regional finances.

As before big amounts of means in form of subsidies and subventions are transferred to closed municipalities and to the budget of the city of Baikonur. Calculation procedure for this type of financial aid remained secret due the specific character of the receivers of this financial aid, but as in previous years the federal budget law imposes stringent requirements on the closed municipalities. In particular, provisions of the law restrict possibilities of authorities of the closed units to grant extra tax allowances.

On the whole provisions of the 2002 federal budget law about financial aid to budgets of other levels should be viewed as aimed at a higher effectiveness of

federal financial aid to sub-national budgets by means of a bigger share of financial aid distributed in accordance with a procedure regulated by different legislative acts and by demands to the receivers of financial aid intended to ensure control of an effective and correct use of federal means.

Programme for Development of Budget Federalism in the Russian Federation until Year 2005

The Russian Federation budget federalism development programme for the period until year 2005 was adopted in summer 2001²⁶. This document was adopted as a part of inter-budgetary relations reform started in 1998 when the Concept of improvement of inter-budgetary relations in the Russian Federation in years 1999-2001 was approved. This Concept posed for public authorities of different levels primary tasks of developing such key elements of multi-layer budgetary relations as distribution of tax receipts and tax authorities and reform of the system of federal financial support of territories of the Federation. Summing up achievements of the concept one can positively state that the main goals in the sphere of reform of the system of federal financial support of territories of the Federation were secured. At present the main source of non-targeted financial aid to regional budgets is the Fund of Financial Support of Regions; means of the fund are distributed among territories of the Federation according to a common for all regions method that is based upon figures of tax potentials and expenses requirements of regional budgets. Funds aimed at investment support of regions and their financial invigoration are accumulated in the Fund of Regional Development and the Fund of Regional Finance Development.

Federal authorities in developing the system of federal financial support to territories of the Federation reached beyond the tasks put by the Concept of improvement of inter-budgetary relations in the Russian Federation: within the federal budget there were established the Compensation Fund and the Fund of Co-Financing of Social Expenses. Their tasks are financing of certain federal expenditure assignments on the regional level and allocation of means to territories of the Federation with the object of a quicker transition to the target payment system of housing subsidies accordingly.

The task of improving inter-budgetary relations from the point of view of tax policies set in the Concept was not performed in full. It should be noted

²⁶ See The Russian Federation government regulation of August 15, 2001 Nr. 584 "On the programme of development of budget federalism in the Russian Federation in the period until year 2005"

though that this state of affairs was caused by objective reasons, namely by the fact that perfection of inter-budgetary relations is one of many tasks of the present tax reform. As a result it is not always possible to introduce changes to tax legislation, only in cases when these changes meet the requirements of effectiveness in improving inter-budgetary relations.

The new Programme adopted by the Government in 2001 sets for public authorities a greater scope of problems in the sphere of inter-budgetary relations reforms, regional and municipal finances. The Programme envisages the following reforms in the sphere in question: regulation of budget arrangement of territories of the Federation, distribution of tax powers and revenues sources of authorities at different levels of power, improvement of financial support to subordinate budgets and improvement of public finance controls on the level of regional and municipal administrations.

The programme of development of budgetary federalism for the first time officially set the problem of budget arrangement regulation on the regional level. Causes of this problem lie in the fact that the federal legislation at present describes only one level of local administration that has budgetary rights. At the same time legislative provisions allow establishment of local governments in accordance with settlement pattern as well as several municipal units on a single territory. Pursuant to the present legislation all municipalities including those located on the same territory have equal budgetary rights. At present the problem of co-existence of different municipalities is solved differently on different territories of the Federation. To solve this problem on the federal level the document in question suggests to legislators to permit establishing municipalities of different levels and to fix the procedure of discrimination of expenses and tax powers between municipal units of different levels.

The Programme separately examines ways to solve problems of non-financed expense powers, i.e. decisions of local authorities about budget expenses of subordinate authorities not accompanied by decisions on corresponding financing of the expenses. This problem is caused by the fact that the current budget legislation refers the majority of types of budget expenses to “co-financed” expenses. As far as there is no legally adopted pattern of discrimination of expense powers among authorities of different levels, there exist no obstacles for federal and regional authorities to impose new expenses on budgets of lower levels, the more so since the requirements of the Budget Code to accompany expense demands by decisions on corresponding financing are not followed anywhere in Russia.

To solve the problem of unsupported expense demands the Budget federalism development programme suggests to introduce a new legislative term: “expense powers” of authorities, which implies a combination of rights and obligations in the following three dimensions: legislative regulation of budget expenses, support of expenses by financial means and administration of budget expenses.

The Programme says that one of its aims is to legally provide public authorities at each level with expense powers, while distribution of expense powers shall be accomplished in compliance with given criteria. It also said in the document that all three elements of expense powers shall be provided to one and the same authority level if possible simultaneously. When the powers cannot be given simultaneously one should be guided by the principle that prescribes that decisions on expenses paid by subordinate authorities shall only be taken simultaneously with a decision on transfer of financial resources that correspond to the expenses.

The budget federalism development programme also views ways to reform the system of distribution of tax powers and tax receipts among public authorities of different levels. In particular it says that an effective inter-budgetary relations system that distributes tax powers shall include a higher level of independence of regional and local budgets in questions of taxation, to achieve that budget receipts that originate from their own taxes on different levels shall be considerably increased. Concurrently the stability of the system of distribution of tax receipts and tax powers shall be ensured for public authorities of different levels and one should give up the customary differentiation of norms of payments originating from control tax revenues to local budgets when an adopted differentiation method is lacking.

At the same time the document in question does not provide any concrete ways to solve the issue of increasing revenues share of own taxes in total tax amounts of sub-national budgets. In spite of the fact that the text provides certain principles of tax powers distribution among public authorities of different levels and some changes in the tax and budget legislation in the period until year 2005 that presumably will help to make the current system of tax powers and tax sources distribution more effective, it is viewed as highly improbable that such measures can have a considerable influence on the revenue base pattern of regional and especially local budgets. It is quite evident that substitution of the currently collected property taxes on organisations and natural persons for a local real estate tax could considerably influence both revenues of local budgets and their tax powers. It should be admitted though, that at present there are no pre-conditions for an effective real estate tax and it is quite improbable that such conditions will appear before year 2005. One more measure suggested in the

Programme is a transfer of a considerable part of powers and revenues from taxation of small-scale business to the local level. On the one hand, if considerable restrictions on revenues of self-employed and enterprises as a criterion of transfer to imputed earnings tax were introduced, this kind of measure could be effective. On the other hand, though, its effectiveness lies in lower administration costs of the current tax regime and an incentive to build up a more profitable business climate in municipalities, while this measure's budget effect is not that evident (taking into consideration both the amount of revenues from the imputed earnings tax in budgets of all levels at present and the total amount of expenses obligations of municipal budgets). In this connection we think that a higher level of budget independence of municipal units shall be reached by both taking decisions in the sphere of redistribution of tax powers and a simultaneous revision of the expenses powers distribution pattern.

A separate section of the Budget federalism development programme deals with the problem of how to make the financial support system of other power levels more effective. As was said before effort to reform the system of inter-budgetary relations in the past years concentrated on giving a higher effectiveness to federal financial aid to budgets of territories of the Federation, which ensured that at present there exists a sufficiently effective mechanism of distribution of subsidies from the Fund of Financial Support of Regions. That is why the adopted Budget federalism development programme makes only qualitative demands to the system of federal financial support to budgets of lower levels. In particular, the Programme points out that it is necessary to legalize the currently used procedure of distribution of means from the Fund of Financial Support of Regions, to refrain from using budget expenses returns and revenues of support receivers when making calculations for amounts of financial aid, but to use assessments of objective differences in revenue possibilities and expense requirements of territories of the Federation and (or) municipal units. It is also necessary to make calculations of financial aid amounts based upon verifiable methods equal for all calculations' participants and to build up rigid budgetary restrictions for receivers of financial aid. Moreover the present document envisages that granting and calculation of financial aid also to budgets of municipal units from budgets of territories of the Federation shall be based on the abovementioned principles as well.

Besides the financial aid calculation requirements the Programme also makes demands to the pattern of financial aid to territories of the Federation. On the whole one can say that this pattern is already built up in the federal budget law for year 2002 discussed above and we will not dwell on it here. On the whole

assessing the Programme section on financial aid one should say that its objectives represent the facts in this sphere of today and correspond to the possibilities of changing the legislation in the nearest years.

A new subject for documents in the sphere of budget federalism in Russia is control of public finance (budget management) on sub-national level. The Programme of budget federalism development contains a separate section on it. It defines objectives in the field of legislative handling of the system of public finance control for medium-term future. Among the most important provisions in this section of the Programme can be named the suggestions about introduction of restrictions on use of their tax and budget authorities by government bodies of highly subsidised regions and territories of the Federation (municipalities) that fail to follow requirements of the federal budget legislation and their budget commitments to the population and other budget means receivers. The public finance control provisions of the Programme also pose the problem of working out of obligatory and recommended federal norms in public finance control, budget services quality requirements, interrelations of sub-national governments and federal government bodies on territories of the Federation etc.

Summing up the results of studying the Programme of development of budget federalism in the period until year 2005 one should note that implementation of its objectives will promote solving of many problems in the sphere of effectiveness of the system of public finances on the federal, regional and local levels. At the same time though one should take into account the current political and economic conditions that will influence implementation of the Programme. In particular the current conditions of the tax and budget reforms will not allow implementation of a number of key issues of the Programme in the sphere of tax and expense authorities distribution among different levels of the budget system. The majority of suggestions on legislative changes shall be implemented taking into account decisions in other spheres. Thus, assessing the Programme as a rather far-reaching one, one cannot but mention that large-scale planning is not quite relevant to the current situation, it would be more correct to make a plan of specific acts for a medium-range outlook that would be associated with other programmes and plans of the Government in the sphere of reforms of the budget sphere, taxation policy, social policy etc.

1.4. The Russian financial markets

1.4.1. *The public debt market*

The external debt market

There was a clear-cut trend toward declining yields on all security types in the market of Russia's external debt obligations in 2001 (see fig. 17 and 18). The plummeting OVVZ yields were most significant in this respect: specifically, while the yields on tranche IV (maturing in May 2003) dropped within a year from 32 to 10 percent per annum, the yield on the eurobonds maturing in 2003 declined from 15 to 6.5 percent per annum. Thus, the yield range on the Russian Government forex bonds narrowed in 2001 from 11-32 percent to 5-13 percent per annum while the prices for the Russian forex bonds reached historically maximal values.

In our view, growing quotations for the Russian securities in 2001 were explained by a number of positive factors, mainly complementing each other, though the impact of certain factors became more significant during some periods.

Specifically, declining yields on the Russian bonds early in the year were to a great extent explained by the effect of a deferred demand for the Russian securities in the portfolios of major international investors. It is obvious that, despite the good indicators of Russia's economic development in 2000, the quota for this security type in the portfolios was changed only since January 1, 2001. This fact could ensure growing prices for the Russian bonds, despite a worsening world economic situation (a high degree of uncertainty in the US capital markets, declining oil prices) and internal problems of Russia's economy (a breakdown of the talks on the restructuring of the Paris Club debt).

Taking into account a relatively unfavorable market situation (a currency crisis in Turkey, declining exchange rates of the currencies of developing and developed economies against the US dollar, a mounting financial crisis in Argentina, falling crude prices), one can point out that, overall, the interest of the world financial market participants to the Russian forex-denominated securities remained fairly high during the year. Similar external negative shocks in 1999-2000 caused a significantly bigger quotation volatility and an increased interest spread between the yields on the Russian bonds and the basis rates.

At the same time, continued relatively high oil prices (practically during the whole year) made it possible to assess the situation in Russia's economy as more sustainable compared with other developing countries. Against this backdrop, a worsening situation in Argentina, one of the major developing financial markets, was one more positive factor for Russia, promoting the movement of capital flows between developing markets toward the Russian obligations. The fact of rising attractiveness and reliability of the Russian securities was confirmed by an upgrading of Russia's sovereign rating to B+ (Standard & Poor's and Fitch IBCA) and Ba3 (Moody's).

The cuts in the basis interest rates in the USA and Europe also positively impacted on the quotations for the Russian bonds, exerting a downward pressure on the yields on all debt instruments denominated in US dollars and euro.

Lower yields on the Russian debt instruments at the end of the year may be explained, among other, by a political factor: improved relations between Russia and the USA and the European countries is a serious signal for international investors to increase the share of Russian assets in their portfolios. In addition, redemption of the first eurobond tranche on November 27, 2001 became a factor which positively impacted on the prices.

The temporary fluctuations of the bond prices were caused mainly by external factors. Thus, the currency crisis in Turkey at the beginning of the second decade of February, which triggered off a capital outflow from all emerging markets, led to a drop in the OVVZ and eurobond quotations by approximately 2 percentage points of the face value. However, already a day or two later the price growth resumed and by the end of the month the prices for the Russian securities had come back to the previous level.

The market of Russia's foreign obligations suffered strong swings in July 2001 due to a worsened situation in Argentina where a threat of default on the sovereign and municipal debt had increased. This triggered off a capital outflow from all emerging markets, though the macroeconomic situation in Russia and its external financial position had been among most favorable and sustainable for the last years. At the same time the scale of price drops demonstrated that investor confidence in the Russian obligations is somewhat higher than in the securities of other countries with the same international rating.

The upheavals in the international financial system in the second week of September (suspension of trading in the USA and at the London Stock Exchange, a drop in most stock indices) as might be expected, had a negative influence and the prices for the Russian obligations continued to decline till the end of September.

The domestic debt market

2001 witnessed a smooth decline of the bond yields with relatively low trading volumes being retained (fig. 19). Overall, during the year, the weighted average yield to maturity on GKO/OFZs declined from 20 percent to 14-15 percent per annum. An average weekly trading volume stood at about 2-2.25 billion rubles. During the whole year the effective yield to maturity on GKO/OFZs remained negative with a demand for these securities being rather low.

There were few significant developments in this segment of the Russian financial market in 2001. Thus, the RF Ministry of Finance in April 2001, for the first time since May 1998, made an early redemption of bonds for the total value of about 1.4 billion rubles (OFZ #25030 issue maturing in December 2001).

The situation in the RF domestic debt market in the second half of the year was determined, firstly, by the movements in the balances on the commercial banks' corresponding accounts at the RF CB and, secondly, by a reduced issuing activity of the RF Ministry of Finance. Thus, bonds of only one 6-months GKO series were placed in October for the value of about 1.3 billion rubles (out of 5 – billion worth that were floated) with an average yield at an auction of 14.03 percent per annum. With the US dollar exchange rate growth accelerating in December, attractiveness of GKO investments dropped while the yields surged to 18 percent per annum.

It should be noted that most transactions in November-December 2001 were in OFZs #25030, GKO #21156 and OFZs #27016 which the bonds issued during the restructuring of GKO/OFZs frozen in August 1998 had been converted to. Obviously, conversion of such a big bond volume (up to 12 billion rubles) under the existing low yields was a success scored by the RF Ministry of Finance in the current market situation.

In 2001 the RF Ministry of Finance, overall, held 18 auctions for the placement of fresh securities, including three auctions for conversion of OFZs #25030 to new securities. The investors were offered 13 GKO series (with the maturities ranging from 4 to 12 months) and four OFZ series (maturing from 2 to 3.5 years). The fresh securities offer totaled 80 billion rubles with a stated demand of about 79.2 billion rubles. Thus, the RF Ministry of Finance placed about 61 percent of the total issued amount, generating 45 billion rubles (over \$1.5 billion) in proceeds. The weighted average rate of return at the auctions (net of the issue for non-residents) stood at about 15.81 percent. So, taking into account the actual inflation rate, the effective cost of borrowing in the domestic market was a negative value for the RF Ministry of Finance.

It should be noted, however, that the situation at the auctions changed through the year. Thus, the RF Ministry of Finance held three auctions in late January-February 2001 for the placement of Government short-term bonds for the total value of 9 billion rubles, with one of the issues intended for non-resident owners of “C” type accounts. The yield at the auctions amounted to 13.5-14 percent per annum, and on GKO for non-residents – to minus 1.37 percent²⁷. At the same time, the weighted average bond yields in the secondary markets were at the level of 19-20 percent per annum.

On the other hand, the RF Ministry of Finance failed to float a fresh issue of 6-months GKO at an acceptable price with only about 22 percent of the issue (about 670 million ruble- worth out of 3 billion) having been placed. However, already on the next day the main part of the issue was placed in the secondary market.

The RF Ministry of Finance held two auctions in 2001 floating government bonds. For the first time after the 1998 crisis, the investors were offered OFZs with 3-year maturities. The results of both auctions should be considered favorable for the Minfin, since the yields on the bonds being floated did not exceed the market values (19.5 percent per annum on OFZs and 15.96 percent on 6-months GKO), insofar, about 60 percent of the offered volume was placed (including 40 percent of the OFZ issue volume).

At subsequent auctions floating fresh bonds (June 27, July 11 and 25), the RF Ministry of Finance had to consent to a premium with respect to the yields of the secondary market. However, only the offers of the short 4-5 months GKO were a relative success, while only a quarter of the 30-year OFZ issue was placed.

Two bond issues –5-months GKO #21153 and 3-year OFZs #27015 were floated in August. The auctions should be considered successful for the Government, since about 75 percent of the offered volume were placed at the interest rate not exceeding the market one.

But already in September the RF Ministry of Finance failed to successfully place fresh securities (5-months GKO and 4-year OFZs) for a total value of 10 billion rubles. Thus, the auction for OFZ placement was deemed not to have taken place, since the RF Ministry of Finance considered the yields announced by

²⁷ A negative nominal yield on the GKO series for non-residents is due to the fact that their buyers obtain the right to repatriate the funds generated by the sale or redemption of the bonds, while the restrictions on the repatriation of funds from “C” type accounts remain in force.

the investors too high, with only 48 percent of the GKO volume on offer were placed at the weighted average yields of 13.9 percent per annum.

In summing up the results of the GKO/OFZ market development in 2001, it should be noted that the market's role in the Russian financial system remains low. The negative effective interest rates and a limited range of outstanding securities make investments in bonds unattractive, reducing the number of potential investors. In the conditions of a significant surplus of the federal budget the role of new issues, as might be expected, should lie in providing assistance to the RF CB in the implementation of the monetary and credit policy. However, the main part of the GKO and OFZ issue, allowed by the Law on the 2001 budget, was, in fact, offered in the market in the first half of the year. At the same time, in autumn with the pressure on the ruble exchange rate mounting and the balances in the correspondent accounts of the commercial banks at the RF CB increasing, the potential investors were offered only the bonds which OFZs #25030 had been converted to.

In our view, such issuer behavior may be explained both by a desire to prevent a rate growth in the market (the RF Ministry of Finance was comfortable with a negative effective price of borrowing) as well as the RF Central Bank's low interest in coordinating the monetary and credit policy pursued through transactions in the open market. As pointed out in the section on monetary and credit and exchange rate policy, maintaining a negative rate on the ruble assets allowed the monetary authorities to a significant extent resolve the "excess liquidity" problem. In addition, on the basis of a comparison between the GKO/OFZ market volume and the balances in the Government accounts at the RF CB, a supposition may be made that the latter played a much more significant role in pursuing monetary and credit policy, while transactions in the GKO/OFZ market required higher transaction costs and more careful decisions.

1.4.2. Municipal and subfederal debt market

In 2001, the consolidated regional budget balanced with a surplus of 1.487 bln. RF Rubles, accounting for less than 0.12% of the budget expenditures and less than 0.02% of the GDP.

Over the year, the surplus amount had diminished almost thirty times against the consolidated regional budget expenditures: in 2000 it amounted to 33.994 bln. RF Rubles, or 3.41% of the budget expenditures. (Table 24).

Table 24**Net debt of regional and municipal budgets (% of GDP)**

Year	1995	1996	1997	January-August 1998	January- December 1998	1999	2000	2001 ²⁸	Including in RF Rubles	Including in for- eign currency
Loans of subfederal and local authorities, including :	0,38	0,87	1,43	0,71	0,33	0,15	-0,29	-0,04	0,00	-0,04
Repayable loans from budgets of other levels	0,07	0,23	0,66	0,05	-0,09	-0,11	-0,03	0,04	0,04	--
Subfederal (municipal) bonds	н.д.	0,16	0,22	0,08	-0,01	-0,05	-0,27	-0,07	0,07	-0,14
Other loans	0,31	0,48	0,55	0,58	0,43	0,31	0,01	-0,02	-0,12	0,10
Reduction of balances of budget accounts	...	0,03	-0,18	0,09	0,02	-0,19	-0,30	-0,05	-0,03	-0,02
Deficit financing through loans and reduction of balances of budget accounts ²⁹	0,38	0,9	1,25	0,8	0,35	-0,04	-0,59	-0,09	-0,03	-0,06

Data source: calculations performed by the Institute of Economies in Transition on the basis of data provided by the RF Ministry of Finance

With a surplus of regional budgets amounting to 8.948 bln. RF Rubles, or 0.98% of the relevant budget expenditures, the deficit of municipal budgets exceeded 15.191 bln. RF Rubles, or 2.63% of the respective expenditures.³⁰

²⁸ In the case of data for 2001, the value indicated in the 1st line of the table is not equal to the sum total of the values indicated in the 2nd, 3rd, and 4th lines due to the round-off errors.

²⁹ The amount of budget surplus is less than the total net loans (indicated negatively) and the increment of balances on budget accounts by the amount of state property sales, which represent a source of funds to finance the budget deficit and which accounted for 7.1 bln. RF Rubles, or nearly 0.08% of the GDP, in the 2001 consolidated regional budget.

³⁰ The surplus (deficit) of the consolidated regional budget is not equal to the total surplus (deficit) of regional and municipal budgets, because it does not include the interbudgetary loans provided by regional authorities to municipal entities.

In contrast with 2000, the relative deficit of municipal budgets (against the relevant budget expenditures) had increased over 1.5 times, while the surplus of regional budgets had quartered. These figures are indicative of the growing tension in the execution of the territorial budgets caused, among other factors, by the redistribution of the collection and disbursement powers, given the general cash balance of the consolidated regional budget (Table 25).

Table 25

Ratio of surplus (deficit) of territorial budgets to the relevant expenditures (%)

	Consolidated regional budget	Regional budgets	Municipal budgets
2001 r.	0,12	0,98	-2,63
2000 r.	3,41	3,95	-1,41
Ratio of the 2001 index to the 2000 index.	0,04	0,25	1,87

Data source: calculations performed by the Institute of Economies in Transition on the basis of data provided by the RF Ministry of Finance

As at 1 of January 2002, the consolidated regional budget of 46 territorial subjects of the Russian Federation had a total surplus of 20.2 bln. RF Rubles, or 2.6% of the respective budget revenues. The average budget surplus accounted for 1.6% of the respective budget revenues. The highest ratio of surplus to budget revenues was registered in St.-Petersburg (4.6%), in the Republic of Altai – 4.3%, in Moscow and Tatarstan – 3.8%.

Over 71% of the total budget surplus was generated by four territorial subjects of the Russian Federation: Moscow, with 44.1% of the total budget surplus, or 8.9 bln. RF Rubles; St.-Petersburg, with an 11.4% budget surplus or 2.3 bln. RF Rubles; Tatarstan, with a 10.7% budget surplus, or 2.2 bln. RF Rubles; and Sakha (Yakutiya), with a 5.1% budget surplus, or 1.0 bln. RF Rubles.

In 2001, the consolidated regional budget of 43 territorial subjects of the Russian Federation balanced with a deficit. The number of budgetary deficient subjects of the Russian Federation had increased over 1.5 times as compared to the 26 regions that showed the budget deficit in 2000. The aggregate budget deficit of these regions amounted to 15.0 bln. RF Rubles.

The average budget deficit accounted for 1.4% of the budget revenues. The highest deficit rates were registered in the Evenki Republic at 89.9% of the budget revenues (it was financed by bank loans), in the Kamchatka oblast at 13.4% of the budget revenues, in the Koryak Autonomous District at 12.7%, and in the Tomsk oblast at 11.1%. (Table 28).

Changes in the structure of accumulated debt

The accumulated debt of the consolidated regional budget³¹ decreased in 2001 by 4.413 bln. RF Rubles, or by 0.04% of the GDP (in 2000 this amount diminished by 0.29% of the GDP). Nearly the entire amount of reduced liabilities was accounted for by the repayment of external debts (i.e. foreign exchange debts). The external liabilities of the regional consolidated budgets diminished by 4.0 bln. RF Rubles, and the domestic liabilities dropped by 413.0 mln. RF Rubles.

With the growth of debt on domestic securities by 6.6 bln. RF Rubles and on federal budgetary loans by 4.0 bln. RF Rubles, the domestic bank debts had declined by 11.0 bln. RF Rubles.

Debts on foreign securities had diminished by 12.7 bln. RF Rubles, while the relevant foreign exchange bank debts had risen by 8.7 bln. RF Rubles.

Interest payments

The total interest payments from the territorial budgets amounted to 143.5 bln. RF Rubles, or more than 11.1% of the consolidated regional budget revenues, which was one-fifth less than in the year 2000 (13.8%). The cost of servicing foreign exchange debts within the aggregate expenditures related to interest payments also decreased from 27.7% to 22.2% (31.934 bln. RF Rubles).

Within the aggregate funds allocated for the repayment of foreign debts worth of 29.6 bln. RF Rubles, the share of Moscow accounted for 63.8%, the share of St.-Petersburg constituted 27.4%, the share of Yamalo-Nenets Autonomous District amounted to 2.9%, and the contribution of the Nizhny Novgorod Oblast was 2.7%. The Republic of Bashkortostan, the Tyumen and Moscow oblasts also contributed to the repayment of foreign debts.

³¹ Without account of the provided budgetary guarantees. The RF Ministry of Finance publishes incomplete data on the accumulated debt of regional consolidated budgets.

Composition of loan proceeds

In 2001, the total loan proceeds within the consolidated regional budget accounted for 126.4 bln. RF Rubles, including 25.6 bln. RF Rubles worth of foreign loans. Only Moscow and St.-Petersburg had managed to raise foreign loans (in the form of bank credits) - 20.7 and 4.9 bln. RF Rubles respectively, which accounted for nearly five-fold increase (in foreign exchange equivalent) of regional foreign loans as compared to the year 2000, when the relevant proceeds amounted only to 4.7 bln. RF Rubles, with the share of St.-Petersburg being 94%.

The total domestic loans of regional and municipal authorities amounted to 100.8 bln. RF Rubles, with the major borrowers being Moscow (21.8 bln. RF Rubles), the Novosibirsk oblast (10.4 bln. RF Rubles), St.-Petersburg (6.8 bln. RF Rubles), the Moscow oblast (4.4 bln. RF Rubles), and the Krasnoyarsk Territory (3.1 bln. RF Rubles).

Despite the fact that on the national level the net loan proceeds of the regional consolidated budget had come out negative, a number of regions opted for the further increase of accrued liabilities. The highest ratios of net loans to budget revenues were registered in the regions with distinct budget deficits, i.e. the Evenki Autonomous District, where the loan proceeds exceeded the budget revenues (transfers including) – 102.8%, and the Koryak Autonomous District – 14.4%, the Kamchatka Oblast and the Krasnoyarsk Territory – 5.7%, and the Novosibirsk Oblast – 5.2%.

In the structure of aggregated domestic loans of the consolidated regional budget, issued securities accounted for 15.0%, federal budgetary loans made up 15.6%, and other loans (first and foremost, bank loans and credits) amounted to 69.4 %.

Table 26

Composition of internal loan proceeds within subnational budgets in 2001 (%)

	2001 г.			2000 г.		
	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets

Total (mln. RF Rubles)	100 803,9	77 432,0	54 113,2	99152,9	82667,1	45959,2
Issued securities	15,0	18,4	1,7	13,2	12,2	6,4
Budgetary loans	15,6	20,5	56,5	12,2	14,9	63,7
Other loans	69,4	61,1	41,8	74,7	72,9	29,9

In 2001, the total balances of budget accounts grew by 4.2 bln. RF Rubles, which in real terms signified an 8.8% reduction. At the same time, the statistical data of the Central Bank of the Russian Federation show that the subnational authorities continued to donate funds to the banking system: with 69.6 bln. RF Rubles of total balances of territorial budget accounts, the aggregate banking claims to the territorial authorities amounted to only 23.3 bln. RF Rubles. Thus, as at 1 of December 2001, territorial budgets were actually advancing credits to commercial banks to the extent of 46.3 bln. RF Rubles. (Table 27).

Table 27

The financing of regional and local authorities by commercial banks (mln. RF Rubles)

Dates	Claims of commercial banks to local authorities *	Deposits of local authorities with commercial banks	Balance of claims and deposits
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
01.01.00	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
01.01.01	18 531,3	36 641,8	- 18 110,5
01.04.01	19 897,5	43 353,7	- 23 456,2
01.07.01	21 871,7	58 267,1	- 36 395,4
01.10.01	21 725,9	64 162,1	- 42 436,2
01.12.01	23 349,0	69 619,8	- 46 270,8

*Public authorities of territorial subjects of the Russian Federation and local authorities
Data source: calculations performed by the Institute of Economies in Transition basing on the data provided by the RF Central Bank.

Accounts payable

The reduction (in real prices) of accounts payable of territorial budgets started in 1999-2000 and continued throughout 2001, provoking the reduction of accounts payable of the relevant budget-funded institutions. As a result, between 1 of December 2000 and December 2002, the outstanding liabilities of budget-funded institutions went down from 5.4% to 3.4% of the territorial budget expenditures (Table 28).

The arrears of wages due to a lack of funding of territorial budgets declined in real terms by over 34.4% from 3.97 to 3.07 bln. RF Rubles, accounting for less than 0.24% of the aggregate revenues of the consolidated regional budget.

At the same time, wage arrears still exceeded 4.4% of the budget expenditures of the Jewish Autonomous Oblast, 3.6% of same in Khakassiya, and 3.2% of the budget expenditures of the Republic of Maryi-El (Table 29). It is worth mentioning that the 2001 decision of the federal authorities to raise significantly the wages and salaries of the staff of budget-funded institutions will objectively complicate the implementation of the regional consolidated budgets and may provoke a growth of wage arrears in some municipal entities.

Table 28

**Debts of state-owned organizations funded from territorial budgets
(mln. RF Rubles)**

	Accounts payable		Accounts re- ceivable	Balance of ac- counts payable and accounts receivable	Balance of out- standing accounts payable and ac- counts receivable
	Including, out- standing debts				
01.12.98	88 061	63 508	5 430	82 631	58 078
% of annual expendi- tures in 1998	22.64	16.33	1.40	21.25	14.93
01.12.99	92 853	71 720	8 102	84 751	63 618
% of annual expendi- tures in 1999	14.31	11.05	1.25	13.06	9.80
01.12.00	92 656	70 814	17 355	75 301	53 459
% of annual expendi- tures in 2000	9.29	7.10	1.74	7.55	5.36
01.12.01	94137	67231	22801	71336	44430
% of annual expendi- tures in 2001	7,30	5,21	1,77	5,53	3,44

* % of annual expenditures of the consolidated regional budget

Data source: calculations performed by the Institute of Economies in Transition basing on the data provided by the RF State Statistics Committee

The economic growth, the unfailing debt servicing by the federal government, and the stable fiscal situation have advanced the international credit rating of the Russian Federation to the B+ level of *Standard & Poor's* ratings scale and further boosted the credit ratings of those territorial subjects of the Russian Federation that satisfy their financial obligations on time (Table 34).

The higher credit ratings serve to improve the prospects of subnational authorities to raise loan reserves. However, one should bear in mind that the credit rating of the Russian Federation belongs to the "speculative" rating category and has yet to regain its maximum level of 1996-1997.

Table 29

Execution of consolidated budgets of territorial subjects of the Russian Federation (%)

	Budget revenues (thou. Rubles)	Ratio of loans to revenues	Ratio of interest payments to revenues	Ratio of balances of budget accounts to revenues	Ratio of budget surplus to revenues	Ratio of wage arrears due to lack of funding of territorial budgets to revenues	Ratio of changed balances of budget accounts to budget surplus	Ratio of net loans to budget surplus	Ratio of property sales proceeds to budget surplus
1	2	3	4	5	6	7	8	9	10

The Central Federal Region

Belgorod oblast	7224537	8,08	6,86	1,07	-4,45	0,03	-41,7	-39,8	-18,5
Bryansk oblast	6081181	0,90	1,23	2,63	2,05	0,03	-104,4	-0,4	4,8
Vladimir oblast	7346193	3,61	2,77	3,97	0,72	0,11	-266,6	150,5	33,6
Voronezh oblast	9063639	16,75	15,13	3,04	-1,81	0,65	95,9	-127,3	-68,5
Ivanovo oblast	5724530	2,00	1,70	2,02	0,25	0,07	-393,7	132,6	161,1
Kaluga oblast	6640986	2,85	2,23	1,89	-0,80	0,06	10,9	-105,4	-5,4
Kostroma oblast	3657884	9,50	10,75	1,48	-0,31	0,74	-42,8	137,9	-195,1
Kursk oblast	5370549	3,33	4,36	1,41	1,05	0,38	-37,4	-78,6	15,5
Lipetsk oblast	7858162	1,55	5,17	2,59	-2,93	0,05	-177,3	80,3	-3,1

Table 29 (cont'd)

Moscow oblast	51133357	8,52	9,71	4,74	-0,92	0,06	-56,4	-10,5	-33,2
Oryol oblast	5122768	10,46	2,40	1,46	-8,55	0,14	-5,7	-94,3	0,0
Ryazan oblast	6093068	4,12	3,98	4,47	2,66	0,18	-132,5	21,2	11,3
Smolensk oblast	5363719	4,52	3,12	2,34	-0,10	0,15	1561,1	-1616,5	-44,6

Tambov oblast	4932501	4,12	5,16	1,02	1,25	0,20	-20,9	-79,2	0,1
Tver oblast	7780002	4,21	4,25	1,96	0,44	0,06	-201,5	85,9	15,6
Tula oblast	8481830	9,89	8,08	3,10	-1,44	0,48	96,9	-155,8	-41,1
Yaroslavl oblast	9352792	8,39	8,39	1,82	-0,79	0,03	34,6	-107,5	-26,6
Moscow	232713860	18,27	22,74	9,52	3,82	0,00	-50,3	-77,6	27,8
Total	389941558	13,70	16,39	6,94	1,93	0,06	-62,2	-77,6	39,7
The North-Western Federal Region									
Republic of Kareliya	6112502	6,89	6,04	1,78	-1,38	0,58	1,8	-93,3	-8,5
Republic of Komi	12756684	5,22	8,38	1,08	1,97	0,49	-5,8	-108,9	14,7
Arkhangelsk oblast	9811690	3,74	3,73	1,05	-0,84	0,39	-6,8	-51,3	-41,9
Vologda oblast	10642760	7,79	2,95	1,92	-7,45	0,15	-22,2	-73,1	-4,7
Kaliningrad oblast	5447327	5,17	5,73	1,47	-0,67	0,03	-94,2	49,4	-55,2
Leningrad oblast	12491347	9,85	10,65	5,81	1,24	0,24	-220,7	105,2	16,3
Murmansk oblast	7567372	6,16	5,43	1,33	-5,82	0,17	-64,7	-17,3	-18,0
Novgorod oblast	4067582	4,81	3,83	2,25	-1,01	0,09	45,5	-124,4	-21,0
Pskov oblast	4496564	6,22	7,61	1,18	0,40	0,47	-93,0	-133,2	126,2
St.-Petersburg Nenets Autonomous Dis- trict	50087386 2733602	23,36 2,01	29,74 0,00	4,89 12,71	4,58 -0,56	0,01 0,00	-51,2 256,1	-55,5 -356,1	5,2 0,0
Total	126214816	13,07	15,50	3,49	0,97	0,18	-90,2	-44,3	31,9
The Southern Federal Region									
Republic of Adygeya	2213642	2,03	0,56	2,56	-0,31	0,19	374,4	-474,4	0,0
Republic of Dagestan	11517614	0,17	0,17	5,57	0,30	0,23	-127,3	0,0	27,3
Republic of Ingushetiya	2372390	1,92	1,92	0,54	-2,15	0,08	-38,8	0,0	-61,2
Kabardino-Balkar Republic	4749035	10,06	14,35	1,19	1,71	0,05	-17,2	-123,6	40,8
Republic of Kalmykiya	1701699	9,24	10,08	1,35	-0,63	0,10	-2,9	-64,8	-32,3
Karachaevo-Cherkes. Republic	1932104	3,52	2,64	2,98	1,23	0,55	-191,3	81,6	9,7
Republic of Northern Osetiya-Alaniya	4502777	9,97	9,21	5,67	-1,21	0,14	177,8	-256,8	-21,0
Chechen Republic	3115018	0,00	0,00	8,92	8,91	0,00	-100,0	0,0	0,0

Table 29 (cont'd)

	1	2	3	4	5	6	7	8	9	10
Krasnodar Territory	25161401	1,50	1,33	3,07	-0,10	0,09	165,6	-203,0	-62,5	
Stavropol Territory	10945568	6,20	5,85	5,15	1,81	0,09	-171,4	22,2	49,2	
Astrakhan oblast	5062829	3,80	3,08	3,20	-0,14	0,00	629,1	-630,7	-98,4	

<u>Volgograd oblast</u>	<u>12410834</u>	8,81	10,77	1,78	1,59	0,74	-43,5	-69,8	13,3
Rostov oblast	19760292	5,65	3,03	2,60	-2,17	0,01	59,5	-145,7	-13,8
Total	105445203	4,48	4,23	3,43	0,22	0,17	-549,2	318,9	130,2
The Volga Federal Region									
Republic of Bashkortostan	35445866	2,76	0,92	3,36	-2,45	0,05	-8,9	-76,7	-14,0
Republic of Mariy-El	3208633	6,56	7,97	0,70	0,76	2,18	-24,5	-150,7	75,2
Republic of Mordoviya	6454507	9,79	9,23	0,79	-1,20	0,58	34,8	-95,3	-39,5
Republic of Tatarstan	57115264	3,01	5,22	3,80	3,77	0,02	-69,4	-33,9	3,3
Udmurt Republic	11910188	0,74	1,97	3,79	1,99	0,03	-59,7	-42,7	2,4
Chuvash Republic	6294798	5,85	6,55	2,38	1,00	0,15	-114,5	-36,0	50,3
Kirov oblast	7432490	5,15	5,37	1,24	0,40	1,59	-107,1	7,1	0,0
Nizhni Novgorod oblast	19185579	16,43	22,22	3,37	1,80	0,12	64,6	-214,0	47,1
Orenburg oblast	11984103	2,09	4,74	1,22	-0,78	0,17	-139,2	92,0	-52,7
Penza oblast	5757400	1,91	3,18	2,56	2,21	0,00	-72,0	-46,6	18,3
Perm oblast	24451523	0,87	0,70	3,97	0,58	0,01	-177,7	38,8	38,9
Samara oblast	27245299	1,90	2,58	5,07	-0,51	0,04	-103,3	34,5	-31,2
Saratov oblast	11697594	7,72	14,87	0,61	1,46	0,46	-2,8	-109,7	12,5
Ulyanovsk oblast	5939096	6,07	6,93	1,34	0,09	0,23	-212,1	-515,7	627,7
<u>Komi-Perm Autonomous District</u>	<u>1203116</u>	2,47	4,53	1,49	2,28	0,21	-29,9	-70,1	0,0
Total	235325456	4,21	5,65	3,23	0,91	0,17	-72,9	-58,7	31,0
The Urals Federal Region									
Kurgan oblast	4794193	2,41	5,09	0,92	2,53	1,71	-22,0	-91,0	13,1
Sverdlovsk oblast	28711530	2,23	4,60	2,91	1,90	0,36	-33,5	-88,1	21,6
Tyumen oblast	18106313	6,64	7,45	8,39	1,17	0,10	-563,9	32,0	431,9
Chelyabinsk oblast	19219431	2,12	2,31	1,73	-0,93	0,01	-37,8	13,6	-75,7
Khanty-Mansiysk Autonomous District	84658540	0,68	0,43	8,31	-8,04	0,00	-95,1	-3,6	-1,4
Yamalo-Nenetsk Autonomous District	35436740	16,01	17,69	1,60	1,11	0,14	2,8	-101,7	7,0
Total	190926747	4,51	5,23	5,41	-2,99	0,13	-90,1	12,3	-22,8

Table 29 (cont'd)

	1	2	3	4	5	6	7	8	9	10
The Siberian Federal Region										
Republic of Altai	2491080	9,88	13,58	1,57	4,31	0,40	-18,3	-81,7	0,0	
Republic of Buryatiya	7496478	27,59	30,13	0,85	0,68	0,29	-50,9	-49,2	0,0	

Republic of Tyva	3184337	7,28	10,31	0,64	3,15	3,61	-4,4	-96,3	0,8	
Republic of Khakassiya	2960538	7,65	8,82	1,46	0,48	2,30	-63,1	-147,9	110,3	
Altai Territory	12877548	14,21	12,23	0,83	-2,04	0,35	11,0	-96,8	-14,2	
Krasnoyarsk Territory	28817666	10,85	5,63	4,58	-8,00	0,49	-23,4	-70,9	-5,7	
Irkutsk oblast	18689392	5,52	4,86	4,12	0,67	0,59	-330,8	112,6	118,2	
Kemerovo oblast	18468506	3,82	8,43	3,28	1,11	0,95	-84,4	-384,9	369,3	
Novosibirsk oblast	16236775	64,09	61,92	1,48	-5,67	0,32	2,6	-91,6	-11,1	
Omsk oblast	11378097	13,00	18,33	1,29	1,84	0,46	16,4	-125,4	9,1	
Tomsk oblast	7765491	29,91	24,53	0,72	-11,13	0,13	-25,3	-70,1	-4,5	
Chita oblast	7703359	1,51	2,53	2,49	2,43	0,77	-59,5	-40,5	0,0	
Aginski Buryatski Autonomous District	584445	1,85	3,58	1,42	1,59	0,24	9,0	-109,0	0,0	
Taimyr (Dolgano-Nenetski) Autonomous District	3650961	2,19	2,19	14,15	-0,37	0,00	-100,0	0,0	0,0	
Ust-Ordynski Buryatski Autonomous District	1082331	7,11	4,11	1,00	-2,33	0,28	29,2	-129,2	0,0	
Evenki Autonomous District	1002940	134,90	42,97	15,41	-89,87	2,13	14,3	-114,3	0,0	
Total	144389944	17,53	16,39	2,97	-2,97	0,61	3,4	-74,1	-29,3	
The Far-East Federal Region										
Republic of Sakha (Yakutiya)	33101223	10,04	12,62	4,74	3,09	0,76	-69,0	-31,1	0,1	
Primorsk Territory	15876250	8,81	11,11	0,82	2,11	1,45	-14,8	-86,5	1,3	
Khabarovsk Territory	17920992	4,24	4,19	1,39	-0,71	0,20	84,4	-6,3	-178,2	
Amur oblast	8003113	4,58	5,80	1,76	1,52	1,48	-55,4	-46,0	1,3	
Kamchatka oblast	4790225	11,59	6,45	1,65	-13,36	1,23	-57,2	-43,0	0,2	
Magadan oblast	5122598	4,74	3,26	0,78	-2,22	1,53	-23,6	-71,9	-4,5	
Sakhalin oblast	7180392	9,53	6,92	4,35	-3,37	0,06	-21,8	-77,4	-0,9	
Jewish Autonomous Oblast	1860952	2,31	2,09	5,21	3,72	4,33	-113,4	10,4	3,0	
Koryak Autonomous District	1113841	35,80	22,22	3,07	-12,73	0,12	13,3	-113,3	0,0	
Chukotka Autonomous District	4018379	4,85	5,57	2,54	2,01	0,81	-64,4	-35,6	0,0	
Total	98987965	8,05	8,73	2,78	0,37	0,90	-174,4	7,6	66,8	
Total of Federal Regions	1291231689	9,79	11,11	4,65	0,12	0,24	-284,3	-296,7	479,8	

Data source: calculations performed by the Institute of Economics in Transition basing on the data provided by the RF Ministry of Finance

Domestic bond issues

In 2001, 11 territorial subjects of the Russian Federation and 3 municipal entities floated bond issues. The issuers included Moscow, St.-Petersburg, the Volgograd oblast, the Irkutsk oblast, the Leningrad oblast, the Tomsk oblast, the Republic of Kareliya, the Republic of Komi, the Republic of Bashkortostan, the

Stavropol Territory, the Chuvash Republic, Volgograd, Novocheboksarsk, and Ekaterinburg (Table 30).

Table 30

Subfederal and municipal securities issued in 2001

Territorial subjects of the Russian Federation	Issued value (thou. RF Rubles)	Ratio of issued value to internal loan proceeds (%)	Share in total issued value (%)
Voronezh oblast	165 517	10,90	1,09
Kostroma oblast	7 668	2,21	0,05
Lipetsk oblast	40	0,03	0,00
Smolensk oblast	500	0,21	0,00
Moscow	6 683 451	30,67	44,19
Republic of Kareliya	15 834	3,76	0,10
Republic of Komi	9 912	1,49	0,07
Leningrad oblast	377 608	30,67	2,50
St.-Petersburg	5 283 325	77,93	34,93
Kabardino-Balkar Republic	20 000	4,19	0,13
Stavropol Territory	109 917	16,18	0,73
Volgograd oblast	375 541	34,35	2,48
Republic of Bashkortostan	971 800	99,49	6,43
Republic of Mariy-El	1 454	0,69	0,01
Chuvash Republic	115 010	31,23	0,76
Sverdlovsk oblast	70 236	10,95	0,46
Khanty-Mansiisk Autonomous District	138 736	24,06	0,92
Yamalo-Nenets Autonomous District	100 208	1,77	0,66
Republic of Khakassiya	24 445	9,96	0,19
Altai Territory	323 619	17,69	2,14
Krasnoyarsk Territory	499	0,02	0,00
Tomsk oblast	350 000	15,07	2,31
Chita oblast	1 500	1,29	0,01
Amur oblast	1 400	0,38	0,01
Total	15 123 785,00	15,00	100

Data source: calculations performed by the Institute of Economics in Transition basing on the data provided by the RF Ministry of Finance

With the general post-crisis decline in the amount of loan proceeds secured by regional and local authorities, the value of floated municipal and subfederal securities fell more than 4 times, from 0.77% of the GDP in 1997 to 0.17% of the GDP in 2001. The number of securities issues also went down as compared to 1997-1998, actually returning to the level of 1992 –1993.

Table 31**Issued value of subfederal and municipal securities (% of GDP)**

Year	1996	1997	1998	1999	2000	2001 ³²
Issued	0,63	0,77	0,47	0,31	0,19	0,17
Redeemed	0,47	0,56	0,48	0,36	0,46	0,23
Net funds	0,16	0,22	-0,01	-0,05	-0,27	-0,07

Data source: calculations performed by the Institute of Economics in Transition basing on the data provided by the RF Ministry of Finance

In 2001, issuers from nine territorial subjects of the Russian Federation managed to raise in the subfederal and municipal securities market an amount exceeding the face value of domestic bonds liable for redemption this year, including the relevant interest. These issuers include Moscow, with the loan proceeds of 4,560.5 mln. bln. RF Rubles net of the cost of redemption and internal debt servicing, the Republic of Bashkortostan (971.8 mln. RF Rubles), St.-Petersburg (440.2 mln. RF Rubles), the Leningrad oblast (358.8 mln. RF Rubles), the Tomsk oblast (350.0 mln. RF Rubles), the Chuvash Republic (34.6 mln. RF Rubles), the Kostroma oblast (2.5 mln. RF Rubles), the Republic of Mariy-El (1.3 mln. RF Rubles), and the Krasnoyarsk Territory (0.4 mln. RF Rubles).

The aggregate value of municipal and regional bond issues remained virtually unchanged at 15.1 bln. RF Rubles in 2001 as compared to 13.0 bln. RF Rubles in 2000. At the same time, it is noteworthy that the volume of securities floated by municipal entities had significantly declined: while in 2000 they accounted for 22.6% of the territorial issues, in 2001 their share nearly quartered to 5.9% (Table 32).

³² Чистое финансирование не равно разнице между объемом привлеченных и погашенных заимствований из-за ошибки округления

Table 32**Net loan proceeds in the domestic subfederal and municipal securities market, in thousand RF Rubles**

	Consolidated re- gional budget	Regional budgets	Municipal budgets
2001			
Net loan proceeds	6 601 447	6 667 592	-66 145
Funds raised	15 123 785	14 226 931	896 854
Principal repaid	8 522 338	7 559 339	962 999
2000			
Net loan proceeds	- 1 877 328	-2 286 175	408 847
Funds raised	13 042 220	10 090 208	2 952 012
Principal repaid	14 919 548	12 376 383	2 543 165

Data source: the RF Ministry of Finance

Over the past three years, only 14 territorial subjects of the Russian Federation and 7 cities have availed themselves of the securities market instruments to raise the required funds. Through the entire post-crisis period, bonds were annually issued by Moscow, St.-Petersburg, the Republic of Chuvashiya, the Volgograd oblast and the city of Volgograd (Table 33).

Table 33**Subfederal and municipal securities issued in 1999 – 2001**

Issuer	Issue registration		
	1999	2000	2001
Territorial subjects of the Russian Federation			
Moscow	*	*	*
St.-Petersburg	*	*	*
Chuvash Republic	*	*	*
Volgograd oblast	*	*	*
Tomsk oblast		*	*
Republic of Komi		*	*
Republic of Bashkortostan			*
Stavropol Territory			*
Leningrad oblast			*
Irkutsk oblast			*
Primorski Territory		*	
Kabardino-Balkar Republic		*	

Republic of Mariy-El		*
Novosibirsk oblast	*	

Table 33 (cont'd)

Issuer Territorial subjects of the Russian Federation	Issue registration		
	1999	2000	2001
Municipal entities			
Volgograd	*	*	*
Ekaterinburg		*	*
Novocheboksarsk	*		*
Kostroma	*	*	
Cheboksary	*		
Arkhangelsk	*		
Dzerzhinski	*		

Data source: the RF Ministry of Finance

External loans

In the October of 2001, Moscow became the first territorial subject of the Russian Federation to enter the Eurobond market after the financial crisis of 1998. Three-year Eurobonds worth of 300 mln. Euro were floated at a 10.25% APR. The loan was formalized as a credit issued by the German *BHF-BANK AG* to the Moscow authorities and funded through the issue of participation certificates. *ING Barings* and *UBS Warburg* jointly acted as the lead-managers of the bond issue. The demand for the Eurobonds exceeded the supply by almost 90 mln. Euro.

Following the successful Eurobond issue, the Moscow authorities decided in November same year to raise a new five-year loan worth of 400 mln. Euro. That loan was also formalized as a credit from a pool of Western banks and funded through the issue of participation certificates. Investor applications were collected by *BNP-Paribas* and *J.P. Morgan*, the co-sponsors - *Merrill Lynch and Dresdner Kleinwort Wasserstein*, a member of the *Dresdner Bank Group*. As a result, within one month the Moscow authorities issued bonds worth of 700 mln. Euros.

In December 2001, the *Standard & Poor's* agency raised the ratings of Moscow and St.-Petersburg, almost concurrently with the rating of the Russian Federation, to the B+ level. Thus, the two municipal ratings remained in line with the country rating (Table 34).

Table 34**International credit ratings of Standard&Poor's****Russia: ratings by the international rating scale**

Issuer	Date of assignment (latest change) of rating	In foreign currency / Outlook	In local currency / Outlook
Sovereign rating			
Russian Federation	22.02.2002	B+/Positive	B+/Positive
Regional and local authorities			
Bashkortostan	13.11.2001	B/Positive	--/--
Irkutsk oblast	03.10.2001	CCC+/Positive	--/--
Moscow	22.02.2002	B+/Positive	--/--
Nizhni Novgorod oblast	06.09.1999	<i>Rating recalled</i>	
Rostov oblast	31.07.2000	<i>Rating recalled</i>	
Samara oblast	13.11.2001	B/Positive	--/--
St.-Petersburg	22.02.2002	B+/Positive	B/Positive
Sverdlovsk oblast	23.08.2001	CCC+/Positive	CCC+/Positive
Tatarstan	09.10.2001	CCC+/Positive	--/--
Yamalo-Nenets Autono- mous District	08.05.2001	CCC+/Positive	--/--

Data source: Standard&Poor's

The settlement of outstanding debts

The revival of operations in the external bonds market is possible, first and foremost, for the most stable and reliable of borrowers, including Moscow and St.-Petersburg which continued to service their debts even during the crisis of 1998. At the same time, the domestic market may be generally characterized by a relatively weak position of the creditors of territorial authorities, with the former often proving unable to get the territorial authorities to repay the debts despite the supporting court decisions.

One of the major barriers to the development of the market of subfederal and municipal debt instruments is the existing procedure for the recovery of funds from territorial authorities in the event of default. This problem is further aggravated by the fact that, even with the economic growth and favorable market conditions, a lot of the territorial subjects of the Russian Federation and municipal authorities have very few effective stimuli for the timely servicing of debts.

The problems relating to the issue of subfederal securities floated prior to the default period still remain unresolved. According to the Rosbank depository,

as at 1 of November 2001, 11 territorial subjects of the Russian Federation did not even start to repay the first tranche of the "rural" bonds issued pursuant to Resolution # 224 of the Government of the Russian Federation "On the economic conditions of operations of the agricultural complex of the Russian Federation in 1997", dated 26.02.97, which matured in 1998-1999.

The economically successful Saratov oblast has satisfied less than 3% of its liabilities. The Arkhangelsk oblast, the Republic of Ingushetiya, the Kabardino-Balkar Republic, the Komi-Perm Autonomous District, the Magadan oblast, the Primorski Territory, the Taimyr Autonomous District, the Republic of Tyva, the Ust-Ordynski Buryatski Autonomous District, the Chukotka and Evenki Autonomous Districts have yet to start to honor their respective obligations.

Table 35

Consolidated data on the redemption of the par value of the first tranche of the «rural» bonds issued by territorial subjects of the Russian Federation (as at 1 of November 2001)

Redeemed 100%
Aginski Buryatski Autonomous District, the Republic of Altai, the Amur oblast, the Astrakhan oblast, the Bryansk oblast, the Republic of Buryatiya, the Vladimir oblast, the Vologda oblast, the Republic of Dagestan, the Ivanovo oblast, the Irkutsk oblast, the Kaliningrad oblast, the Karachaevo-Cherkessiya Republic, the Republic of Kareliya, the Kemerovo oblast, the Kirov oblast, the Komi Republic, the Krasnodar Territory, the Krasnoyarsk Territory, the Kursk oblast, the Leningrad oblast, the Lipetsk oblast, the Republic of Mariy-El, the Republic of Mordoviya, the Novgorod oblast, the Novosibirsk oblast, the Omsk oblast, the Orenburg oblast, the Rostov oblast, the Republic of Sakha (Yakutiya), the Samara oblast, the Tver oblast, the Tomsk oblast, the Tyumen oblast, the Chuvash Republic, the Khabarovsk Territory, the Republic of Khakassiya
Redeemed from 1 to 100%
The Volgograd oblast - 99.97%, the Penza oblast - 99.95%, the Nizhni Novgorod oblast - 99.86%, the Stavropol Territory - 99.55%, the Tambov oblast - 98.48%, the Udmurt Republic - 93.15%, the Jewish Autonomous District - 72.00%, the Chita oblast - 83.63%, the Altai Territory - 82.74%, the Republic of Kalmykiya - 62.45%, the Kaluga oblast - 60.35%, the Yaroslavl oblast - 57.11%, the Belgorod oblast - 57.47%, the Pskov oblast - 51.43%, the Kurgan oblast - 45.74%, the Voronezh oblast - 41.97%, the Yaroslavl oblast - 33.94%, the Republic of Northern Osetiya-Alaniya - 31.23%, the Republic of Adygeya - 28.04%, the Ulyanovsk oblast - 14.61%, the Saratov oblast - 2.74%
Not redeemed
The Arkhangelsk oblast, the Republic of Ingushetiya, the Kabardino-Balkar Republic, the Komi-Perm Autonomous District, the Magadan oblast, the Primorsk Territory, the Taimyr Autonomous District, the Republic of Tyva, the Ust-Ordynski Buryatski Autonomous District, the Chukotski Autonomous District, the Evenki Autonomous District

Data source: Rosbank's Depository

The available assets on the budget accounts of those regions that have not yet begun to discharge their financial obligations several times, or even dozens of times, exceed the amount of accumulated debts (Table 36). It is quite obvious that the Primorsk Territory and the Magadan oblast could quite easily redeem the respective rural bonds.

TABLE 36

Outstanding liabilities on the rural bonds principal of the regions that have not started the redemption of rural bonds (thousand RF Rubles)*

Issuer	Balances of budget accounts **	Outstanding liabilities on the first tranche of rural bonds ***	Ratio of outstanding liabilities on the first tranche to balances of budget accounts, %	Ratio of total outstanding liabilities on rural bonds to balances of budget accounts, %
Arkhangelsk oblast	180 145	17 250	9,6	28,7
Republic of Ingushetiya	132 991	6 020	4,5	13,6
Kabardino-Balkar Republic	52 435	44 030	84,0	251,9
Komi-Perm Autonomous District	48 452	4 380	9,0	27,1
Magadan oblast	169 462	8 040	4,7	14,2
Primorsk Territory	225 396	6 640	2,9	8,8
Taimyr Autonomous District	1 082 136	7 210	0,7	2,0
Republic of Tyva	140 670	7 460	5,3	15,9
Ust-Ordynski Buryatski Autonomous District	12 979	19640	151,3	454,0
Chukotski Autonomous District	464 276	35 970	7,7	23,2
Evenki Autonomous District	376 722	2 950	0,8	2,3

* without account of outstanding liabilities on interest payments, penalties and fines.

** as at 1 of October 2001.

*** as at 1 of November 2001.

Data source: calculations performed by the Institute of Economics in Transition basing on the data provided by the RF Ministry of Finance and Rosbank's Depository

The rural bonds are not the only financial instrument, which the territorial authorities have defaulted on (they are the most «transparent» instruments reflected in the public statistics of defaults committed by the territorial authorities). There are precedents of overdue bank loans to the territorial authorities, defaults

on other issues of subfederal and municipal securities, overdue payments for commodity deliveries, and arrears of wages. Deemed as a possible motive for the non-repayment of the "rural" bonds may be larger outstanding debts on other financial instruments and obligations.

Nevertheless, the weak position of the creditor, even in the event of judicial support, is quite obvious. The problem lies in the applicable procedure for the enforcement of judicial decisions to recover funds from budget accounts in the instances where allocations for the repayment of liabilities were not included in the budget expenditures or were sequestered during the implementation of the relevant budget.

The need for infrastructural investment

Over the past ten years, the majority of territorial entities have faced the problem of aging fixed assets and the deterioration of other facilities of social and economic infrastructure due to the lack of effective investment. The wear and tear of the heating networks and public utilities is increasing, provoking an ever growing number of failures and accidents, which, in turn, automatically boost up the maintenance and current repairs costs.

In the past ten years, the construction of new public utilities has been steadily declining. In 2001 the tendency showed signs of deceleration. However, the rates of new construction have not yet retained the 1998 level, falling 5-8 times short of the 1990 construction rates (Table 37).

TABLE 37

Commissioned public utilities

Year	Water pipe- lines, km	% to 1990	Sewage, km	% to 1990	Heat net- works, km	% to 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
2001	1076,9	14,3	170,9	17,4	163,6	11,2

Calculations performed by the Institute of Economics in Transition basing on the data provided by the RF Goskomstat

Investment in the public utilities infrastructure may prove effective only after the transformation of the institutional management structure in the sphere of housing and public services, including, as a matter of first priority, the reform of the tariff policy to enhance its transparency, the lack of which will make the implementation of commercially viable investment projects impossible. Once the aforementioned problems relating to the improvement of the creditworthiness of the regional and municipal authorities have been resolved, the market of subfederal and municipal debt instruments will be able to ensure the execution of a top priority task of restructuring the public utilities infrastructure.

At the same time, in the short-term perspective, the funding of the public utilities infrastructure may largely depend upon loans from multilateral financial institutions, including the World Bank loans guaranteed by the federal government.

For instance, under the World Bank Loan to finance the project aimed at "Raising the effectiveness of energy use", 19.3 mln. US Dollars has been channeled for the reconstruction of district heating networks to the municipal enterprises and mayor's offices of the cities of Arkhangelsk, Kaliningrad, Ryazan, Semyonov, and Nizhni Novgorod.

The World Bank Loan to finance the project of "Transfer of departmental residential housing into municipal ownership" incorporates a component worth of 43 mln. US Dollars aimed at the retrofitting of the distribution public networks in the following cities: Ryazan, Vladimir, Orenburg, Cherepovets, Volkhov, Saratov and Izhevsk.

Currently pending conclusion is an agreement with the IBRD for a loan of 85 mln. US Dollars for the implementation of the project «Municipal heating networks». These funds will be allocated to the municipal authorities of the Moscow oblast, the Samara oblast, the Kostroma oblast, the Volgograd oblast, the Tambov oblast, the Krasnoyarsk Territory, the Republic of Sakha-Yakutiya and the Republic of Tatarstan for the implementation of investment projects involving the reconstruction of the relevant district heating utilities.

Regional components of loans from multilateral financial institutions

The loans to the Russian Federation provided, by agreement with the creditor, by multilateral financial institutions (i.e. the IBRD and EBRD loans) may be transferred by way of subloans to the participants in investment projects (territorial authorities, joint-stock companies, and the like). As at 1 of July 2000, total

funds disbursed by the territorial authorities since 1994 by way of the IBRD sub-loans amounted to 985.0 mln. US Dollars.

The legal relations between the borrowers and the lenders are regulated by contracts concluded on behalf of the RF Government by the RF Ministry of Finance with the regional and municipal authorities (by the general rule, in the instances where a municipal entity acts as the borrower, the relevant territorial subject of the Russian Federation must provide guarantees for the repayment and timely servicing of the loan to the federal government).

Apart from the repayment of the loan (principal debt), the sub-borrowers, pursuant to the contract, must transfer to the federal budget the pertinent interest payments, commission fees, and penalty interest (in the event of violation of the contractual terms and conditions):

- the interest payments include interest charged for the use of loan funds (the World Bank's regular APR is 5-7%) and the margin levied by the RF Ministry of Finance (from 0 to 2.5% APR);

- a commission fee for liabilities under the unused portion of the subloan (0.75% APR on the unused loan amount);

- penalty fines for every day of payments delay;

- other payments provided for by the contract (usually for the non-performance of specific requirements or terms and conditions stipulated in the contract, i.e. the borrower's violation of the commitment to use specific treatment for the loan account, the non-purpose use of the loan funds or equipment supplied under the subloan agreement, and etc.).

The federal government is allocating significant amounts while the subnational budgets are demonstrating insufficient financial stability (irregular tax receipts and significant non-performable obligations under non-funded mandates) on the one hand, and while the territorial authorities are lacking stimuli to effect the timely debt servicing and repayment, on the other hand.

Under the circumstances, the borrowers are demonstrating a lack of responsible management of the loan proceeds, expecting that the RF Ministry of Finance would treat leniently their violations of the loan agreements. Given the objectively high tension within the subnational budgets, the RF Ministry of Finance is not filing lawsuits against the subordinate public authorities. The logical consequence of such policy is the accumulation of outstanding debts by the subnational authorities.

Viewed as an example of the remaining problems with the repayment of loans by municipal borrowers may be the World Bank Loan to finance the project «Municipal transport». Between 6 of October 1995 to 31 of December 2001,

14 municipal borrowers accrued 114.423 mln. US Dollars worth of liabilities relating to the serving and repayment of the loan, of which they discharged as at 1 of January 2002 only 52.730 mln. US Dollars, or 46%.

While the cities of Cherepovets, Vologda and Rostov-on-the-Don are running no debts under this project, and Ekaterinburg and Samara have partially repaid their liabilities, the cities of Velikiye Luki, Pskov, the Great Novgorod, Tver and Smolensk stopped discharging their respective liabilities in 2000, Nizhni Novgorod – in 1999, Omsk – in 1998, Kostroma – in 1996, and Saransk has completely defaulted on its obligations.

Table 38

Debt of end borrowers on loans from multilateral financial institutions (mln. US Dollars) as at 1 of July 2000

Types of sub-borrowers	Number of sub-borrowers	Amount payable	Amount paid	Overdue payments	Share of overdue payments to amount payable
City administrations (mayor's offices)	22	58,78	24,67	34,11	58,0
Administrations of territorial subjects of the Russian Federation	34	14,99	12,03	2,96	19,75
Total:	56	73,77	36,70	37,07	50,2

Data source: calculations performed on the basis of data provided by the RF Audit Chamber

To resolve the problem of enhancing the effectiveness of utilization of funds provided by multilateral financial institutions, it is necessary to develop and introduce a viable set of stimuli for the timely repayment of loans by the sub-national authorities, i.e. the improvement of stability of the tax base of the subnational authorities, the resolution of the problem of non-funded mandates, as well as the amendment of applicable legislation so as to include therein detailed provisions on the procedures for the recovery of overdue debts from the regional and municipal authorities.

1.4.3. The Russian stock market

The Russian stock market posted fairly decent results in 2001, especially if account is taken of adverse external factors, such as an economic slump in the USA, Japan and the EU, financial crises in Turkey and Argentina as well as declining prices in the natural

resources market. Continued growth of the Russian economy, timely external debt payments and upgrading of the RF ratings related thereto, improved relations with the USA and international financial institutions, further steps in reforming the Russian legislation in keeping with the demands of the market economy have, doubtless, attracted foreign investors to the Russian market. However, one cannot but point out some adverse factors as well. Redistribution of powers and corporate scandals significantly impacted on the quotations of some issuers' shares and the investment climate as a whole.

The Russian market was one of the most profitable ones in the world in 2001. Thus, according to the results of the first quarter, the RTS index was third on the list of the world's fastest-growing stock indicators published by the Merrill Lynch investment bank, topped only by the Shanghai B (China) and Taiwan Weighted Index (Taiwan). In the second quarter the Russian stock market climbed to the second rank topped by the Turkish one this time. As a result of the year the Russian stock indicator became almost twice as "heavy" (by 81.49 percent). For the sake of comparison, Table 1 shows the movements of stock indices in the developed and developing countries.

Within a year the RTS index changed by 129.03 points with the trading volume totaling about \$4.5 bln. Let us point out that the turnover somewhat declined compared with the last year (by about \$5.5 bln), which was determined by the impact of the external factors, specifically, the September 11 events and the unfavorable trends in raw materials markets. Several periods can be identified in describing the movements of the RTS index during the year. In January of last year the stock index grew by 21.4 percent and the trading volume – by 40.4 percent. This was followed by a three-month lateral trend within the 160-180-point band at moderate trading volumes. Growth became manifest in late April-early May, continuing into the second part of June. On June 22 the index reached 227.62 points with a record-high trading volume –over \$50 million- registered on that day. The period of fast growth ended in stagnation. As a result of July the index dropped by 6 percent with the trading volume almost halved in August. Growth emerging later was followed a steep drop after the terrorist attacks on the USA. Within one day, on September 12, the index fell by 5.4 percent with the minimal value of 174.2 points (-15.5 percent compared with September 11) observed on October 3. By the year-end the index climbed to the pre-crisis level: on December 29 the stock indicator reached 206.05 points – the maximal value since May 14, 1998.

As a result of the year, almost all Russian blue chips demonstrated positive movements. The highest-yield shares turned out to be those of Sberbank (+206.93 percent), YUKOS (+192.13 percent), and Sibneft (+173.6 percent). The quotations for RAO UES (+93.15 percent), Mosenergo (+70.83 percent), Surgutneftegaz (+51.5 percent), Tatneft (+45.1 percent) and LUKOIL (+31.93 percent) were less volatile. At the bottom of the list are the shares of Rostelecom (+4.55 percent) and GMK Norilsk Nickel (+2.27 per-

cent since July 9, 2001). It should be noted that the highest yield instruments in 2001 were the shares of the “second echelon” enterprises. The absolute leaders yield-wise were the shares of the Volzhsk Automobile Plant which had become ten times as expensive (the ordinary shares went up by 1086 percent, while the preferred ones – by 966.67 percent). The Tulenergo shares (+330.23 percent) and preferred shares of Lenenergo (+325 percent) became almost three times as expensive.

In the total RTS turnover the share of the RAO UES stood at 32.86 percent (40.0 percent in 2000), LUKOIL –16.65 percent (17.4 percent), YUKOS – 13.2 percent (1.2 percent), Surgutneftegaz – 9.02 percent (8.9 percent) and RAO Norilsk Nickel – 5.18 percent (4.6 percent). Thus, the total share of the five most liquid stocks amounted to 76.91 percent (77.2 percent in 2000) in the aggregate RTS turnover.

The maximal number of deals – over 20,000 – were transacted in the RAO UES shares. The runner-up was the RAO Gazprom with over 17.5 thousand transactions done through the RTS terminals at the Saint Petersburg Stock Exchange.

According to the data of the National Association of capital market participants (NAUFOR), the top five major Russian companies by capitalization as of the end of December were the following: OAO Surgutneftegaz (\$12,585.5 mln.), OAO Gazprom (\$12,349.67 mln.); OAO YUKOS oil company (\$11,585.67 mln.), OAO LUKOIL (\$10,319.9 mln.) and RAO UES (\$6,664.89 mln.)

To explain the above-noted trends in share quotations, let us review the situation in the Russian stock market in 2001 in the context of the changing risk levels. Insofar, the impact of the following factor groups seems especially important:

- The domestic political situation;
- new instruments of the Russian capital market;
- relations with international financial institutions;
- the situation in the international financial markets;
- corporate news;
- trends in oil prices in the world markets.

We will cover the first five factor groups in this section, while the last (but not the least) - trends in oil prices in the world markets - will be analyzed in detail in section 2.1 of this review.

The domestic political situation

Strengthening political stability in the country, the Government's consistent economic policy, adoption of key legal acts by the legislature, doubtless, played a positive role in a successful development of the Russian economy as a whole and the capital markets, in particular.

These components led to an enhanced attractiveness of the Russian economy both for Russian and foreign investors. However, it should be noted that a power struggle between the old and the new elites, accompanied by flagrant scandals was a destabilizing factor which did not contribute to increased capital invest-

ments in domestic companies. Placement of “single team players” to key positions contributed to a speedy decision making on important issues, on the one hand, but on the other hand, this gave rise to questions about the efficiency of the officials appointed to various posts on the basis of their affinity to a political grouping, but not according to their professional achievements.

Unfortunately, the role of the administrative factor in corporate dispute settlement continues to be high, testifying to the imperfect nature of the RF judiciary system. The level of institutional protection of investor rights, including those of foreigners, is also rather low in Russia. The confrontation between the procuracy and the “Most” group in the spring of last year as well as the legal proceedings against the TV6 television company in autumn, triggering off broad repercussions both at home and abroad, scared off investors from the Russian market. All these negative developments prevented growing investor optimism with respect to the prospects of the Russian economy and rehabilitation of the Russian investment climate.

The early spring witnessed several important developments in the Russian domestic and foreign policy areas. Specifically, there was some cooling off in relations between Russia and the USA. In mid-March the State Duma reviewed the issue of no-confidence vote in the Government. Despite the fact that the vote was not approved, the criticism leveled at the government went mostly unanswered. Such an uncertain situation did not contribute to growing quotations in the capital markets, so a lateral drifting of the prices was observed during most of the spring.

As has already been mentioned, a number of important legislative acts were adopted in 2001, among them the Land Code, the Labor Code, the Law “On Investment Funds”, etc. As a result, obstacles to a civilized turnover of non-agricultural lands were removed, a legal framework for collective investments in Russia was created and the principles of managing joint stock and unit investment funds as well as those of supervising their activities were identified. Adoption of these important laws creates potential conditions for inflows of fresh funds to the Russian market.

To put a barrier to illegal capital flows in Russia (according to the FATE requirements has blacklisted Russia), the Committee for Financial Monitoring has been set up under the RF Ministry of Finance. Financial intelligence will monitor all transactions above 600, 000 rubles. The activities of the new agency are expected to enhance transparency of capital transactions in Russia, improve the investment climate with fresh funds of the Russian and foreign investors coming to the domestic capital markets.

New instruments of the Russian capital market

Due to a conflict between the Moscow Stock Exchange - the main trading site for the Gazprom shares – and the Gazprombank, the core turnover of the transactions in the OAO Gazprom shares was moved to the Saint Petersburg Stock Exchange. The share trading is effected at the dedicated trading session with the RTS Stock exchange terminals used. The turnover of Gazprom share trading through the RTS terminals exceeded \$210 million since July 6 (434 million securities).

It is necessary to mention the development of the Russian derivatives market and the emergence of new assets thereon. September 19 witnessed the opening of the RTS futures market (FORTS) in the framework of an agreement on creating a single market for trading in futures and options contracts by the RTS and the Saint Petersburg Stock Exchange. Transactions in 4 futures contracts for the quotations of RAO UES, Gazprom, LUKOIL and Surgutneftegaz shares are currently done at the FORTS, as well as options for futures contracts for the shares of the first two above-mentioned issuers. In the first of hour of the system's existence, the trading volume exceeded 15 mln rubles (147 transactions and 5,206 contracts).

As a result of 2001, about 53 thousand transactions were done in the futures market for the value exceeding 7.8 bln rubles (2 million contracts). The aggregate volume of open positions as of the end of the last trading day of 2001 exceeded half a billion rubles.

The turnover in futures contracts amounted to 7.7 bln rubles (50.3 thousand transactions, 2 million contracts). A record-high turnover in futures at a trading session – 281.7 mln rubles - was recorded on November 26, while December 29 broke the record in the open position volume – 510 mln rubles.

2.8 mln transactions totaling 71.3 mln rubles (24.5 thousand contracts) were concluded for options at the FORTS in 2001.

On November 12, the RTS launched computations of RUIX, the Russian investment index and RUIXOIL, the oil stock index (Chart 3). Computations of the former index include quotations of the seven most liquid ordinary shares: RAO UES, OAO Mosenergo, OAO Rostelecom, LUKOIL oil company, OAO Surgutneftegaz, OAO Tatneft and YUKOS oil company. Computations of the oil index include the shares of the four latter issuers. Futures trading for these indices commenced on December 3 by two contracts immediately with the execution on December 17, 2001 and March 15, 2002.

After the end of the December 17 trading session came the date of the execution of the obligations under all contracts falling due in December 2001. The first execution of contracts in the history of the FORTS futures market was successful. Apart from the contracts to be executed in March, futures with the new execution date – June 2002 – are currently in circulation.

Relations with international financial institutions

Made in January, the Russian Government's declaration of intent to defer payments of the Paris Club debt in the first quarter of 2001 elicited a rather harsh reaction from the creditors. A possibility of restructuring payments of the Russian debt to the Paris Club became one of the widely discussed issues in the very beginning of the year. The total volume of Russia's debt to the Paris Club amounts to about \$40 bln. Ensuing statements by the German and Japanese officials about Russia's membership in G-8 as well as the US harder stance on the issue of crediting the Russian Federation made the RF Government somewhat ease its position. The harsh stance of the creditors, confirmed at the meeting of G-7 ministers of Finance in Palermo, prevented the Russian Government from securing restructuring and debt write off in 2001. At the same time, the "not to pay" alternative, so widely discussed in the Russian political circles, could have led to the country's investment isolation as well as to a domestic political crisis. At that moment the investors were not taking this scenario seriously, which may be borne out by the growing prices for the Russian assets in January (see above). February saw the introduction of amendments into the Law "On the 2001 Federal Budget" which allowed to reallocate part of additional revenue for external debt payments. The Government started payments of the Paris Club debt before the amendments to the budget were approved by the Federation Council. According to the payment schedule, Russia's payments to the Paris Club of creditors in 2001 totaled \$3.73 bln, with \$2 bln payable to the IMF.

In April the RF Government succeeded in finally overcoming tensions in its relations with the Paris Club of creditors: Russia had practically resumed payments to the Club according to the schedule after the disruptions in January.

The relations between Russia and the International Monetary Fund progressed more favorably in 2001. The Minfin remitted \$1.077 bln to the IMF between January and September. Russia's debt to the IMF declined to \$7.69 bln by the end of the elapsed year. Thus, the debt to the Fund will be less than the RF quota in the Fund's Charter Capital. The total public debt of the Russian Federation reached 52 percent of GDP by the year-end, which is an "acceptable level" even for developed countries.

Russia does not currently have a joint program with the IMF. However, Russia does not overrule the possibility of resuming talks with the International Monetary Fund on credit extension in the event of a sharp drop in oil prices.

At a meeting held in Moscow in early October with Horst Keller, Managing Director of the International Monetary Fund, RF President V. Putin announced an intent to make early repayment under the IMF credit amounting to \$4.8 bln extended in the summer of 1998 to the Central Bank to support the gold and currency reserves. According to the Minfin data, the debt of Bank of Russia to the IMF as of mid-2001 totaled \$2.8 bln. In addition, the RF Government plans to create a financial reserve in the amount of 109.8 bln rubles (\$3.5 bln) intending to keep it for repaying part of external debt in 2003, when Russia is to pay a total of about \$19 bln under its external debt.

The world's major rating agencies have noted positive changes in Russia's economy. Fitch Agency has upgraded the long-term rating for forex borrowing to "B+" with the long-term rating in the local currency upgraded to "B". The forecast for long-term rating changes is stable. Standard & Poor's upgraded Russia's long-term rating in forex and local currency from "B" to "B+" and has confirmed its "B" level in the short-term credit rating. Long-term rating projections have been reviewed from "positive" to "stable". S&P report says that Russia's higher ratings reflect a continued improvement of the political climate in the country which has strengthened the RF economy and favorably impacted on the economic prospects and political flexibility. As a result, RF economy is becoming less dependent on the situation in oil markets currently going through an unstable period. Moody's has upgraded the Russian Federation's rating by two ranks in one go – from B2 to Ba3 in forex and from B1 to B3 in the local currency. The forecast for all ratings is stable.

The situation in the international financial markets

Negative movements of the US macroeconomic indicators, such as sales and industrial output, testifying to a declining economic growth rate of the world's largest economy, have forced the US Administration to moderate its monetary and credit policy. The Federal Reserve cut the federal funds rate to 6 percent per annum in early January, also reducing the discount rate initially to 5.7 and later to 5.5 percent per annum. These steps, however, failed to produce expected results. On March 20, the Fed's Board of Directors cut the basic interest rate on short-term bank loans by another 0.5 percent to 5 percent per annum. The investors had been expecting an interest rate cut, but under the existing economic conditions many of them thought that a reduction by half a percentage point was inadequate.

Similar criticism was leveled at the Central European Bank which, on March 30, adopted a resolution on retaining the refinancing rate at 4.75 percent per annum. An unexpected announcement the US Federal Open Market Committee made on April 18 on slashing the federal funds rate from 5 to 4.5 percent pushed the world trading sites up. Thus, for example, NASDAQ grew by 8.1 percent immediately on the day the announcement was made. However, such actions failed to reverse the adverse trends and, to avoid the danger of recession, the Central Banks of developed countries continued to reduce indicative interest rates. The Federal Reserve once again, on May 16, reduced the interest rate by 50 basis points to 4 percent. On June 27 the FOMC further cut the rate by 0.25 percent to 3.5 percent. Thus, the rate has declined during 6 months from 6.5 to 3.75 percent – the minimal value over the last 7 years. The US Federal Open Market Committee, at a session held on August 21, took a decision to reduce the basis interest rate for the sixth time since the beginning of the year. This time it was cut by a further 0.25 percent to reach 3.5 percent – the minimal value since April 1994.

The collapse of the World Trade Center on September 11 and expectations of retaliation from the US Government led to a meltdown of the world's key markets, while no trading took place at the NYSE from September 11 to 17. The week of September 17 to 21 witnessed a substantial drop of the US stock markets: DJ lost 7.68 percent, NASDAQ – 9.9 percent and S&P 7 percent, insofar, S&P closed below 1000 points level on September 20. On September 17 the Federal Reserve once again cut the federal funds rate by 50 basis points to 3.0 percent. To support the euro-zone economy, the ECB cut the interest rates by 0.5 percentage points to the level of 3.75 percent, with the Central Banks of other countries also reducing the key rates. The Bank of England also cut the key interest rate in Great Britain by 0.25 percentage points to 4.5 percent.

On October 2, the US Federal Reserve once again reduced the key interest federal funds rate by another 50 basis points to 2.5 percent – the minimal level since 1962. In response to the rate cut - the ninth since the beginning of the year –the main stock indices went up: DJIA grew by 113.76 points (1.3 percent) to 8950.59, the NASDAQ composite –got heavier by 11.87 points reaching 1492.33. However, the expected reversal still failed to materialize. In November, the Central Banks of the countries playing the key role in the world economic system once again cut the interest rates. The US Federal Reserve took a decision on November 6 –the tenth during the year – to reduce the rate, this time to 2.0 percent. As a result of this, Dow Jones - the key stock index – got by 1.6 percent “heavier”, while NASDAQ – by 2.3 percent. The Bank of England cut the key rate in Great Britain by 0.5 percent to 4.0 percent. On the same day the ECB also cut the key rate from 3.75 to 3.25 percent. In response to these measures the All-European stock index FTSE Eurotop 300 went up by 1.17 percent reaching 1240.71, DJ Euro Stoxx 50 index – grew by 1.83 percent to 3699.62 points. FTSE 100 - the British stock index – increased by 0.18 percent to 5225.5 points, while the French CAC-40 gained 1.36 percent reaching 4554.56. DAX - the key German stock index – gained 1.32 percent reaching 4924.80 points. At the last FOMC session held in 2001 the federal funds rate in the US was further reduced by 25 basis points to the level of 1.75 percent.

It should be noted that the European Central Bank did not make such dramatic interest rate cuts. The ECB eased its monetary policy with reluctance, fearing this could result in accelerated inflation.

The announcement about Enron’s bankruptcy of – major US trader in the gas and electric power market – came as one more shock for the world market. The energy giant collapsed due to intra-corporate machinations as a result of which whole economic sectors – energy, banking, insurance and telecommunications - suffered. According to expert evaluations, the losses suffered by insurance companies alone shall amount to over \$2 bln. Enron’s financial relations with other companies were so complicated that the exact amount of debt still remains unclear.

The company balances show about \$13 bln of debt, however, according to expert assessments, the total liabilities may be up to \$40 bln. However, it should be noted, that the fact that the company had reached agreements with its key creditors on commencement of the company’s restructuring prevented the stock indices from collapsing.

Corporate news

2001 was, overall, a favorable year for the Russian companies. Russia's changed image and its higher ratings had a beneficial effect on the activities of national corporations. Many Russian companies floated their depositary receipts on the world's major trading sites. It is noteworthy that the shares of the telecom and energy companies became the market's "locomotive" at the year - end. The "oil" yielded its positions due to the unfavorable situation in raw materials markets. Among "negative" developments one should mention a big number of scandals and legal proceedings major Russian corporations were engaged in.

Certain steps were made in 2001 to reform the natural monopolies – Gazprom and RAO UES. Thus, The RF President set up a commission designed to liberalize the domestic market of Gazprom shares. The liberalization measures are expected to include an increased share of foreign investors in the Gazprom charter capital, launching the company's securities in the RTS and the MISEX. At that period the Moscow Stock Exchange (MSE) was practically the only site where this issuer's shares were quoted (see above). The market took the news about the event with a lot of enthusiasm and a result of the second week in April the quotations for the gas concern's shares surged at the MSE by about 21 percent. Insofar, the operators' activity dramatically increased: the Gazprom shares turnover amounted to about \$55 mln for one week, exceeding that of RAO UES – the most liquid company in the Russian securities market – by about two-fold.

In May, the company's Board of Directors elected a new Board chairperson –Alexei Miller, who had previously held the position of the deputy minister for energy. Launching of irreversible reforms at the gas monopoly was expected after the removal of Rem Vyakhirev, the head of the concern. The "fly in the ointment" proved to be a scandal related to the seizure of 2.3 percent of Gazprom shares owned by the UFG company and deletion from the voting ballots of four out of the five candidates nominated by the minority shareholders. These developments, coupled with the register closure on May 4, led to a drop in the quotations for the gas monopolist's shares in mid-May.

A commission for reforming the RAO UES energy holding was also set up in spring. The company's restructuring plan and that of creating a free market for electric power enhanced major producers' interest in the shares of the regional energy joint stock companies. The Kubanenergo, Tomskenergo and Belgorodenergo shares have been actively bought up lately. And Mikhail Khodorkovsky, YUKOS' head, has publicly stated his interest in the power sector. In addition, YUKOS has become one of the founders of the Trading System Administrator which is to manage the electric power market.

Computed according to the IAS, consolidated net profit of the RAO UES energy holding in the first half of 2001 grew from below 300 mln rubles (for the first six months of 2000) to 841 mln rubles.

A conflict between Mosenergo and its major shareholder RAO UES led to a top management reshuffle at the regional energy company. However, excellent financial performance in the first half of the year prevented the Mosenergo shares from plummeting. According to the Russian Accounting Standards, at about 2.7 bln rubles, the corporation's net profit increased 6-fold compared with the same period of the previous year.

Sibneft on several occasions surprised market participants by its vague actions which generated many rumors and scared off potential investors. However, the rate of return on its shares in 2001 offset all the risks.

In the first half of 2001 Sibneft posted a net profit of \$613 mln, sales - \$1.663 bln, EBITDA - 871 mln (according to GAAP). The company's net profit for the year is expected to amount to \$1.1 bln (before dividend payments) with EBITDA to climb to \$1.6 bln and sales at \$3.3 bln. The total amount of dividend was about \$900 mln (to the tune of 80 percent of net profit). Thus, the oil company's shares proved to be one of the most profitable instruments of the Russian capital market. The rate of return, taking into account the dividend paid and the growth in quotations, exceeded 215 percent. For the sake of comparison: as a result of 2000 LUKOIL paid 19 percent of its net profit in dividend, Surgutneftegaz - 4.1 percent. In mid-October, YUKOS announced payment of interim dividend for 2001 amounting to 13.3 percent of the company's net profit for the first half of the year.

Computed according to the Russian Accounting Standards, net profit of OAO Rostelecom for 9 months of 2001 went up to 1.8 bln rubles compared with 0.9 bln. rubles for the same period of the preceding year. Sales during the above period increased from 12.5 bln rubles in 2000 to 14.3 bln. rubles. According to the company's report, bigger sales are by 80 percent due to the expanded volume of the services provided and by 20 percent a result of the changes in tariffs. The EBITDA margin for the report period stood at 54.3 percent, which was 5.4 percent higher than for the same period of the preceding year. As a result of 2001, Rostelecom plans to increase its net profit to reach 2.0-2.5 bln rubles compared with 1.03 bln rubles in 2000. The company's improved fundamental indicators were enthusiastically welcomed by the market. After the financial performance indicators were announced the prices of Rostelecom shares went up by almost 1.5 times in November.

One of Russia's major metallurgical companies – Norilsk Nickel also completed restructuring in 2001, designed to enhance transparency and efficiency of the company management. As a result of the reform, the capitalization center was moved from RAO Norilsk Nickel to the Mining Metallurgical Combine (GMK) Norilsk Nickel by way of a share swap, as a result of which the GMK became owner of 96.5 percent of the RAO assets. The RAO's cross holding of 17 percent of the GMK's shares is to be removed by reducing the GMK Charter capital by 17 percent. The shares of GMK Norilsk Nickel are currently the key traded stock of the company. They are also included in the list of shares for computing the RTS index. It is necessary to mention the legal proceedings, related to restructuring, which nearly paralyzed trading in RAO Norilsk Nickel shares on the country's main trading sites. Under a claim filed by a shareholder of three shares (!), a district court of the Kemerovo oblast forbade GMK to use the "Norilsk Nickel" brand name or perform any actions designed to include the shares of OAO GMK Norilsk Nickel in the listings of the Russian and foreign stock exchanges. One more instance of corporate blackmail has again emphasized the domestic companies' legal vulnerability and adversely impacted on the image of Russian companies.

In November, the Government approved and recommended for application the Code of Corporate Conduct elaborated by the FCSM. The Code is a set of rules which major joint stock companies, comprised of over a thousand shareholders, should abide by. The Code describes the rules of conducting shareholder meetings, the rights and responsibilities of the Board of Directors, etc. It is designed to improve corporate governance in the country.

Table 39**Movements in stock indices**

Data as of December 28, 2001	Value	Change since the beginning of the year (percent)
RTS (Russia)	256.75	81.49%
Dow Jones Industrial Average (USA)	10136.99	-6.02%
NASDAQ Composite (USA)	1987.26	-19.56%
S&P 500 (USA)	1161.02	-12.06%
FTSE 100 (Great Britain)	5242.40	-15.75%
DAX-30 (Germany)	5160.10	-19.79%
CAC-40 (France)	4624.58	-21.97%
Swiss Market (Switzerland)	6417.80	-21.11%
Nikkei-225 (Japan)	10542.62	-23.52%
Bovespa (Brazil)	13578	-11.02%
IPC (Mexico)	6467.09	14.42%
IPSA (Chili)	109.10	13.21%
Straits Times (Singapore)	1625.98	-12.65%
Seoul Composite(South Korea)	693.70	33.16%
ISE National-100 (Turkey)	13782.76	45.59%
Morgan Stanley Emerging Markets Free Index	315.22	-5.56%

1.4.4. The corporate bond market

In 2001, the Russian corporate bond market went through a stage of intensive development. In the first place, the domestic corporate bond market had doubled, amounting to \$2.5 bln by the year end. In the second place, the issue of corporate Eurobonds resumed for the first time after the 1998 default – Rosneft,

Gazprombank and the telecommunications company MTS raised a total of \$600 mln. through Eurobond issues.

The domestic corporate bond market

As at the year end 2001, the value of the domestic corporate bond market accounted for 75 bln. RF Rubles (\$2.5 bln). Over 100 issues of corporate bonds floated by 50 leading Russian companies were traded in the market.

The corporate bond yield exceeded by 4-6% the yield of government securities (GKO - "government short-term bonds" and OFZ - "federal loan bonds") with similar maturity dates, it was by 2-3% lower than the bank loan rates (except for the Sberbank's loan rates) and by 1-2% lower than the rates of floated bills.

Most bond issues had been placed through and were traded at the Moscow Interbank Currency Exchange, although barely a half of them were enjoying a fairly liquid market. According to estimates, the Moscow commercial banks made up 75% of investors in the corporate bond market, regional banks accounted for 15%, and the remaining 10% included insurance and pension funds, and other investor groups. The volume of the corporate bond market approximated 1/3 of the volume of the GKO-OFZ market, with a turnover ratio of 1/5.

Prior to the August of 1998, the Russian market of domestic corporate bonds was underdeveloped. For a long time its development had been impeded by the high cost of internal loans dictated by the GKO-OFZ market. In addition, the market was affected by the discriminatory taxation rules applicable to corporate bond issuers, which did not allow (contrary to the cost of bank loan servicing) interest on corporate bonds in the cost. As a result, Russia's fairly high pre-default credit rating made foreign loans more attractive, including those acquired through the issue of Eurobonds.

In 1999, however, the situation changed. In the first place, due to a combination of fiscal and monetary political measures (the budget surplus, monetary expansion through the purchase by the Central Bank of exchange proceeds) the real interest rates went sharply down, even reaching negative values on the government loans. In the second place, Resolution № 696 of the RF Government, dated 26 of June 1999, allowed in the cost the interest (discount) paid by the issuer on its bonds (within the effective refinancing rate of the RF Central Bank

upgraded by three points)³³. And finally, the Eurobond market was closed for Russian borrowers until the second half of 2001.

An important factor that served to speed up the development of the corporate bond market was the scheme used for the restructuring of governmental obligations to non-resident GKO and OFZ holders. Under the proposed arrangement, the bulk of their receipts could not for a long time be repatriated and were instead to be accumulated on the so-called «C» accounts, with a possibility for investment in financial instruments denominated in the RF Rubles. As a result, the «C» accounts had accumulated some \$5 bln, which became a major source of funds for the issue of Russian corporate bonds in 1999. The corporate bonds of the OAO «LUKOIL», the OAO «Gazprom», the AK «Alrosa», the RAO «UES of Russia» and the OAO «Tyumen Oil Company», which were floated in the second half of 1999, were oriented towards these investor groups.

Later, the issuers, which in 2000-2001 included natural monopolies, commercial banks, telecommunications companies, metallurgical and other sectoral enterprises, started to turn towards domestic investors.

The principal tendency in the changing financial arrangements of loan schemes was the transfer from the issue of indexed bonds, whose value was pegged to the Ruble-Dollar exchange rate, to the issue of Ruble-denominated instruments with fixed coupons or coupons linked to the Ruble rate (the OFZ rate of return, the refinancing rate of the RF Central Bank).

In addition, the compromise between the issuer's penchant for long-term bonds and the investor's desire to raise the asset liquidity resulted in the issue of optional bonds or the issuer's offer of put options.

The issuers' policy aimed at enhancing the attractiveness of their securities gradually increased the number of relatively liquid bond issues. As a result, the number of exchange traded corporate bonds rose between December 2000 and December 2001 from 10 to 62, the number of monthly transactions also increased from 185 to 1 355, and the monthly sales rose from 0.3 bln. RF Rubles to 3.6 bln. RF Rubles. At the end of December 2001, MICEX accounted for 96.7% of the monthly trading operations with corporate bonds, the respective shares of SPCEX and RTS came to 1.2%, while the KBST and MSE made up 0.01% of the sales.

³³ To be liable for the specified privilege, the floated bonds had to be traded in the securities market through market-makers licensed by the FSMC of Russia, i.e. at stock exchanges.

Market participants predict that the growth rates of the corporate bond market would remain high (in 2000 the market grew from 12 to 40 bln. RF Rubles, and in 2001 – from 40 to 75 bln. RF Rubles). The corporate bond market is estimated to amount to 150 bln. RF Rubles by the end of 2003, with the number of traded bond issues increasing to 200. The general outlook shows that within the next two or three years, given a favorable environment, this market may level with the market of government securities.

The securitization of the corporate bond market hinges upon the intention of commercial banks to diversify and raise the liquidity of their assets, and the development of non-banking financial institutions, i.e. insurance, pension and unit investment funds. In the medium-term perspective, the introduction of accumulation pension schemes is expected to give a powerful boost to the corporate bond market.

The revival of rating agencies is a sign and, at the same time, a positive factor of market development.

In the first place, the major international rating agencies, apart from assigning *international* credit ratings in foreign and domestic currencies, begin to assign ratings *according to the internal scale*. Due to a higher differentiation of rating values available to domestic issuers, the internal credit rating scale is far more sensitive to the changes of their creditworthiness and, consequently, provides more information to investors.

At present, Russian issuers receive the internal credit ratings from the Russian agency *EA-Ratings*, which was purchased in December 2001 by the international rating agency *Standard&Poors*³⁴. Besides, the Interfax rating agency is expected to raise its market profile in the aftermath of the cooperation agreement signed in October 2001 with the *Moody's* international rating agency.

It is worth remembering that the operations of the corporate bond market are also affected by various unfavorable factors.

In the first place, the tax levied on the issuer at the time of registration of a corporate bond issue is still very high. Pursuant to the Federal Law «On tax levied on securities transactions», the tax rate accounts for 0.8% of the issued value, irrespective of the maturity dates of the floated securities or the placement results. For instance, with the bond yield of 10% APR, the existing tax rate increases the cost of loan proceeds up to 11.8% APR (for 6-month bonds) or up to 13.2% APR for 3-month bonds. In the event of partial placement, i.e. 50% of the

³⁴ The market also makes use of the internal rating scale of corporate bonds, developed jointly by the Zenit Bank and the *Kompaniya* magazine.

stated value, the cost of loan proceeds under applicable legislation, which requires full advance payment of the tax, rises up to 16.5% (for 3-month bonds).

Thus, the existing mechanism actually precludes the possibility of floating short-dated bonds, increasing the cost of loan proceeds for enterprises and negatively affecting the liquidity of financial institutions. It is noteworthy that in the mature markets (i.e. in a number of Western European states) the issue tax is not levied, or the relevant tax rate is 30-50 time lower than in Russia (USA, Germany, South-East Asia).

Table 40

Issued corporate bonds

№	Эмитент	Номер гос. регистрации	Дата окончания размещения	Объем в обращении	Дата погашения
1	ОАО "ТНК"	4-03-00168-A	12.07.00	4 000 000 000	26.06.03
2	ОАО "ТНК"	4-04-00168-A	28.03.01	3 000 000 000	27.03.05
3	ОАО "ТНК"	4-06-00168-A	03.12.01	3 000 000 000	28.11.06
4	ОАО "Газпром"	4-01-00028-A	12.07.1999	3 000 000 000	15.04.03
5	ОАО "ТНК"	4-01-00168-A	09.06.99 - 1 транш, 20.09.99 - 1 2 транш	2 500 000 000	05.09.04
6	ОАО "ТНК"	4-02-00168-A	31.12.99 - 1 транш, 07.02.00 - 1	2 491 841 000	18.01.05
7	Кредит Сервис Ферст Бостон Капитал	4-01-36001-R	20.12.00	2 000 000 000	19.12.02
8	СИБУР	4-01-00163-F	04.07.01	5 127 442	03.12.02
9	АО НКК "Славнефть"	4-01-00221-A	10.04.01	1 000 000 000	09.04.02
10	ОАО Комбинат "Магнезит"	4-01-45002-D	май.01	720 000 000	май.04
11	ОАО "МГТС"	4-02-00083-A	13.11.01	1 000 000 000	12.11.04
12	ОАО "МГТС"	4-01-00083-A	27.10.00	600 000 000	18.10.03 - 1т., 27.10.03 - 2т.
13	ОАО Аэрофлот	4-01-00010-A	22.03.01	600 000 000	31.03.02
14	ЗАО "АПРОСА"	4-08-40046-N	20.12.01	500 000 000	25.11.03
15	ЗАО "АПРОСА"	4-07-40046-N	05.07.01	600 000 000	03.07.03
16	ЗАО "АПРОСА"	4-06-40046-N	16.05.01	600 000 000	14.05.03
17	ЗАО "АПРОСА"	4-06-40046-N	20.03.01	500 000 000	15.03.02
18	ЗАО РТК-Лизинг	4-02-01154-N	25.10.01	1 000 000 000	25.10.02
19	ОАО "Лияновский молкомбинат"	4-01-01328-A	01.11.01	500 000 000	29.10.04
20	ООО "Ренессанс Капитал"	4-01-36007-R	01.11.01	500 000 000	22.10.03
21	Нижнекамскнефтехим	4-01-00096-A	06.11.01	300 000 000	06.11.02
22	Центртелеком	4-01-00194-A	16.11.01	600 000 000	18.11.03
23	НТМК	4-01-00099-A	05.07.01	350 000 000	05.07.02
24	ОАО "РИТЭК"	4-03-00019-F	13.11.01	700 000 000	09.11.04
25	ОАО "РИТЭК"	4-02-00019-AF	02.03.01	300 000 000	01.02.04
26	Объединенные машиностроительные заводы	4-03-30174-D	04.10.01	390 000 000	22.03.04
27	Объединенные машиностроительные заводы	4-02-30174-D	06.09.01	390 000 000	23.02.04
28	ОАО "Объединенные машиностроительные заводы"	4-01-30174-D	20.04.01	280 000 000	02.04.03
29	ОАО "Татнефть"	4-01-00161-A	07.03.01	200 000 000	15.01.04
30	ФК "Рабо Инвест"	4-01-36004-R	24.10.01	150 000 000	22.04.02
31	ФК "Рабо Инвест"	4-02-36004-R	25.10.01	150 000 000	22.04.02
32	ФК "Рабо Инвест"	4-03-36004-R	26.10.01	150 000 000	22.04.02
33	ФК "Рабо Инвест"	4-04-36004-R	24.10.01	150 000 000	19.04.02
34	АООТ "Микрол"	4-01-00601-A	11.10.01	150 000 000	01.04.03
35	Красноярский сахарорафинадный завод	4-01-02382-A	20.11.01	100 000 000	20.11.02
36	ОАО "Русский продукт"	4-01-01306-A	14.05.01	140 000 000	13.03.02
37	ОАО "Протон-ГМ"	4-01-00181-K	февраль.01	100 000 000	30.08.02
38	ОАО "ММК"	4-15-00078-A	03.10.01	315 000 000	08.10.02
39	ОАО "ММК"	4-14-00078-A	08.08.01	315 000 000	13.08.02
40	ОАО "ММК"	4-13-00078-A	23.05.01	126 000 000	28.05.02
41	ОАО "ММК"	4-12-00078-A	16.05.01	126 000 000	21.05.02
42	ОАО "ММК"	4-11-00078-A	25.04.01	126 000 000	30.04.02
43	ОАО "ММК"	4-10-00078-A	27.03.01	126 000 000	01.04.02
44	ОАО "ММК"	4-09-00078-A	20.03.01	126 000 000	25.03.02
45	ОАО Башинформсвязь	4-01-00011-A	01.08.01	100 000 000	15.05.03
46	ОАО Концерн "Калина"	4-01-30306-D	07.03.01	70 000 000	25.02.04
47	Татнефтепродукт		дек.01	50 000 000	дек.03
48	ОАО Стройиндустрия		дек.01	12 500 000	дек.04
49	ОАО "Казанская ГТС"	4-07-55110-D	04.12.01	30 000 000	25.11.03
50	ОАО "Казанская ГТС"	4-06-55110-D	авг.00	30 000 000	май-июль 2002
51	ГУП "Таттелеком"	4-03-20003-R	сен.00	30 000 000	13.08.02
52	ОАО "Татинформ-ТЕЛКОМ"	4-01-55301-D	23.11.99	26 978 400	09.09.02
53	ОАО "Интерсет"	4-01-55751-D	декабрь.00	120 000 000	декабрь.01
54	ОАО "Донской табак"	4-01-30663-E	22.09.99	70 000 000	15.12.09
55	ОАО "Пекарь"	4-02-00094-D	15.10.01	25 000 000	11.10.02
56	ОАО "Уралсвязьинформ"	4-19-00175-A, 4-26-00175-A (10 выпусков)	июнь-ноя. 2001 г.	50 000 000	1 год
57	ОАО "Уралсвязьинформ"	4-18-00175-A	дек.00	25 000 000	1 год с даты размещения транша
58	ЗАО "АДОИП"	4-01-50712-K	июль.00	20 000 000	01.07.03
59	Мурманское морское пароходство	4-01-00068-A	20.07.01	14 000 000	18.01.02
60	ОАО "Сибнефтепровод"	4-01-00103-F	31.12.98	427 500	14.08.06
61	ОАО "Завод Электроники и механики"	4-01-55323-D	10.11.00	1 000 000	
62	ООО "Фармгарант"	4-03-18001-R	26.07.01	1 000 000	24.01.02

Table 40 (cont'd)

№	Эмитент	Номер гос. регистрации	Дата окончания размещения	Объем в обращении	Дата погашения
Банковские облигации					
1	Внешторгбанк	20101000В	24.05.00	1 000 000 000	22.05.02
2	Башкредитбанк	20102275ВВ	19.07.01	1 000 000 000	04.11.02
3	НОМЮС-БАНК	20502209ВВ	15.02.01	500 000 000	15.02.02
4	Русский Стандарт	20102289ВВ	15.11.01	500 000 000	29.10.04
6	Пробизнесбанк	20202412ВВ	06.11.01	100 000 000	05.05.02
7	Международный Банк Санкт-Петербурга	20100197В	07.06.01	99 000 000	
8	Инкасбанк		апр.01	300 000 000	2010 год
"Нерыночные" выпуски					
1	РАО "ЕЭС РОССИИ"	4-01-00034-A	17.02.00	3 000 000 000	1 транш -20.12.2002, 2 транш - 14.02.2003
2	ОАО "НК "ЛУКОЙЛ"	4-01-00077-A	13.08.99	3 000 000 000	22.07.03
3	ОАО Ростовэнерго	4-01-00125-A	30.05.00 - 1 транш, 08.09.00 - 2 транш	2 200 000 000	30.05.2003 - 1 транш, 08.09.00 - 2 транш 29.05.2003 (возможно досрочное погашение через 1 и 2 года)
4	ОАО "Михайловский ГОК"	4-01-00081-A	29.05.00	1 500 000 000	
5	ЗАО ИК "МДМ-Траст"	4-01-95361-P	21.08.00	1 500 000 000	11.08.04
6	ЗАО ИК "МДМ-Траст"	4-02-95361-P	20.10.00	3 000 000 000	4 года
7	ЗАО ИК "МДМ-Траст"	4-03-95361-P	01.12.00	3 000 000 000	
8	ОАО "МОСТОТРЕСТ"	4-01-02472-A		1 050 000 000	10.12.2002 (возм. досрочное погашение)
9	ОАО "Сибирско-Уральская алюминиевая компания"	4-01-30141-D	28.02.00	1 000 000 000	14.02.03
10	ОАО "Самараэнерго"	4-01-00127-A	24.03.00	1 000 000 000	22.03.2003 (возможно досрочное погашение через 6,12, 18, 24, 30 мес.) июнь-август 2003 (возм. досрочное погашение)
11	ООО "ГУТА-Инвест"	4-01-00001-R	30.08.00	450 000 000	
12	ЗАО "Орликов-5"	4-01-00979-H	20.11.00	450 000 000	20.11.05
13	ЗАО "Мясницкая_35"	4-01-00591-H	27.11.00	450 000 000	27.11.03
14	ЗАО "Инвест-Икор"	4-01-22868-H	22.01.01	450 000 000	январь 06
15	ОАО СП "Тулачермет"	4-01-02-072-A	09.04.01	963 830 000	07.06.2003 (возможно досрочное погашение через 1 и 2 года)
16	Балтийское финансовое агентство	4-01-00285-J	25.06.01	2 000 000 000	14.02.06
17	Икор-Финанс	4-01-23175-H	29.06.01	650 000 000	28.06.06
18	ОАО "Тюменьэнерго"	4-01-00159-F	20.12.00	1 514 506 000	20.12.03
19	Интерурал			1 600 000 000	
20	ЗАО "Кремний"			284 160 000	

Data source: The news letter «Corporate and bank bonds», 2002, №1.

In addition, the FSCM registration procedure of issued bonds is too complicated. The preparation stage lasts, at best, from 2 to 4-5 months, defeating the purpose of the short-dated bond issue. The new «Standards for the issue of bonds and relevant prospectuses» approved by FSCM Resolution # 27 of 19 of October 2001, do not simplify or speed up the procedure. Under the circumstances, a possible venue of corporate bond market development should entail the creation in Russia of a sector of commercial securities, i.e. short-term bonds liable for fast-track registration procedures.

The Eurobond market

The first period for the active placement of Russian Eurobonds happened in 1997-1998, when the aggregate value of foreign bonds issued by companies and banks amounted to \$2.5 bln. At the time of default on some of the bank securities (i.e. SBS-

AGRO, the «Rossiyski Kredit»), the restructuring of the UNEXIMBank's bonds, most issues were redeemed on or ahead of time (Table 41).

The second phase of the market development began in the autumn of 2001. In November, virtually simultaneously with the Eurobond issue by the Moscow authorities, Rosneft floated bonds worth of \$150 mln. In December 2001, two more companies made successful bond issues – MTS (\$250 mln.) and Gazprombank (200 mln. Euro). At the same time, the Magnitogorski integrated metallurgical works and Sibneft completed the preparatory stage for the issue of bonds to the extent of 100 mln. Euro and \$250 mln. respectively.³⁵

The cost of external loans went down due to the upgraded credit ratings of the Russian Federation and the VaZ Company, «B+» according to *Standard&Poor's* and *Moody's* respectively, which also boosted the credit ratings of the corporate securities. (Table 42).

Table 42

International credit ratings by Standard & Poor's

Russia: international ratings			
Issuer	Date of latest rating assignment (latest rating change)	In foreign currency / Outlook	In local currency / Outlook
Sovereign rating			
Russian Federation	22.02.2002	B+/Positive	B+/Positive
Corporations			
ALROSA	19.12.2001	B-/Positive	B-/Positive
Vympelkom	21.12.2001	B/Stable	B/Stable
Gazprom	20.12.2001	B+/Stable	B+/Stable
Irkutskenergo	28.06.2001	CCC+/Stable	CCC+/Stable
LUKOIL	19.12.2001	B+/Stable	B+/Stable
MGTS	14.12.2001	CCC+/Stable	--/--
MMK	14.11.2001	B/Positive	B/Positive
Mosenergo	28.06.2001	B-/Stable	B-/Stable
MTS	21.12.2001	B+/Stable	B+/Stable
OMZ	29.01.2002	CCC+/Positive	CCC+/Positive
Rosneft	23.10.2001	B/Stable	B/Stable
Rostelekom	28.07.2000	CCC/Stable	CCC/Stable
North-Western Telekom	11.12.2001	CCC/Stable	CCC/Stable
Tatneft	04.10.2001	B-/Stable	B-/Stable
Uralsvyazinform	17.12.2001	B-/Stable	B-/Stable
Tsentr Telekom	14.12.2001	CCC/Stable	CCC/Stable
YuTK	27.12.2001	CCC+/Stable	CCC+/Stable
Financial institutions			
Alba Alians Bank	29.05.2001	CCC-/Stable	CCC-/Stable

³⁵ Successfully placed in January 2002.

Alfa-Bank	13.02.2001	CCC+/Stable	CCC+/Stable
Bank MFK	26.02.2002	CCC-/Positive	CCC-/Positive

Table 42 (cont'd)

Issuer	Date of latest rating assignment (latest rating change)	In foreign currency / Outlook	In local currency / Outlook
Bank Petrokommerts	08.11.2001	CCC+/Stable	CCC+/Stable
Bashkreditbank	31.08.2001	CCC+/Stable	CCC+/Stable
Impexbank	04.02.2002	CCC-/Stable	CCC-/Stable
Investment banking corporation	15.03.2001	CCC-/Stable	CCC-/Stable
Infobank	04.05.2001	D/--	D/--
MDM-Bank	05.12.2001	CCC/Positive	CCC/Positive
International Moscow Bank	31.01.2002	B-/Stable	B-/Stable
International Industrial Bank	23.01.2002	CCC+/Stable	CCC+/Stable
Insurance companies			
AIG Russia	04.01.1999	AAA/--	--/--
Investment and brokerage companies			
Renaissance Capital Holdings Ltd.	08.11.2001	CCC/Positive	CCC/Positive

Data source: Standard&Poor's

Some of the Russian Eurobond issues involve "indirect" placement schemes, when the Russian borrower acts as the founder of a non-resident company registered abroad, which "formally" becomes the securities issuer. Under this scheme, bonds are actually secured by the guarantees of the Russian parent company, which can now freely and fully dispose of the acquired loan proceeds.

For instance, the MTS subsidiary non-resident company *Mobile TeleSystems Finance S.A.* acted as borrower under the MTS Eurobond issue, and the Gazprombank subsidiary Dutch company *Gazinvest Finance B.V.* became the borrower under the Gazprombank Eurobond issue.

Under the above scheme, the Russian corporate borrower saves in tax payments up to 0.8% of the issued value; the bond issue need not be registered with the FSCM; no license to perform foreign exchange operations is required from the RF Central Bank; and matters pertaining to the double taxation of the investors' incomes are resolved in a simplified manner. The procedure for receiving and repaying the loan proceeds raised under the "indirect" eurobond placement schemes was simplified by Instruction # 1030-Y of the RF Central Bank adopted on 10 of September 2001, which replaced the discretionary procedure for attracting long-term loans from non-resident investors with a notification procedure.

At the same time, Russian investors find it difficult to enter the market of Eurobonds floated by Russian issuers through the aforementioned "indirect" scheme, because resident entities may only engage in the purchase and sale of Eurobonds, if they have a license of the RF Central Bank to engage in capital-flow operations. Regulation # 152-Π of the RF Central Bank, dated 17 of September 2001, provides for an exception to that rule and allows for "the acquisition and alienation by residents in the organized securities market, through authorized banks and for foreign currency, of resident-issued securities denominated in a foreign currency».

This exception applies to Russian government Eurobonds and corporate bonds in the instances where a resident company acts as direct borrower, but leaves out the Russian Eurobonds issued by way of the "indirect" schemes. Given the cautious liberalization of the foreign exchange market, it would be expedient to make sure that domestic investors get access to the entire range of Russian Eurobonds.

Annex 1

Tax Reform and Outlook for Improvements in Tax Legislation

Highlights of Stage One in Tax Reform

The first stage of the tax reform has included the approval of four chapters of Part II of the Russian Tax Code, including «Individual Income Taxation», «Excises», «Value-Added Tax», and «Integral Social Tax».

The principal new development in individual taxation is the establishment of a single rate of 13%. However, individual types of income such as lottery winnings, prize money and other gainings in competitions, games, and other promotions, insurance indemnity paid under voluntary insurance policies if such disbursements exceed the amount of insurance premiums contributed (under personal insurance contracts) or the extent of damage caused to property insured (under property insurance contracts), which is adjusted for inflation, interest accruals on bank deposits in excess of that sum calculated on the basis of a three-fourths of the Russian Central Bank's refinancing rate then in effect or 9% per annum for foreign exchange deposits, and the amount of savings on interest upon taxpayers' receipt of borrowings made at a rate equal to less than three-fourths of the Central Bank's rate are subject to taxation at the increased rate of 35%.

The double taxation of dividends has been largely ended by offsetting those profit tax amounts paid earlier against income tax liabilities.

The non-taxable minimum has been raised substantially (to RUR 400 per month for those making RUR 20,000), as has the so-called child-allowance subtraction (to RUR 300 monthly). A number of new social benefits are also available. Spending on either the taxpayer's education or on the education of their child in a sum of up to RUR 25,000 is subtracted from the taxpayer's tax base. Spending on medical services is to be subtracted in the same manner, with the exception of expenses actually made for costly types of treatment on a list approved by the Russian Government, which will be fully deducted from the tax base.

Such subtractions upon the sale of real property amount to RUR 1,000,000, those upon the sale of other types of property to RUR 125,000, and those upon the purchase or construction of real property at RUR 600,000. The entire amount of proceeds from the sale of real property owned by a taxpayer will be fully subtracted from their taxable income over five years and that of proceeds from other property over three years.

Integral social tax replaces the insurance premiums paid previously into government extra-budgetary social welfare funds. The tax consists of deductions

towards the Pension Fund, levied at a rate of 28% (or 22.8% for self-employed entrepreneurs), contributions payable into the Federal Obligatory Medical Insurance Fund and regional obligatory medical insurance funds at a rate, respectively, of 0.2% and 3.4%, and dues to the Social Insurance Fund owing at a rate of 4% (zero for self-employed entrepreneurs). The State Employment Fund has been consolidated with the federal budget.

Social tax is payable at a descending tax rate of 35.6% per employee earning up to RUR 100,000 per annum, 20% per employee making between RUR 100,000 and RUR 300,000 yearly, 10% per employee making between RUR 300,000 and RUR 600,000 and, finally, 5% (2% from January 1, 2003) per employee earning more than RUR 600,000. The possibility of applying the descending scale is conditional on a certain level of average compensation at an enterprise with a specific number of employees. The tax base, just as the list of income exempted from social tax, is consistent with that under individual income taxation.

The enactment of Part II of the Tax Code has made it possible to tackle a number of important problems relating to value-added taxation. VAT payers now also include self-employed entrepreneurs. The tax base is broader than before, a result of a shorter list of services exempted from VAT. In order to reduce tax administration costs, it is provided that a taxpayer may stop paying VAT if their quarterly receipts do not exceed RUR 1 million. From July 1, 2001, VAT will begin to be collected in relations with CIS nations on the basis of not the country of origin but the country of destination. A taxpayer may choose to rely in their accounting policy either on the cash-based method for determining when tax liabilities arise or on the accrual method consistent with generally recognized international practice.

In excise taxation, the indexing of rates applicable to alcoholic products has been accompanied by a decision to divide excises due on alcoholic products between their producers and wholesalers upon the implementation of an excise warehouse procedure as from June 1, 2000. Excises are now payable on diesel fuel and motor oil, with those owing on gasoline more or less trebled by way of making up for the abolition of tax on sales of fuel and lubricants and for the reduction in the rate of tax on motor road users, which is based on enterprises' turnover. Whereas previously the rates of excises payable on cars depended on engine displacement figures, now the Tax Code makes them contingent on engines' power ratings.

The law implementing Part II of the Tax Code has also provided for tax on motor road users and that on motor vehicle owners to be finally lifted from Janu-

ary 1, 2003 and somewhat extended the list of VAT exemptions compared with their list initially proposed, while limiting validity periods for other like reliefs. From January 1, 2002, taxpayer may begin – at their own discretion - to assess sales of goods, work, and services for taxation purposes on the basis of invoices received (the accrual basis). However, the meaning of the accrual basis here is somewhat distorted: those taxpayers opting for it as their accounting policy in accordance with the relevant statutory changes have the right to determine only the moment when their corresponding tax liabilities arise, but only become entitled to subtractions, like before, upon a confirmation that the incoming tax has been actually paid as part of the purchase price.

Tax policy in 2001

Changes in tax legislation in 2001

Administration

Federal Law No. 195-FZ dated December 30, 2001 (which will take effect from July 1, 2002) lent force to the Russian Code of Administrative Offenses.

This Code governs those issues which are involved, among others, in the imposition of administrative fines for tax evasion and other like wrongdoing. According to Chapter 3 of the Code, an administrative fine is a monetary penalty which may be expressed as a multiple of the sum of tax or other dues outstanding. An administrative fine payable on the basis of arrears of taxes and other dues may not exceed three times the amount of such backlog.

Chapter 15 fixes the specific amounts of fines to be charged on officials breaching financial legislation, including laws on taxation, banking, financial accounting and reporting, and the securities market. Such fines are payable, for example, for failure to register for taxation purposes, for late registration for such purposes with appropriate tax authorities, for the late provision of such authorities or the agency in charge of an extra-budgetary fund with information about accounts opened with or closed at banks or other lending institutions, etc. The same chapter details administrative fines to be exacted from bank officers for defaults on their duties relating to the maintenance of taxpayers' accounts, etc.

Chapter 16 of the Code provides for penalties due for administrative violations of customs rules. Chapters 23 and 28 define procedures for the consideration of administrative offenses by tax and customs authorities, and the federal tax police.

Russian Government Resolution No. 100 dated February 12, 2001 has laid down a procedure for the designation of shortfalls in federal taxes and dues and related late charges as hopeless debts and for their write-downs for the purposes of applying Article 59 of the Tax Code. Such arrears are recognized as hopeless upon the winding-up of a corporate debtor, the bankruptcy of a defaulting self-employed entrepreneur, the death of an individual debtor, or the latter's proclamation by a court to be deceased to the extent of all taxes and charges overdue, except property tax arrears which are deemed bad debts to the extent exceeding the value of the debtor's estate or upon the succession's passing to the State.

Russian Government Resolution No. 602 dated August 21, 2001 approved a procedure for figuring out the tax base when calculating VAT due on advances and other payments received by exporter organizations against future supplies of goods subject to zero VAT, which take more than six months to manufacture.

Such advances are excluded from the VAT base only after the corresponding exporters furnish documents to confirm their receipt. Failing such confirmation in accordance with statutory procedure as required to verify that the goods in question are subject to zero VAT, the merchandise concerned will be taxed pursuant to Russian legislation on taxes and levies.

The Russian Ministry of Finance explained in its Letter 03-07-28/25, dated February 6, 2001, that tax incomings may only be allocated between government budgets at different levels by federal treasury authorities. Upon the issue of a federal law on a federal budget for a specific fiscal year, all receipts coming into the Russian budgetary system are to be shared out among its different tiers on the basis of those applicable rates of deductions which are in force for such year, regardless of the time when the corresponding payments were assessed, in particular, when the respective tax liabilities arose.

The Russian Constitutional Court in its Decision 138-O, dated July 25, 2001, offered clarifications on how its earlier resolution, dated October 12, 1998 and describing its constitutionality check on Article 11.3 of the Russian Law «On Basic Principles for Taxation System in the Russian Federation», should be applied.

The check was prompted by the Russian Ministry of Taxes and Levies' query about whether a tax not actually transferred to the government budget, though written off by a bank, can be deemed having been duly paid in the absence of enough cash on the bank's correspondent account and on the taxpayer's current account. According to the Constitutional Court, it can, but only when it comes to good-faith taxpayers. Should they have doubts or suspicions in this respect, tax authorities will have to prove the mala-fide posturing of taxpayers or banks in

accordance with that procedure prescribed by the Tax Code. Tax authorities may mount such checks upon discovering a shortfall in government budget revenues and, with enough evidence to support their cases, go to state arbitration courts to sue defaulters by bringing actions, in particular, to invalidate improper transactions and recover everything gained thereunder towards the State.

Letter No. ShS-6-14/613 from the Ministry of Taxes and Levies, dated August 8, 2001, for its part, explains the procedure for invoking Articles 83, 116, and 117 of the Tax Code.

That organization having detached divisions located on Russian territory and owning real property subject to taxation is required to register as a taxpayer with the tax authorities both in its own location and in the locations of each of such division, as well as in the areas where the organization's real property and vehicles are registered.

A taxpayer registered with a tax authority on the basis of any of those grounds listed in Article 83 of the Tax Code may not be held liable, as provided for in Articles 116 and 117 of the Tax Code, for failing to file an application for repeat registration or for evading from repeat registration with the same tax authority on any other grounds specified in the same article.

Excises

Federal Law No. 118-FZ, dated August 7, 2001, amended Chapter 22 of Part II of the Tax Code to equate dry gas and casing-head gas following their treatment or processing with natural gas for excise taxation purposes and to alter individual excise rates. Oil and stable gas condensate will no longer be subject to excises from January 1, 2002 (under Articles 1.1 and 1.5 of Federal Law No. 126-FZ dated August 8, 2001). Also for excise taxation purposes, product transfers are treated as sales.

Federal Law No. 126-FZ also amended Part II of the terms and conditions and some other Russian legislative acts.

It clarified that the tax base during sales or transfers of natural gas on the domestic market is to be determined as the value of such gas based on the corresponding prices charged, which may not be lower than those established in the process of governmental regulation, with due regard for duly granted discounts, less value-added tax. During payment for services involved in pumping gas via distribution networks, the tax base is to be exclusive of the value of such services and the sum total of rates.

Russian Government Resolution No. 1023, dated December 27, 2000, approved rules for the manufacture and sale of special regional stamps for marking alcoholic products and paying advance excises on such products. Alcoholic

products sold from organizations' excise warehouses are all subject to marking by means of such special regional stamps, with the exception of beer and alcoholic products imported into the Russian Federation. Such stamps are produced by Russian winners of tenders arranged by the executive authorities of Russian Federation constituents. The value of a stamp may not exceed RUR 0.5, including the costs of its transportation to the Ministry of Taxes and Levies' branch in the corresponding Russian Federation constituent. Taxpayers include the costs of such stamps among expenses subtractable from their income or corporate profits for taxation purposes. Stamps are purchased from the Ministry's branches in Russian Federation constituents, but only after paying advance excises on alcoholic products.

Taxpayers may not transfer such stamps to any other parties. Russian Government Resolution No. 915 dated December 19, 2001 fixes the rates of advances payable during purchases of special regional stamps for excisable goods, including:

- RUR 0.3 per stamp for alcoholic products with an ethic alcohol content, by volume, of up to 25% inclusive; and
- RUR 0.8 per stamp for alcoholic products with an ethic alcohol content, by volume, of over 25%.

Russian Government Resolution No. No. 863 dated December 7, 2001 amended the above Russian Government Resolution, No. 1023 dated December 27, 2000, to modify the rules for the manufacture and sale of special regional stamps for alcoholic products. Under the changes, such stamps are to be used to mark all alcoholic products (other than imports and beer) with an ethyl alcohol content, by volume, of over 9%, which are sold from organizations' excise warehouses. Such products are to carry stamps of the Russian Federation constituent where they will be sold through the retailing or public catering network (the only exceptions being individual Russian Federation constituents in the Far North, where it is allowed to sell products carrying special stamps from other Russian regions).

Ministry of Taxes and Levies Letter No. BK-6-07/846 dated November 6, 2001 explains that the list of taxes and other dues is established by the Tax Code. The procedure for the obligatory marking of alcoholic products with stamps to confirm the legality of such products is as prescribed by Russian Government Resolution No. 938 dated August 3, 1996. According to Article 193 of Part II of the Tax Code, in effect since June 1, 2001, all alcoholic products produced and retailed on Russian territory are subject at all times to marking by special regional stamps the procedures for the manufacture and sale of which are established by

the Russian Government in its Resolution No. 1023 dated December 27, 2000. It is unlawful to mark alcoholic products by identification stamps, quality stamps, or any other stamps introduced by regional laws or injunctions. The Ministry of Taxes and Levies' regional branches are under orders to prohibit sales of products carrying any markings other than those provided for by the Tax Code or related follow-up documents.

Ministry of Taxes and Levies Letter VG-6-03/502 dated June 29, 2001 stipulates that excisable goods taken out of Russian customs territory under the customs export procedure to other CIS countries from July 1, 2001 are subject to excise taxation in accordance with that procedure prescribed in the Tax Code. That procedure for the collection of value-added tax and excises which was in effect in bilateral trade with the Belarus Republic before July 1, 2001 will continue in force.

Integral social tax

In accordance with Articles 25 and 26 of the Federal Law «On 2001 Federal Budget», dated December 27, 2000, a number of Russian ministries in 2001 (including the Ministry of Defense, the Ministry of the Interior, and others) were exempted from integral social tax to the extent payable towards the Russian Social Insurance Fund, the obligatory medical insurance funds, and the Russian Pension Fund after being assessed on the basis of military pay, food and clothing allowances, and other disbursements to individual categories of military servicemen or employees in connection with the performance of their military duties or other duties of equal status.

Federal Law No. 198-FZ dated December 31, 2001 amended the Tax Code and individual other Russian legislative acts on taxes and levies. The Tax Code amendments concerned some key provisions in Chapter 24, «Integral Social Tax», in particular, definitions of «taxpayer», «taxable assets» (the definition of this term was related to the Chapters «Profit Tax» and «Individual Income Tax» and to the procedure for determining the tax base under the summary taxation system, etc.), and «tax base».

The tax base for self-employed entrepreneurs subject to the summary taxation system was defined as the result of multiplying their gross earnings by 0.1.

The Law also updated rules for employing the descending tax scale. If at the time of advance payments the tax base accrued from the start of the corresponding year per individual, as divided by the number of months completed in the preceding tax period, works out to less than RUR 2,500, the tax is payable at the maximum rate, regardless of the actual tax base per individual. Such taxpayers may not use the descending tax scale until the end of the tax period concerned.

The average tax base per employee at taxpayers having more than 30 employees is to be calculated by disregarding payments to those 10% of employees who draw the highest income and that at taxpayers with 30 or fewer employees is to be calculated by disregarding payments to those 10% of them who draw the lowest income. Computations of the average tax base per employee are to take account of the average number of employees.

In order to assess the tax or advance due, those amounts owing to the federal budget are to be reduced by the rate of insurance premiums payable under the obligatory pension insurance scheme to the Russian Pension Fund.

Ministry of Taxes and Levies Letter No. SA-6-05/759 dated October 8, 2001 updated the procedure for self-employed entrepreneurs and employer individuals to calculate advances or premiums payable towards integral social tax (Exhibit No. 6 to Ministry of Taxes and Levies Order No. BG-3-07/469 dated December 29, 2000, as amended by the Ministry's Order No. BG-3-05/243 dated July 18, 2001). Taxpayers are to pay such advances monthly within that period prescribed for transferring funds to banks in order to pay compensation to employees for the preceding month, but on or before the 15th day of the following month.

Calculations for integral social tax advances are to be submitted to the regional branch of the Ministry of Taxes and Levies in the area of the taxpayer's registration on or before the 20th day of the month following the month being accounted for.

A joint letter from the Ministry of Taxes and Levies (No. BG-6-05/658), the Pension Fund (No. MZ-16-25/7003), the Social Insurance Fund (No. 02-08/06-2065P), and the Obligatory Medical Insurance Fund (No. 3205/80-1/i), dated August 28, 2001, explains the procedure for paying integral social tax or premiums by corporate taxpayers including detached divisions.

Under Article 243.9 of the Tax Code, those taxpayer organization which incorporate detached divisions pay integral social tax in their locations, as well as in the locations of each of such divisions. The amount of tax payable in the location of a detached division is determined on the basis of the latter's tax base. Those taxpayer organizations with detached divisions which have no separate balance sheet and current account and which do not make disbursements or pay other remuneration to employees or other individuals may pay integral social tax or premiums in a centralized manner in their respective locations. Determinations of whether conditions are in evidence for using descending integral social tax rates are to be made for an organization as a whole.

Value-added tax

Federal Law No. 179-FZ dated December 28, 2001 amended Articles 149 and 164 of the Tax Code. The changes concerned the levy of VAT at a rate of 10% on pharmaceuticals (including medicinal substances, among them those made within pharmacies themselves), medical products, and printed periodicals (other than advertising or erotic periodicals).

Ministry of Taxes and Levies Letter No. BG-3-03/461 dated December 27, 2000 explained that VAT refunds paid during the export of goods, work, or services are to be made by tax authorities in accordance with that procedure and within those periods prescribed by Chapter 21 of the Tax Code. Decisions to refund VAT to exporters of goods, work, or services in amounts of up to RUR 5 million over one month, as well as to such taxpayers as traditionally act as exporters, regardless of the amount of refunds due thereto, are to be made by tax authorities in the areas where such exporters are registered. After making the corresponding decisions, the authorities concerned are to send requests for VAT refunds to appropriate federal treasury agencies. Decisions on VAT refunds in amounts of over RUR 5 million to taxpayers other than traditional exporters are made by the regional branches of the Ministry of Taxes and Levies. Such decisions are to be made within two months.

Ministry of Taxes and Levies Letter No. VG-6-03/130 dated February 12, 2001 explains that an organization having detached divisions is to pay VAT at its own location, as well as at the locations of each of such divisions. At the same time, considering that 100% of VAT paid on Russian territory goes to the federal budget, such organizations in 2001 may pay VAT in a centralized manner – their consolidated payments comprising value-added tax due from their detached divisions as well – at the organizations' own locations. After deciding to pay their VAT in either manner (on a centralized basis or at the location of each detached division), taxpayers are to expressly state so in their orders on 2001 accounting policies.

Ministry of Taxes and Levies No. VG-6-03/184 dated March 2, 2001 explains the procedure for applying Article 146.2.4 of the Tax Code. In accordance with these explanations, the performance of work and the provision of services by such organizations as make part of the system of governmental agencies and local authorities in cases where these organizations are obliged to do such work and supply such services under applicable federal, sub-federal, or local acts are not to be treated as sales and, therefore, are not subject to VAT.

State Customs Committee Letter No. 01-06/51165 dated December 26, 2001 explains the procedure for the collection of VAT from January 1, 2002 dur-

ing the exportation of individual categories of goods onto Russian customs territory. VAT concessions will no longer be on offer from January 1, 2002 in these cases for the following goods:

- pharmaceuticals, medical products, and medical equipment, as well as raw materials and components for their manufacture;
- raw and other materials, and equipment purchased by handicraft ventures in order to make their products (Clause 13.12 of the relevant Instructions);
- production equipment, as well as components and spare parts, which are not produced in the Russian Federation; and
- media products and books relating to education, science, and culture.

Ministry of Taxes and Levies Letter No. VG-6-03/502 dated June 29, 2001 explains the procedure – in effect since July 1, 2001 – for charging indirect taxes in bilateral trade with other CIS countries. Until July 1, 2001, sales of goods, work, and services to such countries were equated to their sales on Russian territory. When goods were imported from other CIS countries, Russian customs authorities did not levy any VAT on them. From July 1, 2001, all goods sold to business entities in other CIS nations (other than oil, including stable gas condensate and natural gas) will be subject to VAT at a zero rate. Therefore, importers from July 1, 2001 will have to pay VAT, while exporters will be entitled to offset VAT payments against dues owing from them or to obtain VAT refunds.

Corporate profit tax

Federal Law 50-FZ dated May 9, 2001 amended the Law «On Profit Taxation of Enterprises and Organizations» in connection with the novation of Russian government securities.

In addition to procedures already in effect, the statute established a practical arrangement for determining those profits subject to profit tax concessions and interest yield from sales of government securities which are derived from the sale of government securities acquired as a result of the novation of third-series domestic government foreign-exchange loan bonds.

The law also granted broader benefits and rights to the holders of government securities upon their novation. They may use proceeds from the sale or retirement of all securities, including those being traded and those not in circulation on the organized securities market, to cover losses from the sale or retirement of those government securities obtained through their novation. The law details the procedure for allocating gains from the redemption of federal fixed-coupon-yield loan bonds to clear off taxes, fines, and late charges overdue to the federal budget. It also institutionalizes a new procedure for assessing and paying or withhold-

ing tax on interest on government securities with due regard for that method for determining interest accruals which is prescribed by the Tax Code.

For the purposes of enabling research organizations to take advantage of profit tax privileges in 2001, the Russian Government on February 2, 2001 issued Resolution No. 91 to establish a procedure for the determination of those R&D undertakings (as listed in the measure) the funding of which by such organizations out of their own profits qualifies them for tax abatements.

In such cases, a research organization itself selects those R&D efforts it intends to finance out of its retained profits, and submits a query to the Russian Ministry of Industry, Science, and Technology to find out whether they fit the description of those entitling taxpayers funding them out of their own profits to appropriate concessions. The Ministry is to answer such queries within one month.

Income tax

Federal Law No. 71-FZ dated May 30, 2001 amended provisions on the income taxation of yield from securities, as set out in that chapter in Part II of the Tax Code which deals with income tax. The resulting adoption of the same approach which underlies the corporate profit taxation law (division of securities into those traded and those not traded on the organized market, and list of expenses accepted for subtraction) makes a taxpayer's dealing with securities, including derivatives, into an independent business activity in its own right – without obliging the taxpayer to register with a tax authority as a self-employed entrepreneur.

Whereas in the case of profit tax the need for accepting losses from all securities, including those traded and those not traded on the organized market, is dictated by the fact that the market should offer equal conditions for any entrepreneurial activities (with legal entities having been specially established by their founders in order to maintain such activities), the need for furnishing preferential conditions for individuals' transactions with papers not in circulation on the securities market compared with any other activity not requiring their registration as self-employed entrepreneurs is not quite obvious.

A uniform approach is also inapplicable to determining the tax base for both revenues generated by the trust management of securities and gains from transactions with securities under contracts of agency or commission agency. The Russian Civil Code requires that assets provided for trust management should be recorded by the trust manager on a separate balance sheet. This means that the trustor's revenues or losses are determined on the basis of entries on the trust manager's balance sheet. The extension of the existing definition of taxable in-

come to apply to incomings from the transfer of assets for trust management is improper. Expenses under a trust management contract are incurred by the trust manager rather than by the taxpayer. The former makes up for such expenses out of the assets being managed. They also constitute the source of compensation payable to the trust manager.

Relations arising out of contracts of agency or commission agency concluded during a taxpayer's transfer of assets to professional entities licensed to operate on the securities market are governed by such contracts. Expenses incurred by agents, commission agents, and factors acting in the process of deals closed thereby with the corresponding taxpayers' assets transferred thereto as part of the transactions can be verified.

Pursuant to Article 974 of the Civil Code, an agent acting under a contract of agency is obliged to promptly provide the client with everything gained from transactions undertaken as part of the deal. In accordance with Article 975, the client is obliged to reimburse the agent for the costs incurred.

Under a contract of agency service, a factor acts in their own name and assumes those rights and obligations arising out of a transaction with a third party (Article 51 of the Civil Code). In keeping with Article 1011 of the Civil Code, contracts of agency service are subject to the same rules applicable to contracts of agency and commission agency.

Where such contracts are for securities, then expenses suffered as part of performing these transactions can be regarded as the costs of purchasing or selling the securities concerned.

Business on the organized market is transacted through its professional participants, i.e. on the basis of such contracts, which is why all expenses incurred by an agent or factor acting professionally on this market should be subject to subtraction.

New chapters of the Tax Code

Corporate profit tax

Drafting work on Chapter 25, «Corporate Profit Tax», of the Tax Code has had a fairly long history, with the text undergoing substantial changes – of not only a technical, but also conceptual nature – from reading to reading. It should be assumed that there is still a way to go, since the chapter already approved appears to have certain flaws and peculiarities, one of which is not quite consistent with fiscal purposes and another is at variance with the principle of neutrality with respect to both investment decisions and investment financing sources. In order to understand the situation as it currently stands, it is appropri-

ate to recall those conflicts of interest between the Ministry of Finance and the Ministry of Taxes and Levies, on the one hand, and the Industrialists' and Entrepreneurs' Union and the Ministry of Economic Development and Trade throwing its weight largely behind it, which preceded the chapter's discussion.

In November 2001, the State Duma received two competing drafts which represented different versions of Chapter 25 of the Tax Code. One bill, «On Additions to Part II of the Russian Tax Code (Chapter 25, 'Corporate Income Tax')», was sponsored by the Unity caucus, though it had been drafted by the Russian Ministry of Finance with the participation of the Ministry of Taxes and Levies and with due regard for numerous proposals made over the past four years by various parties, including the Institute for an Economy in Transition. The other draft law, «On Additions to Part II of the Russian Tax Code (Chapter 25, 'Corporate Income/Profit Tax')», was tabled by State Duma deputies V. K. Gartung, V. M. Dubov, and G. V. Kulik. Both was based on that version of the chapter on income tax which had been sponsored in the State Duma in the spring of 2000 for its second reading by Unity (and which was then numbered as Chapter 23).

Unity's draft drew a number of legal criticisms and was taken to task by business people and MPs alike for granting relatively wide-ranging powers to tax authorities, while offering relatively little protection to taxpayers. Be what it may, the chapter was returned for a first reading. As a result, it was the draft suggested by Mr. Gartung, Mr. Dubov, and Mr. Kulik that was accepted as the basis. A conciliation commission was set up and quickly processed all those proposals available into a text which was approved after its first reading on April 4, 2001. Considering the short time over which the panel had to do its work and the large number of contentious issues, it is hardly surprising that the agreed chapter emerging from the first reading was soon found to have a number of contradictions and technical errors. An expert team continued to improve the text also during meetings of the Subcommittee on Taxes of the Duma's Committee on Budgets and Taxes. Other authors likewise contributed a number of suggestions for improvements.

Debates flared up for the most part over the following key issues.

Definition of taxpayer

There were a great deal of differences, for example, over the definition of «taxpayer» in general and «tax resident» in particular. The State Duma eventually rejected all definitions suggested for «tax resident», including that found in the Ministry of Finance's draft. Upon the results of discussions, «tax resident» remained a term undefined in the Tax Code for profit taxation purposes and this may, in the long run, spell revenue shortfalls for the government budget as the tax

base in the case of foreign entities will be smaller compared with similar arrangements in many other countries.

Taxable assets and tax base

The question of how taxable assets should be defined also sparked off serious arguments. The text from the Ministry of Finance proposed income instead of gross profits as the taxable asset. In the end, it is the word «profits» that was chosen to designate the asset targeted by the tax concerned. The switch in terminology from «income» to «profits» can hardly be deemed important. However, there were also more serious differences when it came to defining the asset to be taxed. Its detailed definition in the Ministry of Finance's draft relied less on accounting characteristics and more on economic notions (gains in the value of a taxpayer's assets and/or an increase in the amount of claims or a decrease in the amount of debts, monetary or other incomings, and income as commercial benefits). It was provided to use market prices as the basis for evaluating revenues and expenditures on a wider scale than under the alternative draft. In this sense, the definition concerned was more in line with the principle of horizontal justice and allowed fewer possibilities for legal tax avoidance and, in particular, constituted grounds for invoking a number of rules to prevent transfer pricing practices. The main objection to this approach was the insufficiency of formal rules for applying the proposed definitions, which, in the opinion, of critics, could make for their arbitrary interpretation by tax authorities. The architects of the alternative draft, for their part, made much heavier reliance in their definition exercise on accounting procedures. This drawback was removed in the process of the subsequent review by inserting direct references to the procedure for assessing the tax base, as set out in the chapter, but some definitions as a result became largely tautological. This situation can hardly be described as ideal, but it will only be possible by applying this chapter in practice to find out how seriously it interferes with an unequivocal perception of the taxation procedure.

Taxable and non-taxable income

The list of taxable and non-taxable revenues also generated much controversy. That version of the chapter which was approved after its first reading included a long list of non-taxable kinds of income. It was shortened in the final text. The draft coming out of the first reading, for example, provided for a tax exemption for all advances and prepayments received, including those received by taxpayers employing the cash basis method for tax grossing-up. Such relief for advances enables taxpayers, especially those maintaining cash basis accounting, to avoid paying taxes. The final text provides for taxpayers using the cash basis method to include advances among their taxable income, while those relying on the accrual

basis method are to not to pay the tax on their advances received. However, in order to reduce loopholes for tax evasion, it would be advisable – in accordance with that practice in evidence in other jurisdictions – to tax advances also in the case of those maintaining accrual basis accounting, with the exception of prepayments under contracts for goods which take a long time to manufacture. In this instance, income can be acknowledged as the final value of products, multiplied by the relation of the period's length to the performance term of the contract. A softer-line option could be taxing or tax-exempting advances depending on product characteristics. It would be possible in accrual basis accounting, for example, to tax prepayments received for services provided by such firms as have no assets, i.e. possible fly-by-nights. Under an even more lenient arrangement, the result for such firms could be made conditional on the existence of a tax history.

Revenues added to the list of those kinds of income not subject to taxation after debates on the proposed chapter included, for example, transfers of assets, among them cash, from one enterprise to another without being included in the recipient's taxable income where it owns the transferor by more than 50%. Upon asset transfers from a subsidiary to the parent, this will effectively mean dividend payments free of taxation, and such tax-free dividends will be paid not to all shareholders, but only to the parent. This arrangement, therefore, will create advantages for holding concerns compared with other organizations. Where a parent owns a subsidiary by less than 100%, it can also be seen as a tax benefit for the purposes of paying dividends actually only to major shareholders in disregard of minority shareholders' interests. Similar problems may arise also where funds are transferred to a subsidiary from the parent, especially if the former is not wholly-owned by the latter.

Expenses subtractable and non-subtractable from the tax base

The bill drawn up by the Ministry of Finance introduced the term «tax subtractions», which is not completely equivalent to the notion «expenses included among the costs of products, work, or services» which is currently used in legislation. The classification of tax subtractions, as proposed in the draft, was somewhat different from that of expenses to be included in costs under laws in effect prior to the enactment of Chapter 25 of the Tax Code. However, the text approved after the first reading referred to «tax subtractions» in connection with some forms of tax privileges, while those costs essential for business purposes, which were subtractable from the tax base, were described as «expenses to be taken into account in tax base assessment». The same terms are used in the final version of the chapter. The classification was preserved overall, even if with cer-

tain amendments. The general categories of expenses remained the same as before, including material costs, labor costs, depreciation costs, obligatory and voluntary insurance premiums, and other expenses for the production and marketing of goods, work, or services. The following new categories of expenses were added: repair and maintenance costs for fixed assets and other property, the costs of using natural resources, and R&D costs. Such changes did not amount to a mere adjustment of wordings compared with existing legislation. All essential business costs are now accepted as subtractable. There certainly are some restrictions, but these are imposed in those cases where their absence will furnish fertile ground for evasion from paying taxes or maintaining tax planning. Furthermore, the new chapter of the Tax Code does not set some of those restrictions which are applicable in world practice, and enables enterprises to subtract certain costs before these are actually incurred through the accumulation of reserves.

The separation of R&D costs as a distinct category offers broader opportunities for their subtraction from the tax base. It would be advisable to establish a uniform procedure for subtracting productive and non-productive expenses for R&D projects, since it is impossible for tax authorities to distinguish between such expenses during their checks. However, the drafters did not see eye to eye on this issue as well. The Ministry of Finance's draft initially proposed that expenses for that research which yielded desired results that found practical uses should be capitalized and included among costs evenly over five years and that those expenses which did not bring about such useful results should be written off immediately to the extent of 70% of their actual amount. This proposal was not conducive to larger-scale R&D efforts which are always associated with risks. The alternative draft suggested that non-productive spending be subtracted in the current period in full, while capitalizing productive expenses. This was bound to lead to a situation where enterprises would find it advantageous to record their expenses for R&D undertakings as misspent. Under the final version, both productive and non-productive costs are to be capitalized over three years, but the latter are to «be evenly included among other costs over three years to an extent not exceeding 70% of the actual spending». This can prompt a trend whereby non-productive costs will be documented as productive. Fixed asset repair and maintenance costs are to be accepted for subtraction in the current period on much more preferential terms than before. It should be said that unlimited subtractions of repair costs can spell openings for wrongdoing and, therefore, should be subject to restrictions.

Compared with the Ministry of Finance's draft, the list of subtractable expenses in the final version also includes the costs of setting aside provisions for

bad debts (Article 266) and provisions for warranty repairs and warranty services (Article 267). Taking such costs into account for taxation purposes is at least disputable. The establishment of warranty service provisions reduces the tax base by entitling the taxpayer to subtract them before expenses are actually made. The formation of bad debt provisions substantially eliminates the advantages of making the accrual basis method obligatory for taxation purposes. Ordinarily, hopeless debts should be an exception in the real sector, since its enterprises usually are well-familiar with those customers to which they ship sizable batches of their products without prepayment, which is required, as a rule, from those contractors whose reliability has not as yet been reliably proved. However, the champions of bad debt provisions (just as those advocating the cash basis method of accounting) made their cases by referring, *inter alia*, to payment defaults on the part of the State. It is unlikely that it will prove possible to drop these statutory provisions as long as the State continues to violate its obligations.

Among other expenses restrictions on the subtraction of which were either lifted or reduced, mention should be made of advertising costs, the costs of property and commercial risk insurance, the costs of servicing loans obtained from banks and other lenders, and personnel training costs. The authors of all drafts agreed that it is necessary to expand opportunities for such subtractions from the tax base, but they differed on the extent of such expansion. The text finally approved provides for a substantial liberalization in subtracting the costs concerned – though subject to certain continuing constraints.

There were a number of proposals to diminish restrictions of such subtractable spending even further. One draft, for example, provided for no limits on the subtraction of expenses incurred under long-term life insurance, long-term voluntary pension cover insurance, non-governmental pension cover insurance, and voluntary medical insurance contracts. However, schemes designed to avoid paying taxes by making use of insurance contracts in the absence of relevant restrictions are already employed too extensively for free subtractions to be permitted, and this fact was duly taken into account by the law-makers. The chapter they approved imposes certain controls. But the ceiling on subtractable expenses is made contingent neither on the number of the persons insured nor on the amount of insurance premiums per employee. This may increase differentiation in the population's income levels and does not square with taxation practices in developed nations. Those restrictions which were placed in the Ministry of Finance's draft on the subtraction of expenses for business travels (*save per diems*) and of entertainment costs were also lifted. These categories of expenses are often used to disguise personal spending as business costs. In practice, it is impos-

sible to verify the need for such expenses in order to derive gains. Limits set on travel and accommodation expenses by authorizing the subtraction of only the costs of economy class tickets and sojourns in hotels of a certain comfort level are a normal and common practice. Entertainment costs can be limited in just the same way by being made dependent on the enterprise's operating scale. Proposals along these lines were put before the State Duma, but did not find the deputies' support.

The Tax Code still offers certain possibilities for tax evasion, and the number of such get-outs has even increased in some cases, including those whereby tax dodging can be accompanied by siphoning off of profits. Such escapes include, but are not limited to, the absence of restrictions on the subtraction from the tax base of those expenses the actual amount of which is impossible to check, for example, the costs of consultancy or information services. Some drafts provided for such limits on the amount of spending on advisory, legal, information and other like services from affiliated parties, since it is determined solely on a contractual basis and makes it possible to pay lower taxes, with account taken of their different rates, by exaggerating the expenses of that enterprise which has to pay taxes at the higher rates. In addition, tax rates differ from region to region, special rates are in place for small business ventures and, last but not least, it is also possible to avoid paying taxes through the instrumentality of affiliates registered in offshores. However, no curbs on such expenses were included in the final version of the chapter.

Borrowing service costs

Unlike the existing procedure for paying interest on funds borrowed, the Tax Code allows the relevant expenses to be subtracted from the tax base, regardless of the purposes for which the corresponding loans or credits were obtained. However, since interest revenue can under certain circumstances be taxed at lower rates than corporate profits, it is advisable to regulate the subtraction of such interest payments from taxable profits. This is why it was decided to preserve restrictions on the amount of subtractable interest payments on loans. Those bills mentioned above and put before the State Duma allowed such service payments to be subtracted at the refinancing rate plus 3% in line with the procedure enforced before. However, three % amounts to different relative figures under different refinancing rates. The subtraction permitted by the Tax Code's approved chapter is limited to the refinancing rate increased by 10% on ruble loans and 5% on foreign exchange loans.

The practice of subtracting interest payments without any limits imposed on the amounts of such loan servicing encourages the replacement of share capital

by debts where income tax on individuals' interest revenues is lower than the corporate profit tax rate or where interest revenue taxation anywhere in the world uses a rate that is lower than the profit tax rate.

A desire to reduce the tax base by artificially boosting spending to service debts spells insufficient capitalization.

There is a variety of ways how tax shortfalls from inadequate capitalization can be reduced through debt controls or interest subtractions. It is possible to do so, for example, by setting a ceiling on the debt-asset ratio or on interest rates or by prohibiting debts between related companies from being subtracted. These options, however, appear fairly difficult to implement from the standpoint of their administration and they are also not always effective enough in limiting interest subtractions. One was still approved as part of the final version of the Tax Code's chapter in question. Under it, subtractions of interest owing to insufficient capitalization are only to be invoked with respect to liabilities to those organizations of which the taxpayer is a participant or founder. This is clearly not enough. Interest can be paid as interest to an organization's own shareholders, and the paying organization can be formally altogether unrelated to the taxpayer. So the rule should apply to all interest. The rule for the subtraction of interest in the event of insufficient capitalization, as set out in the chapter approved, stipulates preferential procedures for leasing companies (as in their case, just as in the case of legal entities, the rule becomes applicable when the debt-to-equity ratio reaches 12.5 compared with 3 for other organizations). Initial provided for a smaller benefit: the rule was to be invoked when the ratio reached 10, but in both cases the arrangement does not prevent inadequate capitalization practices.

Procedure for accrual of depreciation for taxation purposes

Important changes relevant to authorized cost subtractions also affected the procedure for subtracting depreciation allowances. That procedure which was in effect prior to the implementation of Chapter 25 of the Tax Code was based on the linear method of writing off depreciation allowances and relied on obsolete depreciation rates. On top of this, the asset classification was unduly cumbersome. Those drafts of the chapter which were put before the State Duma in the fall of 2000, as well as many related amendments, called for depreciation to be charged for taxation purposes on the basis of the diminishing balance method. This enabled enterprises during the first months and years of using depreciable property to include a substantial portion of its value among costs. One appreciable advantage of this arrangement was that whereas income generated by an asset decreases as the asset wears out with time, depreciation based on the diminishing balance reflects the asset's commercial amortization more accurately compared

with the linear method. Instead of the differentiated scale of depreciation rates currently in place, it was proposed to maintain accounting and the basis of and for just seven large categories of assets, as identified for depreciation purposes, each taken as a whole. Combined with the diminishing balance method, this would significantly streamline depreciation accounting and make it much easier to check the correctness of the corresponding postings. It should be said that the proposed procedure could have been made even simpler and more transparent. It was possible, for example, to provide upon the sale of fixed assets for the value of assets remaining in a specific depreciation category to be reduced not by the calculated residual value of the assets sold, but by proceeds from the sales. This would make it possible to stop computing residual values altogether and make accounting for depreciable property extremely easy (as it is in a number of countries – in particular, Canada – using a similar approach). Where it is problematic to figure out the market value of second-hand assets (in connection with the transitional nature of the Russian economy), however, the above procedure can open certain opportunities for tax dodging, which is why the proposed option could be seen as justified at the given juncture in development and facilitating marked simplifications at a later stage. Another deficiency of the suggested plan consisted in the need to calculate asset depreciation accruals on a monthly basis. This was because the Ministry of Finance wanted monthly accounting periods for some enterprises. A changeover to annual taxation and accounting periods could substantially simplify accounting and necessitate computer depreciation allowance computations only once per annum. However, the legislators found the advantages of such streamlining to be negligible and decided that assets should be depreciated each accounting period after being calculated on the basis of monthly rates.

The Ministry of Finance's draft incorporated some measures plugging some loopholes previously used by those evading taxes, in particular profit tax and income tax by camouflaging personal spending as essential business costs. This included restrictions on possibilities for depreciating expensive cars, leisure vehicles, housing, aircraft, and vessels. The alternative bill provided for no such constraints. The State Duma finally resolved on lowered depreciation rates for pricey cars.

It should be said yet again here that it was provided (in both competing drafts) for those fixed assets commissioned prior to the implementation of the Tax Code's Chapter 25 to be divided into separate depreciation categories subject to reduced depreciation rates. This can hardly be described as a reasonable proposal. The use of such reduced rates would complicate accounting and tax

authorities' checks on the accuracy of depreciation allowances. However, the provision in question was preserved in the final version of the draft.

Unlike the draft drawn up by the Ministry of Finance, the alternative bill called for preserving the investment privilege accorded by legislation then in effect. It should be noted that the grant of this privilege would make it much more difficult to maintain accounting in those large asset categories identified for depreciation purposes, since it would be necessary to follow the histories of assets purchased by making use of the concession over at least two years (considering that the amount of the benefit was to be included in the tax base should the assets concerned be sold during this time by the taxpayer). In addition, the Ministry of Finance was justifiably unhappy with existing legislation that made it possible to depreciate assets acquired on privileged terms based on their full value, i.e. to subtract the amount of the benefit twice. Since this circumstance was likewise to be taken into consideration when calculating depreciation allowances, asset accounting in large depreciation categories was bound to become even more complex.

As already noted above, gaping disparities in views defended by different groups with enough clout to influence decision-making led to the creation of a conciliation panel. The latter's work resulted in acceptable compromises on a number of issues. Depreciation, however, proved an exception. That draft of Chapter 25 of the Tax Code which was prepared by the conciliation commission and approved after its first reading on April 4, 2001 included serious, sometimes ill-considered, changes to the depreciation procedure for taxation purposes compared with previous drafts.

a) It should first of all be said that the conciliation panel's work resulted in a more complicated procedure for assessing depreciation charges, which could pose problems for both taxpayers and tax inspectors running checks on their tax accounting. The trickier procedure, even if detracted from existing possibilities of tax evasion, increase the costs of tax collection, and it was possible that the need for more sophisticated controls could backfire by spawning new forms of dodging. As individual provisions of the draft are discussed below, efforts will be made to provide examples of an unduly involved depreciation procedure and show the possible consequences of such complications.

b) The text clearing the first reading provided for depreciation rates not to be fixed in the Tax Code for the large asset categories identified (as proposed in prior drafts), but to be calculated depending on the depreciation accrual method used and the useful lives of specific assets (although the Ministry of Finance's latest draft called, on the contrary, for useful lives to be determined on deprecia-

tion rates and to serve solely for the purpose of determining the duration of the obligatory existence of an asset, i.e. exclusively for the possibility of its transfer to other parties without documenting such transaction). Although there were formal descriptions of how asset categories should be identified for depreciation purposes, it was actually required in accounting to trace down the entire history of depreciation charges on individual assets. This was a no minor circumstance which complicated both accounting proper and relevant tax checks and was further exacerbated by those provisions discussed below which allow temporary transfers of assets between different depreciation categories so as to make assets subject to lower rates or mothballing and by the procedure whereby the value of an asset category is to be lowered by 10% of the residual value.

Formally, the draft called for all assets to be divided into 12 categories. However, it envisaged a special accounting procedure for such property as was obtained by a taxpayer before the implementation of the chapter in question by taking advantage of the investment concession, as was used under special conditions or leased out, and for expensive cars and minibuses. Finally, the possibility of temporarily applying lower rates also made it necessary to identify the assets concerned in accounting. In other words, records for depreciation purposes would have to be kept in fact for a much wider range of asset categories or sub-categories.

It was unclear which useful life was to be taken into account for the purposes of calculating depreciation rates: each category comprised assets of such useful lives which fit into a certain range of such terms. The final version of the chapter preserved the clause about the range of useful lives covered by each asset category and entitled taxpayers to themselves select a useful life within such range, but limited the number of such ranges to 10. Russian Government Resolution No. 1 «On Classification of Fixes Assets Included in Depreciation Categories», dated January 1, 2002, provided for the existence of 10 such categories of assets falling within different ranges of useful lives.

c) The draft stipulated that some of the depreciable property acquired prior to the implementation of Chapter 25 of the Tax Code could be depreciated by the linear or the non-linear method, at the taxpayer's own option, with the choice of the linear method likewise presupposing the depreciation of and accounting for property as part of large asset categories, or property pools. However, it is in principle unreasonable to rely on such pools under the linear method of depreciation, because relevant arrangements are, if not altogether unfeasible technically, then still overly complicated and this deprives them of the main advantage of maintaining accounting by dividing assets into large groups.

d) The draft granted privileges for financial leasing projects. This issue is separately reviewed below. Here, it would be relevant to note that we see the preferential treatment of financial leases as inadvisable. However, the final version of the draft preserved and even widened benefits on offer for financial leasing activities.

e) Upon the retirement of depreciable property, the combined value of assets in the corresponding category was to be lowered by the residual value of such property at its retirement date. The residual value of an asset was worked out using an equation which did not take account of the numerous special features of depreciation accruals (such as cut rates, reducing ratios, mothballing, etc.). The combined value of an asset category was computed as the sum total of individual residual values, and the reason for which large asset categories were formed was lost in the process.

Furthermore, where it was possible to temporarily phase assets out of a specific category with their subsequent return (after mothballing or cut-rate treatment), the sum total of individual residual values calculated on the basis of equations set out in the draft would not coincide with the same category's value determined «naturally», i.e. by reducing it by the amount of depreciation charges accrued. All this would engender enormous problems during checks on the accuracy of depreciation allowances. It should be remembered that the concept of new tax laws presupposes keeping tax records and financial accounts apart. The use of large property pools subject to simple and uniform rules for assets of all types for all for taxation purposes would make for the maintenance of depreciation accounting for taxation purposes in a manner that would make it possible to assess the tax base and enable tax authorities to run their checks in a minimum of time. A probe to verify the properness of depreciation allowances would then take a short time even at a major enterprise, thus sparing tax authorities efforts for uncovering such instances of tax evasion as cause the heaviest damage to the government budget and constitute the greatest hazards from the standpoint of accounting distortions. That procedure for depreciation assessments which was proposed in the draft would put inspectors before the choice of either not looking into how accurately depreciation charges were figured out at all or investing huge efforts into this kind of check – with a predictably inconsequential result for government budget revenues.

f) It was proposed to apply the ratio of 0.7 to the depreciation rate applicable to fixed assets obtained with funds directed to finance capital investments, which were previously excluded from the tax base, and to assets recorded on the balance sheet before the implementation of Chapter 25 of the Tax Code. This

would somewhat cushion the consequences of a green light to be given to the depreciation of assets acquired by taking advantage of the investment concession, though the general problem would still stay put.

Let us call attention yet again to what posed the principal problem when it came to the depreciation procedure prescribed by the draft approved after its first reading. The different methods of determining depreciation accruals for taxation purposes, which are employed in world practice, can be divided into two classes – those whereby accounting for depreciable property is carried out for each asset separately and those whereby such accounting is done for whole large asset categories. Both options have their deficiencies. The first makes it necessary to keep information about the original costs of each asset and the amounts of related depreciation charges and to calculate the asset's residual value, which turns both the maintenance of relevant records and the performance of checks on their accuracy a fairly tough proposition. Yet, this system makes it possible to the greatest extent to differentiate accounting procedures for different assets subject to depreciation, in particular, to depreciate them by using not only the diminishing balance method, but also the linear method, as well as diverse combinations of such methods, and to employ more differentiated depreciation rates. The second option results in the existence of a small number of large asset categories, each new asset is assigned to a specific category, and further depreciation proceeds from the latter's aggregate value, with the value of an asset once added to such total value being only subtracted therefrom as part of the depreciation allowances assessed for the category. In this situation, use is made of only the diminishing balance method, each asset is actually depreciated over an infinitely long time, and the category's combined value upon each depreciation accrual is reduced by such amount. Upon an asset's sale, the aggregate value of the category is reduced by a sum equal to its selling price less reimbursable indirect taxes. This option has a pro in its utter simplicity. Both depreciation allowances assessments and checks on their accuracy take a really negligible time even at a really large company owning a great deal of diverse assets (and the largest time input in this case would be in verifying whether different assets were properly included in specific categories). The cons of this arrangement consist in its lesser flexibility and in incentives to buy durable assets qualifying for those categories subject to high depreciation rates. Adverse spin-offs, however, can be forestalled by organizing the asset categories concerned so that equipment performing similar functions would all find itself in the same group. Errors in the allocation of resources would then be minimal, and inducements to get hold of assets with longer operating lives will fuel demand for better-quality equipment.

The text approved after the first reading provided for a combination of methods relating to the above two. Since the depreciation of each individual asset and the depreciation of a number of assets as a whole category are incompatible principles which cannot be applicable to one and the same asset, however, their fusion led to the forfeiture of advantages of each and the aggravation of drawbacks of each. Several ways out were workable under the circumstances. It was possible, for example, to return to that option with large-asset-category-based accounting which was proposed by the draft sponsored on October 25, 2000 by simplifying the relevant procedure applicable to fixed assets. It was also possible to apply different principles to different categories of equipment. Given this approach, buildings and structures could be depreciated by using the linear method. In this case, of course, separate records would be kept for each individual asset, and information about depreciation allowances charged would be preserved for tax accounting purposes. Some assets could also qualify for the mothballing procedure. Since there are few such facilities, the corresponding accounting would be only a shade more complex compared with large asset category accounting, while the use of the linear method for depreciation accruals for the facilities concerned would be more justified than for other assets, as that income generated thereby tended less to decrease with time. In addition, depreciable assets could be divided - depending on how long they had been in use - into two large classes, with accounting to be maintained for individual durable assets and large asset category accounting for short-lived assets. Buildings and structures would be depreciated in keeping with the linear principle. The other assets - each accounted for individually - would be depreciated based on the diminishing balance method over a number of years until the residual value is finally written off linearly.

Apart from everything else, it was also possible to preserve the existing depreciation system pending the final elaboration and installment of new arrangements.

However, it was decided in the end to forge large asset category accounting and to opt for the maintenance of individual accounting for each of buildings, structures, and conveyance facilities on the linear basis or for the employment of combined non-linear methods (i.e. the diminishing balance method until the residual value of an asset comes down to 20% of its original cost with its subsequent linear write-off) to depreciate all other assets. Either the linear or the non-linear method could be chosen for that property (other than buildings, structures, and conveyance facilities) purchased before the implementation of the final version of Chapter 25 of the Tax Code.

Other costs

When it came to other costs, neither the draft approved after the first reading nor the final text imposed any restrictions on the costs of business travels (other than per diems) and entertainment costs, even though the Ministry of Finance had proposed such measures. This type of spending is often misused to conceal personal expenses under the guise of business costs. It is practically impossible to exercise control over such expenditure in order to verify that it is really necessary to derive income. Limiting the costs of business travels and accommodation to economy class tickets and stays at hotels of certain comfort levels is a normal, common practice. Entertainment costs can be made subject to limits dependent on the operating scale of an enterprise.

Both the Ministry of Finance's draft and the final text of Chapter 25 place restrictions on the costs of maintaining housing, utilities, and social- and cultural-service establishments, and this makes it possible to scale down practices whereby such costs are used to cover consumption spending by personnel at their enterprise's expense. It is provided in this respect to compare the conditions on which the corresponding services are provided with those on offer from organizations supplying them as their regular business. The requirement that such conditions should include the public nature of the relevant contract should have been included in the final text. But it was not.

Accounting method and establishment of bad debt provisions

The question of whether it is obligatory to employ the accrual basis method for taxation purposes generated much debate. The grant of the right to choose between the cash basis method and the accrual basis method for taxation purposes creates possibilities for both tax planning and direct tax evasion through the establishment of affiliated go-betweens to sell a producer's products without returning its dues thereto. The switchover to mandatory accounting for products sold and resultant proceeds based on the fact of product shipments rather than the receipt of payment for them, i.e. the changeover from the cash basis method to the accrual basis method will make it possible to avert the negative impact of inflation on government budget revenues and detract from adverse impulses for the escalation of the crisis of mutual payment defaults by enterprises. This issue is exceedingly important, and it was largely a surprise that it proved possible to win a positive solution to the question, especially considering that efforts to ensure that VAT liabilities be accepted on the basis of accrual accounting had failed. It should also be taken into account that in point of fact, existing legislation makes it possible for taxation purposes to maintain accordance for income using the cash basis method and that for costs by using the accrual basis method.

To be sure, at the initial stage of a transition to a new taxation system it is possible that there may arise such tax liabilities as exceed the taxpayer's available paying possibilities. It is quite possible that the number of enterprises subject to bankruptcy proceedings will increase. In order to preclude the bankruptcies of companies finding themselves in hot waters for objective reasons, provisions should be made for a transitional period during which tax payments may be deferred, but this right should be granted on the basis of well-substantiated calculations. Those costs required to go through this transitional period should later be compensated for by the reduced scale of tax dodging, fewer inducements to employ barter arrangements and surrogate money in settlements, and a general economic recovery.

In this light, it does not appear entirely unacceptable - as a temporary measure - for enterprises to set aside bad debt provisions. However, in order to avoid wrongdoing, it would be advisable to impose fairly tight restrictions on the amount of such reserves and clearly define procedures for their establishment, or to make subtractions of hopeless debts from the tax base conditional on the taxpayer's prior reasonable and sufficient efforts to recover such liabilities. This would at least diminish opportunities for manipulating debts in order to reduce tax liabilities. State Duma deputies suggested in their alternative draft that even those taxpayers relying on the cash basis method of accounting to be allowed to put together such provisions. This proposal was later rejected in the bill prepared by the conciliation commission. Taxpayers using the cash basis method may not set aside bad debt reserves. But the commission's draft put effectively no restriction in terms of which debts can be pronounced bad. Such a constraint was added later in the course of the draft's discussion: «the amount of bad debt provisions may not exceed 10% of the tax/accounting period's earnings». However, 10% is too much for dubious liabilities. The dispatch of as many as 10% of all goods by value to unreliable customers for payment upon delivery be paid for cannot be deemed rational conduct by an enterprise acting in the interests of its shareholders.

In addition, the tax base may be decreased 45 days after the origination of debts, though not by 100%, but by 50% of the liabilities. However, the entire sum of the debts may be subtracted upon the expiry of 90 days after their arising. If one remembers that the accounting period is a quarter and that advances are paid upon the results of the preceding quarter, one will realize that the losses of those using paying defaults in order to siphon off profits or downsize tax liabilities will grow - but not by such margin as will make this practice completely disadvantageous.

In just the same manner, the final text fails to make the right to include hopeless debts among costs on the taxpayer's efforts to recover such liabilities.

In order to reduce the scale of tax evasion, the right to subtract hopeless debts from the tax base and perhaps the right to establish bad debt provisions could be linked to the taxpayer's efforts to recover the debts concerned, with those failing to bring legal actions (at least against large debtors) being denied such rights. In addition, certain conditions precedent could be laid down in respect of contractor firms so that hopeless debts would only be accepted for subtraction if these conditions were met. Such subtractions would then not be allowed, for example, if a taxpayer is owed a large sum from a firm with which it has not had any contracts before, or which is dormant, or which was organized only recently and does as yet have any tax history. In other words, attempts should be made to take action against fly-by-nights organized specifically to avoid paying taxes. A harder line should also be taken on debts between related parties.

As already noted above, the establishment of bad debt reserves at the expense of the tax base can only be justified as a provisional measure. Where the State assumes an unduly considerable portion of risks of erratic decision-making by company managers, this leads to an ineffective deployment of resources in the economy. Therefore, non-banking institutions should not be permitted to set aside any bad debt provisions at all.

The final text of Chapter 25 authorizes small ventures to employ the cash basis method. Organizations are entitled to determine the date when income was derived or expenditure was made under the cash basis method if the sum total of their proceeds from the sale of goods, work, or services over the preceding four quarters, net of VAT and sales tax, does not exceed RUR 1 million per quarter (Article 272). Small enterprises may be permitted to use the cash basis method, especially if maintaining summary accounting. But it is important to ensure that sellers do not use this method to record proceeds received from buyers relying on the accrual basis method where such sellers and buyers are related parties or where sellers are regular suppliers to buyers and if sellers over preceding two years encountered situations where the same buyers remained indebted to them for more than one month to an extent exceeding one-half of the value of monthly shipments to such customers.

However, even should all of these circumstances be duly taken into account, the arrangement concerned will still leave openings for tax evasion.

Firstly, some types of income, including those from entrepreneurial activities, under the Tax Code are to be included not among proceeds from sales, but

among non-operating revenue and this is true, for example, of leasehold payments received. This substantially broadens the circle of those parties entitled use the cash basis method of accounting. The RUR 4 million per annum restriction should be imposed to include not only proceeds, but also non-operating revenue.

Secondly, income drawn by affiliated parties should be consolidated for the purposes of determining whether a specific enterprise meets the above criterion. In order to reduce tax planning possibilities, it would be possible to restrict the right to replace accounting methods unduly often, for example, by allowing taxpayers to change over to a new method only once every three years.

Benefits and subtractions

The issue of tax benefits and subtractions provoked especially gaping differences³⁶.

It should be said that the draft sponsored by the Unity caucus (after being drawn up by the Ministry of Finance) provided for fewer tax concessions compared with those laws in effect before 2002. It did not provide, for example, for the grant of investments benefits (which were already mentioned above). However, even this draft provided for some privileges which can hardly be deemed justified. In many cases, these were on offer to taxpayers engaging in such activities as are considered to be socially important, even though being loss-makers. Of course, a profit tax benefit granted in respect of an unprofitable activity could not bring about an increase in the latter's after-tax profitability, but the arrangement made it possible to lower tax liabilities by understating costs in those lines of business subject to such preferences and overstating them in others. The undue complication of the tax system and the reduction in its transparency, which unavoidably accompany the provision of benefits, along with problems related to tax administration constitute a factor which tends to detract from government budget revenues.

The alternative draft provided, in addition to those concessions stipulated by Unity's bill, for the reinstatement of certain privileges which had already failed to justify themselves before, in particular those relating to funding for production-oriented capital investments, the financing of housing construction, and the maintenance of social- and cultural-service facilities on the taxpayer's balance sheet, as well as concessions for profits obtained from newly-launched production operations. The Ministry of Finance's draft called for reasonable measures to encourage investments, namely: an extended list of subtractable costs, changes to

³⁶ Subtractions here are understood mean a form of tax benefits in the terminology used in that version of the chapter's draft approved after its first reading.

the depreciation procedure, and substantially broader possibilities for loss carry-overs. Those measures envisaged by the alternative draft were redundant in terms of presupposing the possibility – under certain conditions of reducing the tax base by sums markedly in excess of business costs. The draft effectively made it possible to subtract capital financing costs from the tax base twice – when incurring such costs and taking advantage of the relevant investment benefit and when subtracting depreciation accruals, the latter posting accompanied by the indexing of the corresponding assets' residual value and hence, depreciation. It was also provided to preserve preferences benefiting the upkeep of social- and cultural-service establishments, which represent numerous opportunities for tax avoidance.

The investment benefit issue merits special mention. Although the final version of Chapter 25 no longer includes any such benefit, the issue of restoring them is already being raised and is bound to continue to be discussed in the future as well. Pressure from special-interest groups wanting such privileges, including subtractions of investments made from the tax base, is going to be strong and it appears useful to compare the arguments for and against such concessions.

Various tax measures aiming to stimulate investments were and continue to be used in diverse countries, including both developed industrialized nations and developing countries and transitional economies. Tax concessions for investments have many a supporter, but even they concede that encouraging capital inputs by dint of tax measures cannot outweigh other, more fundamental drags on investments such as political risks, possible instability, and inadequate legislation protecting ownership rights³⁷. In order to substantiate the need to grant new or preserve existing benefits, it is often argued that Singapore and Taiwan and later Ireland were able to achieve visible economic growth after offering tax incentives. However, these countries then did not have anything like the adverse economic, political and administrative situations in evidence – and serving as the main factor restraining investments - in many transitional economies. In contrast, many countries failed to bring about any meaningful gains in investments despite privileges to investors, while others – like Chile or Estonia – advanced economically without providing any such preferences.

³⁷ Both the economic community in general and entrepreneurs have lately become clearly aware that after the lowering of political risks, the main obstacle to investment financing in the Russian economy is the so-called crisis of confidence in Russian enterprises on the part of potential investors, including both domestic and foreign ones.

It should be noted that investment benefits are offered at a cost to the economy and it is essential to weigh their possible consequences when pondering whether to offer them.

The more obvious of the costs concerned include government budgetary losses. It is important to realize that such losses resulting from the preferential treatment of some taxpayers inexorably mean an extra burden on other taxpayers, as the government budget has to make up for the shortfalls either by raising rates for other taxes or by accumulating debts which will have to be paid by future generations or will force the State to drop some socially essential projects involving financing for social benefits or other special boons. Significantly, the losses in question are all too often not offset by the gains resulting from investments, considering that benefits are for the most part granted for investments which will be made anyway. The experience of countries granting such benefits demonstrates that these are mostly used when investing in short-term high-yield projects.

Another form of obvious losses from benefits consists in the latter's opening of opportunities for tax evasion. This includes both direct possibilities of dodging taxes by employing various schemes so as to become eligible for concessions without actually having the right to them or by profiting by more tangled tax legislation which results from the grant of benefits and which complicates tax administration. Measures needed and taken to reduce losses from that tax planning associated with benefits are difficult to implement and make taxpayers positions more uncertain, which can check those very investments which the benefits seem to have been designed to facilitate.

Other losses, which are not so plain and not so readily quantifiable, yet very important and perhaps even the largest, result from the distorting nature of benefits. The latter change the pattern of after-tax profitability in a number of activities, and this leads to an ineffective placement of resources.

For a number of reasons, benefits and subtractions carry a special weight for Russia owing to their ability, especially in that form in which they have been made available here, to contain competition in the economy. Profit tax concessions equal to up to 50% of gains are accessible to only those enterprises which are already in business and report sufficient profits. It should also be said that restrictions enabling taxpayers to reduce their taxable profits by only those sums in excess of their depreciation accruals are easily bypassed or at least cushioned by claiming lower depreciation rates in the course of investments. Upon asset value indexing, this makes it possible to reap substantial rewards from the benefits concerned. It is, of course, easier for major companies with considerable as-

sets to obtain such concessions. The 50% restriction on the subtraction of taxable profits can also be mitigated by large enterprises, for example, by financing a portion of spending by highly-paid professionals at the expense of the former's profits instead of increasing direct compensation payable to such employees. Therefore, those firms which were organized only recently and are only taking their first steps on a specific market are compelled not only to simply compete with veteran players there, but to vie with them in conditions where the latter enjoy further advantages in the form of benefits available to them. These include not only investment subtractions, but also other concessions, although the investment benefit is certainly the most important. This circumstance becomes critical where newcomer enterprises find themselves unable – owing to the insufficiency of financial markets – to raise enough funds to cover their expenditure. In a monopolized economic sector, benefits on offer can enable the monopoly to prevent entry by competitors at lower costs. It is known that for a number of reasons, monopolies often maintain surplus capacity. One of the reason why is that their existence enables them – should there arise the risk of market penetration by a potential rival – block the latter's entrance by threatening to quickly expand output for a short time to a level at which lowered prices will ruin the competitor. Should the maintenance of redundant capabilities be financed by other taxpayers, this option becomes particularly attractive. The expansion in the use of investment subtractions in Russia through the inclusion of funds allocated for the purposes of housing construction among costs reducing the tax base aggravated the problem. A enterprise long in business, should it qualify for the benefit, can use it to financing a portion of compensation provided to its employees in the form of chapter housing and is thus able to reduce not only capital costs, but also labor costs. This makes it even more difficult for companies entering the corresponding economic sector to compete its veterans. A portion of those costs accepted for subtraction from the tax base which are often used for the tax-free financing of employees' personal spending or for tax avoidance can likewise be used for the same purposes. For the above reasons, the specific features of investments concessions available in Russia led to further unfavorable consequences in addition to those usually brought about by such benefits granted elsewhere in the world.

The above considerations are especially important because restrictions on competition eventually check investments and increases in output. Without being able to compete with major long-standing enterprises on equal terms, new companies are created in much smaller numbers than would be possible and investments which could fuel economic growth are made on a more narrow scale than desirable.

Finally, it should be said that international practice demonstrates that tax benefits introduced as provisional measures tend to be very hard to abolish. This is also because the availability of such concessions makes it tempting to put off efforts to remove those underlying causes which impede investments and because it is undesirable to worsen taxpayers' positions compared with the present situation for political reasons. The latter argument, by the way, was often voiced when the chapter on profit tax was discussed. Those making this argument disregarded the fact that the issue should be considered as a package and that resulting constraints on taxpayers' possibilities in some respects were going to be compensated for by broadened possibilities in others. Pressure from international investors interested in tax advantages also often prevents limits on benefits.

The best time for canceling privileges is when the tax system is in the process of reform. The overall alleviation of the tax burden (including relief with respect to a whole range of taxes) cuts the ground from under the feet of those predicting a deteriorating in taxpayers' position. The loss of concessions for most taxpayers is more than balanced out by the general reduction in the tax burden and speculation over the fact that individual business transactions have become less profitable becomes pointless.

The above arguments against tax preferences indicate ways how the problem of financing investments in Russia can be resolved. As already noted earlier, principal efforts should be concentrated other than on tax legislation. The most important thing in the Tax Code is to remove – so far as this is possible – the distorting effects of taxation, as well as those inducements to asset stripping and profit siphoning-off which exacerbate the crisis of confidence, and to furnish conditions to enable newly-launched production operations to compete with long-standing businesses.

However, as the draft chapter was discussed, the list of benefits overall, far from shrinking compared with other drafts, grew even longer (with only insignificant contractions in some respects). In the end, it became clear both to the Government and to law-makers that such a large number of preferences will have unwelcome consequences. The grant of concessions to some categories of taxpayers prompted demands from others for similar privileges and it turned out as a result that it does not appear possible to deal with the problem by preserving those tax rebates already accorded. And so, although the Union of Right-Wing Forces' proposal for lowering tax rates and cutting back on tax credits on a phased basis was initially rejected during debates, it had become apparent by the time the State Duma's Committee on Budgets and Taxes met on June 15, 2002

that a decision to dismantle benefits and bring down tax rates could well represent a way out.

It is this kind of solution that was suggested by the Government at that meeting and substantially supported by the Committee's members who decided to take away all benefits and subtractions granted by Articles 275 and 276 of the draft clearing the first reading, including concessions regarding funds allocated for charitable purposes.

As a result, the tax rate was lowered by a larger margin than proposed by the Government (to 24% rather than 25%).

The decision to lower the profit tax rate simultaneously with the abolition of benefits and subtractions with respect to such tax, which was passed by the time of the second reading, is definitely an appreciable stride forward in shaping such tax legislation as will meet the principles of neutrality and horizontal justice.

It should be noted, however, that the decision was implemented not quite consistently. The matter is that tax advantages available to some categories were not limited to those benefits and subtractions covered by Articles 275 and 276. Such advantages are granted by articles listing subtractable costs and subtractable revenues, or special tax base assessment procedures for individual categories of taxpayers. Some of these privileges were linked to a certain extent to the existence of benefits and constituted a way of compensating those taxpayers which did not qualify for such preferences for such injustice.

Tax advantages with respect to financial leasing

All drafts submitted to the State Duma (with the exception of amendments prepared by the Institute of Economy in Transition –IET) offered to a greater or smaller extent certain benefits on financial leasing. Such benefits were finally included into the latest version of Chapter 25.

Firstly, taxpayers shall be granted the right to select the party with where the property should be accounted for. Financial leasing in itself provides an opportunity to transfer tax benefits. This means that for an enterprise which has either tax benefits on profit or operates with losses it is more profitable to conclude a lease contract instead of purchasing machinery and equipment (and having to pay for it either right away or by installments); lease agreement provides the right to transfer the accrual of depreciation interest to the lessor while adjusting respectively the terms of payment. The above right of choice makes it possible to transfer advantages to the other party too, provided the lessor is taxed at a rate lower than the taxation rate which the lessee is to pay. Moreover, the right is granted to depreciate property transferred (received) under financial leasing contract with a special coefficient not exceeding 3. It is possible to find a justification (though

rather debatable) for benefits on depreciation of machinery and equipment transferred under short-term lease (rent), since indeed it is worn out quicker. Under long-term lease, however, moreover, under financial leasing, which already creates advantages for the parties the above measure is excessive.

Indeed, financial leasing partially helps to resolve the issue of financing investment. Being in its economic essence a sale by installments (and in most developed countries the above transaction is recognized as such), it has an advantage for the parties to the transaction that in the event of bankruptcy of the user of property, the property taken into lease shall not be included into bankruptcy estate, but shall be returned to the owner, in other words, to the lessor. This is to the benefit of both parties to the transaction, since the above form to fund investments is usually applied even in absence of special tax benefits, still the more so, that the nature of the transaction allows in certain cases to receive tax advantages even in instances when they are not specially granted. Under the circumstances, only the risks of the lessor go down, while the risks of other creditors are growing. Since in Russia the law does not provide for public notification that an enterprise has property which had been taken into lease, creditors may not get any objective information on whether an enterprise has sufficient assets to pay back the loan. Moreover, financial leasing, particularly return leasing is frequently used to strip the assets to affiliated structures. The existence of the coefficient of 3 applied to the depreciation rate of leasing assets creates considerable and unjustified advantages for this form of investment financing as compared to others, and naturally, may hinder the application of other forms of investment financing. It would be extremely important to exclude benefits provided to financial leasing in instances of return leasing. Return leasing is applied only in cases when there are no problems with financing investments, and the enterprise either intends to transfer tax benefits to the counteragent, or is going to exclude the assets from the bankruptcy estate in the event of bankruptcy.

Deferring losses to future periods

Another issue which should be considered under a different angle after benefits are cancelled is the deferral of losses to the future. The drafts of the Tax Code were attempting to introduce more liberal rules for deferring losses to future periods than those existing in the effective taxation system, that is, the term during which such deferral would be possible was extended from five to ten years, and restrictions which existed due to the Law On Tax on Profit of Enterprises and Organizations (i.e. the deferral of losses was possible exclusively in equal portions) were partially eliminated. Both drafts however, retained the interpretation of deferral of losses as a tax benefit with a respective limitation on ac-

cepting losses incurred in the past together with a number of other benefits within the amount of 50% of taxable profit. In the draft version of the Tax Code passed in the first reading deferral of losses was not treated as a benefit, but the rule which required that the aggregate decrease of the taxable base by the amount of losses and certain benefits should not exceed fifty % was retained. After the cancellation of benefits, however, the State Duma Committee for Budget and Taxes proposed and the Duma approved the provision aimed to restrict the possibility of deferral of losses by the amount not exceeding 30% of the tax base. It should be noted that the Ministry of Finance some time ago came out with a proposal to limit the amount of losses by which the current taxable base could be decreased by fifty %. Limitation of the possibility to extract losses out of future income, particularly out of a part of the profit, does not seem to be an adequate measure aimed to make conditions for all enterprises equal and create a favorable environment for investment. The above procedure is not at all better, and for many enterprises it proves to be even worse (particularly for those whose investments bring profit long-term) than that when losses were deferred in equal portions. It is common knowledge that if the taxation procedure is symmetrical to profit and loss (i.e. in the event of losses incurred, the taxpayer is compensated for the negative amount of tax in some form), with the introduction of such tax the investment risks will not only stop growing, as compared to the situation where there are no taxes, but even go down with regard to the investments, since in the instance described the state will share part of the risks.³⁸ In other words, a tax which fully

³⁸ - Since the solution of this issue seems to be of extreme importance we would like to illustrate it with the following example. Let us assume that a certain person who is unwilling to take risks is offered to play a game following the rules described below. He chooses one side of a coin (heads or tails) Then the coin is tossed and the player gets a ruble, if the upper side of the coin happened to be the one which the player had named before. If that is not the case, he himself has to pay a ruble. If an individual does not intend to take risks, he will refuse to participate in the game. In order to make the game appealing for him, the terms of the game should be such that the mathematical expectation of a premium would be positive, moreover, with the bid set the premium should get larger in reverse proportion to his unwillingness to take risks. Assuming that for the participation on the game it will be sufficient for him to get a ruble and fifty kopecks, if he wins, while in case of loss he would have to pay just one ruble.. Now let us go back to taxation. If the tax is 50%, and is fully compensated for in case of loss (the compensation is paid either directly, which, by the way does happen in certain taxation systems, though on agreed conditions, or the losses incurred in the game are summed up with income from other sources, for taxation purposes, or the right is granted to defer losses for the future with the amount of loss subject to indexation). After taxation the premium will amount to

compensates for losses leads to an increase into risk assets, meanwhile, a portion of the prize money from such investments which corresponds to the tax rate will go to the state who acts as a non-voting shareholder of an investing enterprise. Such system encourages the development of new production facilities, innovative activity and stimulates foreign direct investments. Complete or almost complete compensation of tax would be most likely a measure too radical for Russia, but limitation on the deferral of losses for the future by the amount equaling 30% of the tax base would serve exclusively short-term fiscal objectives (and the benefits from such limitation for the budget revenue would obviously be insignificant even short-term), thus, significant obstacles will appear for long-term and innovative projects.

Integration of taxation

The Unity Party (Yedinstvo) bill provided for the elimination of double taxation of dividends in instances when either residents are recipients of dividends or there are international treaties on elimination of double taxation (see Articles 310, 319). The integration of taxes proposed in the draft law was not complete, anyway that form of integration would allow to include taxes on dividends into the paid part of the total tax. Problems would arise with dividends to be paid to the next recipient, since the amount which was rebated for would decrease the obligations of the first recipient of the dividends, and respectively, the amount to offset for the shareholders thereof. The alternative draft law did not provide for integration altogether and double taxation of dividends for resident recipients was retained.

Tax integration is generally considered as a significant advantage of a taxation system. Corporate integration implies a procedure due to which dividends

0,75 rubles, while the loss will equal only 0.5 rubles). If under the situation the stake is doubled, the premium will amount to 1.5 rubles, and the loss –1 ruble, that is, the same amount as prior to the introduction of the tax. This option was quite acceptable for him. Thus, the player will double the stake, that is, will increase investments into risky assets. At the same time, the state will either get an income or incur losses together with the investor and in the same proportion. Now let us modify the example. The same tax will be introduced but losses are not compensated by the tax system. This means that if the player wins he will bet just fifty kopeks, in case of loss he will have to pay one ruble. The mathematical expectation of the prize money become negative. It is obvious that an individual who does not intend to take risks will refuse to participate in the game. In terms of the issue considered by us this will imply that part of the investments which could have been made in the absence of taxation, will not be made due to the introduction of a system asymmetric to profits and losses.

are taxed just once, which makes it possible to avoid double taxation of the income of a corporation (another name to it is an integrated tax system). There are at least four ways of corporate integration. Firstly, corporations are taxed, but dividends paid to shareholders are not subject to taxation. In this instance two additional issues should be resolved: in which manner dividends received by non-residents should be taxed, and what is to be done with the tax of the dividend recipient if corporations had not used any benefits. Secondly, corporations may pay profit tax and leave tax on dividends to be paid at the source. Then double taxation may be avoided, provided tax on dividends withheld at the source is accounted for as tax on individuals, while the already paid tax on income of corporations is accounted for as tax on dividends withheld at the source. This integration method is known as a method of absolute/perfect corporate taxation. Under the third option corporation pays the profit tax and dividends are exempt from taxation, but only to the extent to which paid-out income has been taxed. The fourth method involves full offset of tax when corporate tax is cancelled, while corporate income is fully taxed at the level of individuals. This method is not expedient under the Russia taxation system, since it requires that individuals file income declarations, which is something we would not recommend to introduce in this case. Moreover, the above method allows to defer tax payment until there is accretion to the capital. But one of the reasons to apply profit tax is the possibility to tax part of the non-realized accretion of capital.

It is easy to see that the tax integration scheme adopted in the first reading was close to the second method. The differences may be accounted for by the fact that aggregate obligations under the above system will be minimized if the portion of the paid-out income of corporation including the amount of tax are considered as the income of the recipient of the dividends. An increase of the calculated tax on dividends does not lead to the growth of the aggregate tax obligations for, in that case a larger amount will be accepted as the amount to be deducted from the end recipient. Such scheme has never been proposed. It was proposed to accept the actual amount of paid out dividends to be subject to taxation at the source.

However, the State Duma deputies found the above procedure too complicated, and a decision was taken not to propose any tax umbrella. Finally the decision was to tax the difference between the amount of dividends received and paid by an organization at the rate of 6% for the resident recipients and the rate of 15% for non-residents. No problems should arise in such case, until equal rates of profit tax are retained for all resident enterprises and there are no benefits. The right to grant benefits, however, is envisaged for regional authorities (they may

bring down the tax rate for certain categories of taxpayers within the range of 4%. Moreover, as it was noted in this survey, parties concerned are exerting pressure on the State Duma in order to regain the benefits they used to have.)

Moreover, the above procedure takes into account only the dividends of one single period, while more sophisticated integration systems of taxation offer to maintain dividend accounts and off-set the tax paid in earlier periods, if an enterprise has decided to pay out profit previously remaining unpaid. Therefore, in future most likely an issue of introducing a more developed integration system will be raised.

Taxation of extraction of mineral resources

Federal Law #126-FZ of August 8, 2001 On Introduction of Amendments and Amplifications to Part Two of the Tax Code of the Russian Federation and Some Other Legislative Acts of the Russian Federation, and On Deeming of Certain Other Legal Acts of the Russian Federation To Have Lost Force which was submitted to the State Duma by the Government of the Russian Federation and providing for a rather drastic reform of the system of taxation of mineral and raw materials sector may be considered a significant step forward in the tax reform in Russia.

Federal Law #126-FZ incorporated Chapter 26 «Tax on Extraction of Mineral Resources» into the second part of the Tax Code and also incorporated respective amendments relating to the introduction of the above tax into other legal acts of the Russian Federation, specifically, into Law On Subsoil. Federal Law #126-FZ a new tax was introduced – tax on the extraction of mineral resources – to be effective starting with January 1, 2002. The above tax is to replace three other taxes which were effective between 1992 and 2001: royalty for the use of subsoil, deductions for the reproduction of mineral and resource base and excise duties for oil and gas condensate. The procedure for calculation and payment of the above tax shall be based on the effective rules for calculation of payment for the use of subsoil in the course of mineral resources extraction. Organizations and individual entrepreneurs engaged in extraction of mineral resources shall be deemed taxpayers. Extracted minerals shall be deemed objects of taxation, and the values of extracted mineral resources shall be regarded as the tax base. Different tax rates are established depending on kinds of mineral resources in percent to the value of extracted minerals (Table 43). The established tax rates are determined on the basis of average actual rates of royalty and half of the formerly effective rates for the deductions to reproduce mineral and resource base (the other half of the above payments, same as under the effective tax system, will

remain in the disposal of mining enterprises, the use of the money received is not regulated though). As regards oil, the tax rate also accounts for the amount of excise duty.

Table 43

Tax rates for extraction of mineral resources with respect to certain kinds of mineral resources

	Rate (in percent)
Oil, gas condensate extracted from oil and gas condensate fields	16.5
Natural gas from gas deposits, gas condensate from gas condensate fields	16.5
Non-ferrous metals	8.0
Rare metals	8.0
Precious metals (with the exception of gold)	6.5
Gold	6.0
Natural diamonds, precious stones	8.0
Radioactive metals	5.5
Ferrous ores	4.8
Coal	4.0

Source: Federal Law #126-FZ of August 8, 2001.

Taxpayers who have carried out search and exploration of the fields under development with their own funds, or who have compensated all the costs of the state incurred thereby in the process of search and exploration of the respective mineral reserves (under the effective legislation such users of subsoil did not make payments to recover mineral and resource base) pay the tax on extraction of mineral resources with the coefficient of 0.7. In the event of implementation of the production sharing agreement (with the exception of agreements concluded prior to Chapter 26 of the Tax Code coming into effect) the rate of tax on the extraction of mineral resources is used with the coefficient 0.5.

In a number of instances zero tax rates have been established, specifically, in the event of associated gas production and oil-well waters, production of mineral resources in the process of development of residual lower quality reserves, and reserves of mineral resources which were previously written off the accounts, and in some other instances.

For the years 2002-2004 in conformity with the effective law the volume of output in real terms will be deemed the tax base, while the tax rate is established as RUR 340 per ton. A specific tax rate regarding oil shall be adjusted with the account of the world oil prices level and fluctuations of the ruble exchange rate. For the purpose a special correction coefficient shall be used which allows to considerably bring down the regressive nature of such tax.

The replacement of the three formerly effective payments (payment for the use of subsoil, deductions for the reproduction of the mineral and resource base and excise duty for oil and gas condensate) by a single tax on extraction of mineral resources seems to be quite justified both from a theoretical and practical standpoint. Given the world experience, the tax to be introduced will actually function as a royalty (payment for the right to develop reserves to the owner of resources). With regard to oil this will actually mean that payment for the use of subsoil will increase from the average current value of 8.2% to 16.5% collected at a single rate while at the same time payments to be used for the recovery of the mineral resource base and the excise duty will be cancelled. Application of a single tax rate amounting to 16.5% is in conformity with the world practices (for instance, in the USA a single rate of royalty equaling 16.67% is applied with respect to off-shore oil fields held in federal ownership). At the same time, use of such taxes as deductions for the recovery of mineral and resource base shall be channeled to the funding of geological and prospecting works in areas where mining enterprises operate and which pay and put to use the above deductions. In other words, the money goes to well-developed mining regions which accounts for extremely low efficiency of such works. A large portion of payments aimed to reproduce mineral and resource base is concentrated in budgets of different levels, and the use of these funds is not target-oriented. The major bulk of work to reproduce mineral and resource base should be carried out with the funds of enterprises. However, the costs of enterprises to carry out geological and prospecting works should be compensated for through mechanisms generally accepted in the world.

Introduction of tax on the use of natural resources allows to simplify the tax system and bring it in line with the world practices. At the same time, establishing a specific rate of tax on the use of oil until the market pricing mechanism starts working smoothly and taxes are calculated respectively will make it possible to overcome negative tax consequences of transfer pricing.

Federal Law #126-FZ provides for a radical redistribution of tax payments collected in the process of natural resources extraction between budgets of different levels. For instance, when hydrocarbon raw materials were developed, 40%

of payments for the use of subsoil (royalty) were channeled, in conformity with the effective legislation, to the federal budget, and 60% - to territorial budgets. At the same time, when hydrocarbons were extracted in the territory of an autonomous okrug which is a constituent of an oblast or krai, the royalty would go to the budget of this particular oblast or krai thus making up half of the amount of payments received by the federal budget, which means that the portion received by the federal budget would amount to just 20%. Since the greater part of oil is extracted in such autonomous okrugs, and primarily in Khanty-Mansiisk, the average weighted portion of the royalty going to the federal budget dropped to just a quarter of the respective total tax. An amplification to Article 48 of the Tax Code of the Russian Federation which was adopted as part of the Law under consideration provides that 80% of the amount of tax on use of natural resources shall be directed to the federal budget, 20% - to the budget of a subject of the Russian Federation. When hydrocarbons are extracted in the territory of an autonomous okrug which is a constituent of an oblast or krai, the federal budget should receive 74.5% of the tax amount, the autonomous okrug budget – 20%, while the budget of an oblast or krai would respectively get 5.5%.

Along with the amendments introduced into the Tax and Budget Codes, Federal Law #126-FZ provides for an incorporation of a number of principle amendments and amplifications into other legal acts, including the Law of the Russian Federation On Customs Tariff. Amendments to the above Law for the first time in legislative practice establish by law the maximum amounts of export customs duties for hydrocarbons which are subject to change depending on the level of world prices. The export duty on oil, for instance, was set at a zero rate, with the average price of up to 109.5 dollars per ton for the «Urals» oil brand having formed at the world markets for the preceding two months. With the fluctuations of world oil prices within the range of 109.5 to 182.5 dollars per ton, the export duty rate should be established in the amount not exceeding 35% of the difference between the actual average oil for the previous two months and 109.5 dollars; with the world oil price exceeding 182.5 dollars per ton the export duty rate shall be established in the amount not exceeding 25.53 dollars and 40% of the difference between the actual average oil price for the preceding two months and USD 182.5.

Amendments to the Law On Subsoil adopted by Federal Law #126-FZ establish a system of special tax payments for the use of subsoil which include: lump-sum payments for the use of subsoil in the event certain events referred to in the license ensue; regular payments for the use of subsoil (shall be collected in the event of search and exploration of natural resources deposits and construction

and operation of underground facilities unrelated to extraction of natural resources); payment for geological information on subsoil; fee for participation in a tender (auction) and a fee for issuance of a license.

Sales tax

The necessity to introduce additional legal regulation of the sales tax was determined by the decision of the Constitutional Court of the Russian Federation. The RF Constitutional Court by Decision #2-P thereof, dated January 30, 2001 ruled that when the regional sales tax was established by the Federal law, the legislator failed to ensure the implementation of the requirement that the object of taxation shall be established exclusively by federal law and in due procedure. It is impermissible to introduce regional taxes which allow to form budgets of some territories at the expense of the tax revenue of other territories and transfer payment of taxes to the payers of other regions (Decision of the Constitutional Court of the Russian Federation of March 21, 1997).

When the right to introduce sales tax was granted to subjects of the Russian Federation, the issue of the tax jurisdiction was not resolved. Since issues of tax jurisdiction are unregulated by the federal law, such situation does not exclude a possibility of multiple taxation of operations, including those which are conducted at the inter-regional level when goods, works and services are sold for cash. Regulation of tax venue by laws of the subjects of the Russian Federation may lead to the violation of rights and interests of other subjects of the Russian Federation.

Federal Law #148-FZ of November 27, 2001 incorporated amendments and amplifications to Part Two of the Tax Code of the Russian Federation and Article 20 of the Law of the Russian Federation «On the Fundamental Principles of the Tax System in the Russian Federation. Chapter 27 On Sales Tax of the Tax Code of the Russian Federation will come into effect on January 1, 2002, and starting with January 1, 2004 this Chapter will lose legal force.

Under the Tax Code of the Russian Federation the sales tax shall be established by the Tax Code and laws of the subjects of the Russian Federation, and shall be enacted by respective laws of subjects of the Russian Federation (which shall determine the rate, procedure, terms of payment and form of reporting). Sales tax shall be paid in the territory of the respective subject of the Russian Federation.

Payers of the sales tax shall be organizations and individual entrepreneurs in the venue of sale of goods (works, services) to the population.

A list of socially relevant goods was retained, which means that when certain essential commodities are sold sales tax is not to be paid. Such items include bread and bakery products, milk and dairy products, oil, and a number of others.

Tax base shall be defined as the value of the sold goods (works, services), calculated on the basis of current prices (tariffs) with the account of value-added tax and excise duties. Tax period equals one month. The maximum sales tax rate shall not exceed 5 %.

After the sales tax is enacted in the territory of the Russian Federation, taxes provided for by sub-paragraphs d, f, i, j, k, l, m, n, o, p, q, r, s, t, y, v of paragraph 1, Article 21 of the Law of the Russian Federation On the Fundamental Principles of the Tax System in the Russian Federation, specifically:

- levy on needs of educational institutions collected from legal entities;
- tax on construction of objects of production designation in a resort zone;
- levy on the right to trade;
- tax on resale of motor vehicles, computers and personal computers;
- levy on dog owners;
- license fee for the right to sell wines and alcoholic beverages;
- license fee for the right to conduct local auctions and lotteries;
- levy for issuance of documents to move to another apartment;
- parking fee;
- fee for the right to use local symbols;
- levy for the participation in horse races;
- levy on prizes received in horse races;
- levy on persons participating in pari-mutuel in horse races;
- levy on transactions performed on exchanges, with the exception of transactions provided for by legal acts on taxation of operations in securities;
- levy for shooting cinema and television films;
- levy for cleaning territories of populated centers;
- levy for opening a gambling business.

The adopted version of the Chapter dealing with the sales tax partially eliminates inconsistencies with the RF Constitution which the Code used to contain and to which the Constitutional Court referred to. Specifically, the Code defines the concept of an object of taxation, the right of the authorities of subjects of the Russian Federation to introduce additional items into the list of taxable goods (works, services) was eliminated; vaguely defined concepts and notions which have no legal content were eliminated, etc. It is an obvious merit of the Code that the list of goods (works, services) exempt from sales tax was harmonized with a similar list relating to the VAT exempt items. The Chapter does not contain any

provisions which would make sales tax dependent on the form of payment for goods (works, services).

At the same time there is no mention of the issue relating to collection of sales tax in the event of sale of goods (works, services) to organizations or individual entrepreneurs for their own consumption, which distorts somewhat the nature of the tax. It is not spelt out clearly whether the sales tax will be collected in the events goods (works, services) are purchased by individual entrepreneurs. On the other hand, introduction of the mechanism of sales tax compensation in instances when organizations (individual entrepreneurs) purchase goods (works, services) and use thereof for production purposes makes the sales tax even more similar to VAT.

Single agricultural tax

Federal Law #187 of December 29, 2001 incorporated amendments and amplifications to Part 2 of the Tax Code of the Russian Federation, and other legal acts relating to taxes and levies.

The Tax Code was expanded by Section VIII.I «Special Tax Regimes. Taxation system for Agricultural Commodity Producers (Single Agricultural Tax). The single agricultural tax (SAT) will be enacted by the law of a subject of the Russian Federation on the respective tax. Transfer of organizations, peasant (farm) enterprises and individual entrepreneurs to payment of single agricultural tax shall be performed irrespective of the number of workers on the payroll.

Object of taxation shall be the space of agricultural lands which is in ownership, possession and (or) use). The space of agricultural lands evaluated in conformity with the cadastre value shall be deemed tax base. The methodology for determining thereof shall be established and approved by the Government of the Russian Federation.

An enterprise (individual entrepreneur) shall be transferred to the payment of SAT, provided the portion of proceeds from the sales of agricultural produce received on agricultural lands in the preceding year shall make up at least 70% of the total income.

The transfer to SAT shall mean that the above tax will replace the aggregate of taxes and levies subject to payment in conformity with Articles 13, 14, 15 of the Code, except for the taxes and levies listed below:

1. VAT;
2. Excise duties;
3. Payments for pollution of the environment;

4. Tax on purchase of foreign banknotes and payment documents denominated in foreign currency;
5. State duty;
6. Customs duty;
7. Tax on property of individuals (regarding residential buildings, premises and structures owned by individual entrepreneurs);
8. Tax on property transferred as inheritance or gift;
9. License fees;
10. Insurance premium for mandatory pension insurance (shall be paid in conformity with the legislation of the Russian Federation on pension schemes).

Agricultural organizations of industrialized type (such as poultry factories, greenhouse complexes, beast breeding farms, cattle breeding complexes, etc) defined in accordance with the list approved by legislative (representative) bodies of subjects of the Russian Federation pursuant to the procedure established by the Government of the Russian Federation shall not be deemed agricultural commodity producers.

The tax period shall be fixed as a quarter. The tax rate shall be established in rubles and kopeks paid on the basis of one hectare of agricultural lands. It has also been established that the replacement of several taxes by a single one does not mean an introduction of a new tax, but is considered as a special regime.

The single agricultural tax has a considerable number of deficiencies, including those described below.

In Russia, large agricultural enterprises which are able to maintain full accounting for the whole aggregate of taxes form the basis for agrarian production. As for minor agricultural enterprises, farms, etc. no one has cancelled the requirement to pay imputed tax which such enterprises may use for simplification of accounting. It does not really seem justified to apply imputed tax to agricultural holdings which engage in production on the territory of 200-300 hectares and employ thousands of workers.

Significant tax benefits granted in agricultural sphere lead to a situation that VAT and social payments have become major payments of agricultural enterprises to the state. Due to the nature thereof VAT cannot be included into a single tax (the unsuccessful experience of Ukraine in 1998 convincingly demonstrated that). Hence, all tax and payments cannot be consolidated anyway.

The introduction of a single tax implies that industrialized agricultural producer, in other words, agricultural intensive enterprises, will be singled out, since at such enterprises a single rate of the land tax will lead to a considerable de-

crease in the tax burden and a fairly high profitability of production. However, it is impossible to work out a uniform criterion for such «industrialized enterprises», which means that enterprises will be classified in an administrative procedure with all negative consequences to follow.

Finally, when a single tax is introduced, no legal restrictions will force agricultural enterprises to maintain the whole bulk of accounting and financial reporting, therefore, this will lead to the loss of information on the activity of enterprises which is rather scarce as it is, and this is definitely a loss both for state management and business.

Prospects for improving tax legislation

Improving taxation of small business

Encouraging the development of small business in Russia has been an issue on the agenda for quite a long time. A portion of small enterprises insignificant as compared to that in many other countries, and a fairly small number of the employed in this segment, unsatisfactory movements in the output, low investments in small business lead to a conclusion that the position of small enterprises in the Russian is not very advantageous. The status of small business is naturally determined not only by the tax environment. But the impact of taxation on distribution of resources among industries and sectors of the economy may be considerable. Among reasons for unequal treatment of small business relating to taxation one could primarily name the system of tax benefits which had been affective till 2002 with respect to taxation of profit. The above system could grant certain advantages to major enterprises only, since the use of most benefits by small enterprises was fraught with difficulties for small and medium enterprises, and for relatively young businesses (for more detailed information see section New Chapters of the Tax Code, paragraph «Tax on profit of organizations» included into this survey). It could be expected that cancellation of benefits starting with 2002 and the parallel gradual decrease of profit tax should lead to leveling off of the terms of taxation and raising competitiveness of medium enterprises. However, even after the above amendments are introduced small business may remain at a disadvantage. AT the same time, the operation of small business is frequently followed by tax evasion. A dominating majority of both politicians and economists who study small business acknowledge that at this stage of development of the Russian economy it would be difficult to come out of the difficult situation in the above sphere without taking special measures with respect to small business.

In order to select specific forms of taxation of small business it is necessary to give answers to the following questions.

- Is the development of a special taxation regime aimed to mainly encourage the development of small business or is that done for fiscal purposes? Other issues may be resolved depending on the answer to this particular question.

- What losses of tax revenue is society ready to incur for the sake of small business development? Is encouragement of small business the key goal anyway?

- Should the tax base be determined on the basis of the performance of enterprises or should it be artificially computed proceeding from the values of certain natural indicators?

- Should special taxation regime be accepted by taxpayers voluntarily, or should everybody meeting respective criteria be obligated to apply the above tax requirements?

- What restrictions should be established for the right to accept a special regime, provided that is done on a voluntary basis, to avoid a situation when the advantages of the special regime may be used by those for whom such regime was not designated?

Regarding the first question it may be maintained that the decision taken will be aimed to introduce a regime encouraging small business. At any rate, the fiscal objective may be resolved separately, and this will imply to a greater extent combating generally accepted ways of tax evasion, not so much any special measures with respect to small business.

This leads to another question. There exists a fairly popular opinion that a maximum favorable taxation regime may be created, which in fact means legal tax evasion. In principle that is an issue of regulatory nature, and such a decision could be taken provided public opinion approves thereof, but then comes up a serious problem of tax evasion by major enterprises who will be, firstly, disguising themselves as small businesses, and secondly, through the use of affiliated counteragents registered as small enterprises. Thus, if it might be possible to put up with the loss of budget revenue from taxation of small business, losses from tax evasion by major enterprises who would be trying to take advantage of benefits for small enterprises would be an excessive compensation for such a system, particularly if it is possible to avoid thereof.

Imputed tax selected as a basic one for taxation of small business is typical for many countries. Certain problems arise in connection therewith, somehow they are resolved in each case individually. This method is also used in Russia. Mandatory imputed tax is used pursuant to the Law On Single Tax on Imputed income for certain Kinds of Activity. Under the now effective simplified system of

taxation of subjects of small business imputation is also used in form of a patent. In this instance imputed tax (patent) is voluntary and used as an alternative for individual entrepreneurs, while for legal entities applying a simplified system it is a minimum which may be applied towards tax liabilities. The tax liabilities towards which the patent is accepted as a minimal payment shall be determined not in accordance with general principles, but in conformity with the simplified system accepted voluntarily and implying, depending on the regional legislation, either taxation of the proceeds of an enterprise or the aggregate income thereof. Such tax, on the one hand, adds to the violation of the principle of «horizontal justice», and on the other, does not exclude tax evasion, unless restrictions on entering the system are well thought out. In this sense, a tax calculated on the results of performance of an enterprise seems more preferable to us. At the same time, for it not to act in a distortive manner, it would be desirable to subtract the expenses on production factors (a rule which has not been used strictly under the effective simplified system).

Whether the special taxation regime shall be voluntary or mandatory depends on the answer to the first question set on the page above. With any definition of the tax base in a manner different from the generally accepted one, a possibility cannot be disregarded that even if there is no tax evasion, tax liabilities will prove to be less than those provided for by special rules. Therefore, if the key objective is to encourage business, either voluntary or contested (mandatory) system is used. A mandatory (contested) system, given the legal mentality of the Russian population and the state of the judicial system, would most likely become another declaration difficult to enforce. Apparently, a voluntary system would be a more acceptable option.

To limit categories of taxpayers who apply special regime is a fairly complicated task. It was mentioned above that the advantages of the special regime may be unlawfully used by major enterprises which would lead to losses in tax revenue. This consequence somehow may prove to be not the most essential one. Any method of determining the tax base which differs from the generally accepted one offers possibilities for tax evasion through conclusion of transactions between persons applying different regimes. For instance, when a taxpayer using the general procedures pays for the products manufactured by a payer of the imputed tax, the tax base of the former shall be decreased by the cost of products stated in the contract, while the tax base of the latter shall increase. It is particularly easy to use such way of tax evasion when providing services, and it is being actively used with the participation of individual entrepreneurs (specifically, with respect to payment of salaries and wages). Another example refers to the sale of products

by a taxpayer applying the cash basis method of accounting to a taxpayer who uses the accrual method. If the money is not paid officially under the contract, the seller will not have any tax liabilities, while the liabilities of the buyer will go down. In such cases it is either impossible or extremely difficult to legally prove tax evasion. It is easy to see from such examples that for tax evasion described above it is sufficient to create several affiliated enterprises. Therefore, permanent costs relating to the method described are high and for that matter unacceptable for small enterprises. But the gains received may be considerable and exceed regular profit received as a result of simplified taxation. That is, it might so happen that large enterprises may receive greater advantages from the system than small businesses, thus the latter will again find themselves unable to compete in the market. The losses of the budget incurred in connection with the established special regime will prove to be useless costs only, while the goal to expand the activity of small business will not be achieved.

Basing on the above rationale the IET proposes the following concept of taxation of small business.

In contrast to the regimes of taxation of small business described the system proposed provides for uniform rules of taxation of businesses with various organizational and statutory forms.

Both systems proposed for taxation of small business – simplified system and imputed tax – are opted for on a voluntary basis. This approach allows to avoid a situation when subjects of small business for whom due to certain reasons special approaches to taxation are not beneficial are unable to pay taxes on generally accepted terms.

The right to apply either a simplified system or imputation arises with the taxpayer only if the aggregate income thereof (proceeds for the sales for products, works, services plus the income from non-sales operations) does not exceed four million rubles per year. The above synchronization of the criterion for applying simplified tax with the turnover criterion, when the right not to register as a VAT payer arises allows to significantly simplify the administration of taxation of small business. Such relatively low thresholds which determine a possibility to use benefits allow to create preferences for small business and exclude altogether the use of benefits by major enterprises. Moreover, it is necessary to retain and even expand the currently used list of restrictions with respect to the application of a simplified taxation system and imputation. This includes prohibition to use simplified system by payers of excise duties, credit organizations, etc., certain extra regulation will prevent the use of benefits and special taxation regimes by major enterprises for evading tax payment (when providing services to enterpris-

es, legal services, etc). Thus, tax preferences will be provided to small business. Specifically, when income is determined to verify if certain criteria are met, it is proposed to take into account the income of affiliated persons, at least of those who engage in the same kinds of activity, or who act as counteragents of the taxpayer claiming for the application of the simplified system.

The simplified system replaces the income tax imposed on individuals if the latter act as entrepreneurs with respect to income from entrepreneurial activity and the tax on profit of organizations (company income tax). Imputed tax replaces all taxes, but for several ones (state duty, tax duty, land tax, etc.).

Income shall be the base for a simplified tax. All money proceeds related to business activity shall be taxed, but for those which are not included into income (that is, with the exception of loans, pledges, advanced payments, contributions to charter capital, return of taxes paid in excess), less money payments, except those which are not allowed to be accounted for as costs. Insofar, depreciated property is subtracted from the tax base in full amount upon actual payment, while the interest must not be subtracted. For enterprises using simplified system restrictions with respect to deferral of losses shall be applied. Social tax (subtracted from the tax base) shall be paid by an enterprise and an individual entrepreneur on generally accepted terms in conformity with the payroll. As regards individual entrepreneurs social tax shall be calculated on the basis of the amount of salary of an individual entrepreneur, but it should not be less than three-fold amount of the minimal statutory wages. An income tax with the rate of 13% shall be paid from that amount.

Such tax base allows to considerably lower the tax burden for entrepreneurs engaged in small business, since the system does not require dual accounting and allows to limit accounting record to the income and costs ledger, and the list of property subject to state registration. Such taxation technique leads to the absence of investment costs taxation and thus encourages the development of small business.

The imputed tax base is determined by the laws of the Russian Federation with natural indicators characterizing the degree of profitability of a business being used. Imputed tax is calculated on the basis of standard indicators, with the break down by groups of organizations and entrepreneurs engaged in various kinds of activity in various comparable conditions. The list of standard indicators shall be established by subjects of the Russian Federation for each kind of activity, and includes the requisites of the place where entrepreneurial activity is performed, availability of infrastructural facilities, the assortment and nature of manufactured goods and provided services, characteristics of the premises used,

existence of additional advantages related to the localization of business, etc. Under the imputation system, part of the integrated tax (25%) covers social tax. Imputed taxation allows to encourage the development of efficient small enterprises, stimulate extra income (as compared with the average indicators) which is taxed at a zero rate.

Simplified tax shall be collected at the rate of 16.5%, with 4% going to the budget of the subject of the Russian Federation, 12.5% are directed to local budgets. At the same time, a subject of the Federation has the right to establish benefits within the portion of taxes collected at the respective level. Imputed tax shall be established by the subject of the Russian Federation in the amount of up to 16.5% and is mainly directed to local budgets, with the exception of social payments accounting for 25% of the tax amount and the portion of subjects of the Federation which they are entitled to establish up to 20% of the tax amount. Establishing rates at such a level is aimed to create favorable conditions for the development of small business.

The prospects for improving VAT

The system of levying the value added tax in the part of granting VAT exemptions and revocation of the preferential 10 percent rate should be improved along the following lines.

It is necessary to rescind a 10 % tax rate (according to the data from the Ministry for Taxes and Levies, in the first half of the year, about 10 % of the tax base was taxed at this rate), concurrently taking measures in the area of the social protection of the population.

It is necessary to substantially reduce the number of exemptions from the tax in sales on the territory of the Russian Federation, currently listed in Article 149 of the Tax Code. Insofar, it is necessary to:

- exclude or move to other Articles of the Tax Code tax exemptions arising due to the absence of the taxation object;
- significantly reduce the scope of grounds for tax exemptions, retaining only such operations as: financial and insurance services (banking operations, insurance and re-insurance, financial services, etc.); public and quasi-public benefits (health care, education, telecommunications, public transport); services in the field of culture and arts; lotteries and sweepstakes; transactions in real estate (the sale of land plots, buildings, leasing of real estate); not-for-profit activity of not-for-profit organizations and charitable activity;
- retain in Article 149 the exemptions determined by the provisions of effective legislation or the specifics of economic activity.

It is also necessary to incorporate amendments in Article 150, regulating granting of VAT exemptions in importing goods to the territory of the Russian Federation. Insofar, the amendments should be designed at bringing the provisions of Article 150 in compliance with the provisions of Article 149, as well as compliance with international agreements and other specifics of economic activity established by effective legislation.

Our calculations show (Table 44) that, in the event of revocation of the benefits and introduction of a VAT uniform rate, the previous level of VAT revenues may be reached by reducing the tax rate to 16 %.

Table 44

VAT rate	20 % + 10 %	20 %	18 %	17 %	16 %
Volume of VAT revenues in the conditions of 2002 (Bln rubles)	712.4	885.6	797.0	752.8	708.5

Compensation of losses due to the revocation of the road tax

To compensate for revenues upon revocation of the road tax (RT) the excise rate on gasoline, diesel fuel and motor oils should be raised 3-fold (in the prices of 2001).

In recalculation of the proposed rate with the account of the situation of 2003, it is necessary to bear in mind that the excise rates are of specific nature and should be indexed. Given the inflation rate projections of 25 % for 2002-2003, it is necessary to establish the following excise rates for 2003, as shown in column 4 of Table 45.

Insofar, estimated increases of retail prices for car gasoline show that substitution of lost revenues solely by excises on car gasoline, diesel fuel and motor oils will lead to significantly higher prices for these types of fuels (diesel fuel – by 14-22 %, AI-80 by 34-54 % and AI-90 by 41-67 %).

Preliminary calculations under the currently proposed option of reforming the value added tax show, that upon cancellation of the benefits while retaining the tax revenues at the previous level, the VAT rate may be cut to 16 %. In order to compensate for the revenues formerly received from the RT being rescinded together with the revocation of the VAT benefits, the rate of the value added tax should be retained at the previous level (the VAT tax base is not expected to shrink upon increasing the rate, it will only increase due to the revocation of the benefits.). In order to get an opportunity to increase VAT revenues, substantiat-

ing this increase by replacing the RT being rescinded, it is necessary to review these draft Laws as a single package in the RF State Duma.

Table 45

	Excise rates in 2001, rubles/t	Excise rates approved for in 2002 rubles/t	Excise rates in 2003 (indexing of 2002 rates by 13 %) rubles/tr	Rates which should be established for 2003 to offset lost revenues, rubles/t
Excises on car gasoline (with octane number up to 80/over 80)	1350/1850	1512/2072	1710/2340	5000/6875
Excises on diesel fuel	550	612	690	2000
Excises on motor oils	1500	1680	1900	5500

If the VAT rate is increased with the effective benefits being retained, then, to compensate for lost revenues resulting from RT revocation, the VAT rates of 20 and 10 % should be increased to 25 and 12.5 %, respectively.

Another option to compensate for revenues from VAT envisages more moderate excise increases (by two-, but not three-fold, as proposed under the first option), about half lost revenues upon the RT revocation. Insofar, as estimates show, this option leads to a permissible growth of prices for car gasoline and diesel fuel (about 30 and 10 %, respectively). Given the fact that the excise indexing in 2002 by a two-year inflation (about 25 %), the following excise rates should be accepted for 2003 (see column 3 of Table 46, excise indexing by 2.23 times compared with 2002):

It is expected in this situation that the second half (about RUR 50 bln in 2001) will be collected through other taxes.

This amount may be offset, for example, by increasing the VAT rate by about 2 percentage points (if the benefits are cancelled, the rate will be cut not to 16 but to 18 %, which will allow to additionally get about RUR 54 bln).

Another way to offset may be by significantly increasing the rate of the tax on car owners applying a progressive scale (a small tax on cheap cars and a big one – up to U1000 - on expensive ones). According to preliminary estimates, the revenues from this tax may be increased to RUR 30-40 bln per annum (or an earlier proposed option of the car owner tax with a variable rate depending on the car power may be used). It is also possible to introduce additional charges for

road use (Euro-vignettes etc.), which will allow to additionally collect about RUR 10 bln ³⁹.

Table 46

	Excise rates in 2001, rubles/t	Excise rates approved for 2002, rubles/t	Rates for 2003 (indexing of 2002 rates by 13 %) rubles/t	Rates that should be established for 2003 to offset 50 % of lost revenues, ruble/ t
Excises on car gasoline (with octane number up to 80/over 80)	1350/1850	1512/2072	1710/2340	3375/4625
Excises on diesel fuel	550	612	690	1375
Excises on motor oils	1500	1680	1900	3750

In addition to the options given above, it should be noted that in offsetting the revenues lost as a result of RT revocation by excises and VAT, a redistribution of revenues in favor of the federal budget takes place. So, to retain the proportions of revenues of the federal and regional budgets (the territorial road funds) upon the unchanged ratio of federal and regional roads, it is necessary to revise the mechanisms of allocating the subventions for construction and servicing of roads.

Improving taxation of the profit of organizations

Despite the shifts to neutrality, efficiency and equity of the tax system achieved in Chapter 25 « Tax on of the Profit of Organizations» of the Tax Code adopted by the State Duma, compared with the earlier existing taxation procedure, some problems still remain which need not be resolved immediately but at least to be discussed seriously and, as may be supposed, will be a subject of discussions by economists as well as politicians.

A discussion of the following measure may be proposed, some of which are designed to reduce tax evasion while the others – to cut investment costs:

- taxation of advance payments received (advance payments for goods, works and services). Even under the accrual method, to avoid tax evasion, it is

³⁹ Only estimated revenues are given in the text, they may be defined more precisely using the data on the tax base.

expedient to include most advance payments in the tax base, making exceptions only for advance payments for the products with specific characteristics;

- introducing restrictions on the transfer of funds between the head company and a subsidiary without tax payments, which may be permitted if these funds represent a capital transfer and a relevant adjustment of the number of the shares of the head company in the subsidiary is made;

- limiting the right to choose an accounting policy for tax purposes, providing for impossibility of frequent changes thereof and specifying the procedure for computing a maximal income, under which the choice is permitted;

- reducing or canceling the benefits under financial leasing;

- establishing a uniform procedure for inclusion in the costs of all research and development work, whether producing or not producing results;

- developing the rule of inadequate capitalization, taking into account all indebtedness, but not only indebtedness to foreign individuals;

- removing the restriction on loss carry forward by 30 % of the tax base. The loss should be accepted within the limits of the total generated profit during an established period;

- introducing restrictions on the procedure for forming provisions for doubtful debts and on inclusion of bad debts in cost composition, determining the right to reduce the tax base by the efforts of the taxpayer for debt recovery;

- restricting the right of forming provisions for impairment of securities for securities market professional participants, as well as for forming provisions for warranty repairs and warranty maintenance;

- making more precise the procedure for integration of taxation.

The arguments in favor of the above-cited measures are spelled out in greater detail above, in the section «New chapters of the Tax Code» of this survey, in the subparagraph dealing with the tax on the profit of organizations..

Improving taxation of production of minerals

To further improve taxation in the mineral sector, it will be necessary to start using market prices when calculating tax, as well as to adopt a more flexible approach to taxation of the extraction of minerals. In particular, it will be necessary to develop and adopt respective legal acts and regulations providing for reduced royalty rates to be applied to depleted or hard-to-recover reserves. It would be advisable to make rates of the tax on production of minerals conditional on the extent of depletion of a particular deposit. In the oil sector, it is a share of initial recoverable oil reserves which have already been produced that may be used as an indicator of such depletion. For example, if from 80% to 90% of recoverable

oil reserves have been extracted, the tax may be paid at a reduced rate equaling 0.75 of a regular rate, or if the above percentage exceeds 90%, then the tax rate might be 0.5 of the regular rate. Two other coefficients – water content of production and average production rates of an oil well – may also be used as indicators of deposits' depletion. Reduced rates applied to deposits (licensed subsoil sections) at later stages of their development will encourage more rational use of oil fields as they will result in extracting a larger portion of oil of existing oil reserves. In addition, further development of depleted oil fields will result in additional tax receipts paid to the state budget, including the profit tax, property tax, single social tax, etc.

The enactment of Chapter 26 of the Tax Code means that a newly adopted taxation system in the mineral sector will be based on two components: the tax on production of minerals (royalty) and the profit tax. The above system may be further improved by introducing a special windfall tax (tax on super-profits) in the mineral sector, i.e. the tax on additional income from production of minerals (the «TAI»). This tax may be introduced for new deposits instead of a portion of the tax on production of minerals. TAI will take into account geological and economic conditions of production of hydrocarbons and encourage investment in developing new fields and deposits. In case of very efficient projects, the above tax will ensure that royalty payments to the state budget are paid on the basis of an ascending scale. At the same time, conditions for implementing less efficient projects will become more favorable.

If adopted, TAI would mean the transfer to a new taxation system based on three components: the tax on production of minerals (royalty), the tax on additional income, and the profit tax. Such system will be better since it relies on taxation of revenues to a much greater extent.

There should be another component of the taxation system which will encourage investment and give an opportunity to take into account particular conditions of development of mineral resources. The above component should provide for establishing a special taxation regime for production sharing agreements (PSAs). Such a regime will ensure stable economic and legal conditions for operations of a PSA investor throughout the entire period of implementing a respective PSA project. At the same time, to safeguard the interests of the State, certain restrictions should be established. In particular, laws and regulations should provide for an exhaustive list of costs which may be recovered by an investor out of cost oil (production). It would also be advisable if laws and regulations provided for a maximum annual amount of costs to be recovered when implementing a PSA project. This will ensure that there will be a certain amount of profit oil

(production) and that the State will receive revenues even at initial stages of projects' implementation. One should also address the issue of payment of taxes and other charges under a PSA project in kind, i.e. in the form of a certain portion of produced mineral resources.

However, it would also be advisable to preserve the existing 30% quota of all proved mineral reserves which are allowed to be developed on PSA terms. One should focus on improving the system of state regulation and control over the process of preparing, negotiating and implementing PSA projects. It would also be advisable to keep in place the existing quantitative restrictions relating to the mandatory use of domestic equipment and other inputs, as well as local personnel when implementing a PSA project (there is a 70% quota for equipment and other inputs, and an 80% quota for local employees). The above restrictions will have related positive impact on the economy (an increase in revenues, production growth, and more jobs in related industries).

Improving taxation of agricultural enterprises

All arguments in favor of introducing a single agricultural tax are boiled down to streamlining the procedure for paying tax. However, the need to streamline the above procedure is not an industry-specific requirement. The complex nature of tax reporting usually constitutes grounds for introducing certain simplified procedures for the smaller businesses; it should be noted, however, that most agricultural enterprises do not fall within the above category.

Besides, the newly adopted law makes competitive conditions for the more efficient enterprises worse. Under Article 346(2), agricultural enterprises with an intensive production cycle (poultry plants, stock farms, fur farms, etc.) are excluded from the scope of the above law. This means that taxes due from universal agricultural enterprises producing poultry or pork, for example, will be four times lower than those payable by intensive-production enterprises. Thus, it will be difficult for the latter category to compete. Upon its publishing, the law has already been intensively opposed by the more efficient enterprises.

In view of the foregoing, the scope of the above tax should be limited to small agricultural enterprises with no more than 60 employees and no more than 100 hectares of agricultural lands. Such an amendment to the law will also eliminate the need for the Government of Russia to develop a procedure for deeming agricultural businesses to be enterprises of industrial type.

In addition, it would be advisable to introduce a new tax period of one year for small enterprises which are to start paying the [new] agricultural tax. It would considerably streamline the taxation system for small enterprises.

Prospects for improving taxation of property

Tax on property transferable in conformity with the inheritance and donation procedures should be turned into a federal tax. Just as of today, only transfer of property included into exhaustive lists should be taxed, while tax rates should be differentiated depending on the degree of kinship with the deceased or the donor. A high minimum which shall not be subject to taxation should be provided for with respect to taxable property. As regards regional taxes, tax on property of organizations should be retained (company property tax). The base for the above tax should be adjusted in such a manner that monetary funds, goods in stock and some other accounts of a company recorded in the balance sheet should be exempt from taxation. The tax base should be formed as the sum total of the value of the real estate and fixed assets. We propose to retain the maximum tax rate (in the amount of 2%) within the above range regional legislative bodies will be entitled to establish specific tax rates. The transfer of powers to grant additional tax benefits to territories (with respect to the above tax and other) should be followed by a considerable decrease of benefits linked to these taxes established by federal laws.

In order to rebate the lost income of municipal budgets caused by the stage-by-stage revocation of municipal profit tax, it would become possible to grant the right to increase the tax rate on the property of organizations (company property tax) up to 3 %. It is expected that the company property tax should be replaced by tax on real estate included into the list of local taxes. Integration of land rent and taxes on real estate would bring down considerably costs on administering taxes. At the same time, creation of a single tax real estate cadastre is a major stage in reforming real estate taxation. Rules for compiling the cadastre should be developed and approved at the federal level in order to avoid abuse on the part of regional authorities. The next stage should involve the appraisal of real estate for taxation purposes with the application of methodologies established by law and on the basis of the market value of real estate objects.

Long-term a significant stage will be the transfer to appraisal of property on the basis of the concept of a «single property complex», and inclusion of agencies representing the authorities into the category of taxpayers. Title owners of real estate objects shall be payers of this tax, while the object of taxation will be, at the discretion of regional authorities, land plots, buildings, structures and installations either separately, or as a property complex, with the tax base being determined on the basis of the market value thereof. We propose the maximum tax rate of 2 %. Part of the real estate should be not subject to taxation (property be-

longing to state power bodies and government, local self-government, budget organizations, and similar categories of property.)

Introductions of this new tax presupposes a huge amount of preparatory work relating to compiling cad asters of land plots and real estate objects, the appraisal thereof, hence the transfer to the above tax will take a long time and will not be introduced simultaneously in the territory of the whole of Russia.

Compensation of losses caused by revocation of the sales tax

Adoption of the new Chapter of the Tax Code on the sales tax does not resolve issues related to compensation of the revenues lost by the RF subjects due to the revocation of this tax as of January 1, 2004. The following options for compensation of losses caused by revocation of the sales tax are currently possible:

1) Generation of additional revenues as a result of increasing some regional and local taxes, specifically, the company property tax, the individual property tax, the land tax and other taxes.

2) Given revocation of the sales tax when canceling some exemptions from the payment of the value added tax and cancellation of the preferential 10-% rate of VAT. A reduction of the standard rate of the value added tax is possible with the account of the forthcoming revocation of the sales tax and subsequent compensation of the revenues lost by the budgets of the subjects of the Russian Federation and local budgets through a system of federal financial aid.

Other taxes

In the near future it would seem reasonable to transfer the proceeds of the gambling tax to the budget revenues of the subjects of the Russian Federation, and also pass to the jurisdiction of regional authorities some powers relating to the regulation of the above tax.

The state duty should not undergo serious changes, however, it should incorporate some charges and dues that are now being cancelled. Specifically, there is a proposal to introduce a state fee for the registration of commercial and not-for-profit organizations, registration of amendments incorporated into the founding documents, and services deemed as legally significant which are provided by government agencies (for example, by the Ministry of Justice for registration of property rights) and the State Automobile Inspectorate, including the issuance of state license plates and technical passports, issuance of patents for an invention, a useful model, a production prototype. It would be logical to introduce a state duty (fee) for the registration of bills of exchange and promissory notes, as well as, in

view of the revocation of the tax on transactions in securities, for the registration of securities issue prospectuses.

It would seem useful to go over to taxing all purchase and sale transactions at a single rate of 0.2 %.

Until the land tax is replaced by the real estate tax, only general principles of taxation should be provided for, pursuant to which local authorities should determine the procedure for computation and payment of taxes, specific tax rates for land plots (within the range from 0.1 to 2 % of the relevant tax base). Insofar, the tax base is defined as the cadastre value of the land plot. It is proposed to delegate the procedure for determining the cadastre value to the Government of the Russian Federation. We would also recommend to give up the procedure of transferring land tax to the federal budget.

In the coming years – until the real estate tax is introduced – the fiscal role of the tax on the property of individuals should be gain importance, specifically, by way of levying higher rates on prestigious and expensive real estate, application (under certain conditions) of the market value of objects for tax calculation, and factoring in for taxation purposes the price of uncompleted real estate objects. At the same time, the fiscal role of the above tax should enhanced with the account of the progressive nature thereof to prevent possible negative consequences for individuals with moderate incomes.

Among the big number of the formerly applied local taxes, it is proposed to retain tax on advertising, the maximal rate of which may be established as 5 % of the value of advertising services. The significance of this tax as a source for replenishing local budgets should be even greater after the restrictions on the amount of advertising expenditure provided for by the Code within the framework of the profit tax are cancelled.

Part 2. The Real Sector

2.1 Production Macrostructure

—GDP Production: Dynamics and Structure

Goods and Services Production

In 2001 the Russian economy is characterized by a high and stable growth rate. According to 2001 totals, GDP rose by 5% compared with 2000, investments in capital assets— — by 8,2 %, and output— in the manufacturing sector— by 4,9 %. The rise— in the output of goods was ensured by the market for infrastructure— services— emerged over— the— period of reform. In comparison with 2000, commercial freight turnover showed a 3,1% in, — while wholesale trade grew by 5,2 %, and— the output in the sector for communication services grew by 19,9%. While the production of goods grew by 6,5 % per year, — the output in the sector for market services— rose by by 4,1%.

—The development of market— for consumer-oriented services is characterized by acceleration of growth in comparison with the prior year. In 2001, retail turnover grew by 10,8 %; the volume of paid services grew by 0,8%. So, in 2001, the retail turnover growth rate exceeded— the 1997 pre-crisis rate at 11,4 %.

Against the background of economic growth, an evident asymmetry has emerged in regard to production growth, disposable income, and final demand, which does not allow an unambiguous evaluation of economic performance. With results of 2001 economic activities being undoubtedly positive, the comparison of major social development guidelines shows that the negative impact of the August 1998 recession upon Russian economy has not been eliminated entirely.

While—in 1999-2000 growth in demand in the household sector was restrained by low purchasing power rate, in 2001 the situation reversed. The 19,8% rise in real wages—and the 21,4% growth in real pensions had a positive impact upon demand activity in 2001. Real disposable income rose by 5,9% in 2001. However, in spite of active social policy, living standard guidelines are still much lower than those of 1997.— In 2001, real income accounted for approximately 83,0% as compared to 1997 level.

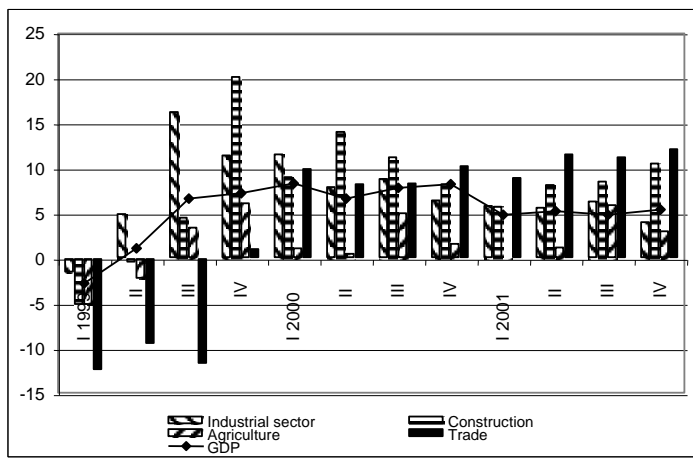
Table 1.
The dynamics of major macroeconomic variables in the period 1997—2001
(percent per year)

	1997	1998	1999	2000	2001
Gross Domestic Product	100,9	95,1	103,5	109,0	105,0
Base industries goods and services production	-	94,2	104,6	108	105,7
Industry output	102,0	95,1	108,1	111,9	104,9
Base capital investments	95,0	93,3	105,3	117,7	108,7
Agricultural output	101,3	86,8	104,1	107,7	106,8
Freight turnover	96,6	96,6	105,8	105,0	103,1
Retail trade turnover	104,7	96,7	92,3	108,7	110,8
Foreign trade turnover	101,7	84,7	86,7	129,7	104,1
Real disposable income	106,3	83,8	85,8	109,3	105,9

Source: Goskomstat, Russia (State Statistics Committee of Russia)

Fig. 1

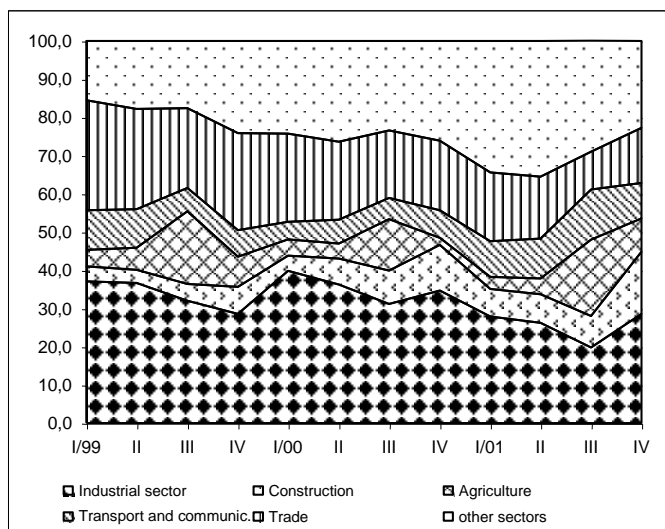
Change in the real volume of GDP and gross value - added of sectors of the economy, as % to the respective period of the prior year.



Source: Goskomstat, RF Ministry of Economic Development and Trade

Fig.2

Contribution of the economy's sector between 1999 to 2001, by quarters



The distinctive feature of 1999-2000 consisted in the change in the shares of sectors of the economy. The economic renewal was progressing alongside with positive dynamics of output of goods and services. The positive dynamics of GDP was fixed in II Quarter 1999 and was hence secured by increase in basic industries' output. When industrial growth of the first half of 1999 compensated for the fall in production in the previous year, the noted tendency towards economic recovery was in place afterwards. The positive contribution of construction and trade to the economic development growth rates enhanced from 2000.

While analyzing the process of economic recovery, we may divide the period in question into the following stages subject to the degree of impact the factors have:

- Active import substitution between late 1998 through early 1999 determined by the Rb.devaluation progressing within the framework of relatively low natural monopolies' prices, a sharp decline in import, and restrained growth in salaries and wages;

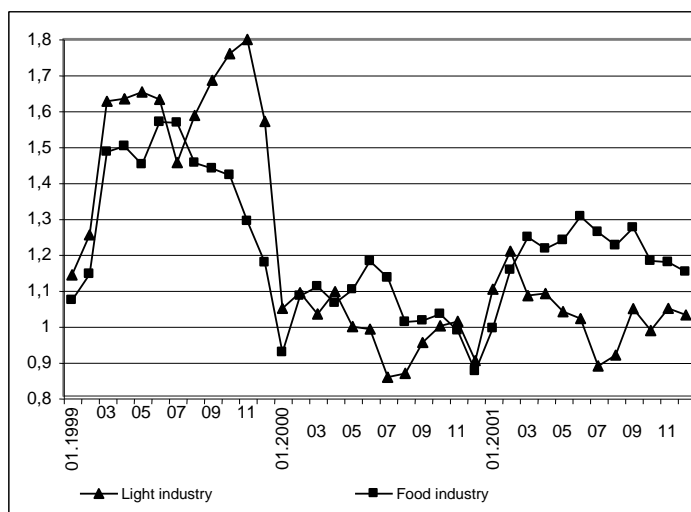
- Rise in external demand from the second half 1999 connected with better market prospects for fuel, energy sources and minerals;
- Rise in domestic demand for investment resources from III Quarter 1999 determined by increase in firms' revenue;
- Rise in domestic consumer demand from the second half 2000 caused by an active social policy.

At the first stage, consumer-oriented industries, which traditionally proved to focus on the domestic market found themselves in advantageous position. The output of consumer goods rose by 8,7 % in 1999 and exceeded the overall rate of growth in the industrial sector and the one in the retail trade turnover. In 1999, the share of sub-sectors of the consumer sector in industrial production growth accounted for 13,2 % against 8,4 % in 1998.

Формат: Список

Fig. 3

Dynamics of gross output of light and food sectors between 1999-2001, as % to December of the prior year; the retail trade turnover=1



In 200-2001, the impact consumer industries had upon production growth remained unchanged resulted from both residual effects of import substitution in relation to light and food industry and of currency devaluation inertia. The comparison of monthly dynamics of output of consumer goods shows a gradual decline in the gap between the growth rate in light and food industries' output and dynamics of the retail trade turnover. It was the light industry whose reaction to changes in domestic market situation was the most notable one. On the one hand, with purchasing power growing, production expansion opportunities are restrained by technical and economic characteristics of the sector's production capacity. On the other hand, with the ruble exchange rate growing, the industry loses its competitive advantages and yields to import goods pressure. While in the 1st Quarter 2001 the import share in total nonfoods resources accounted for 45,9 %, in the 3rd Quarter it rose up to 51,4 %.

The growth in investment demand appeared to be a characteristic feature of the economic renewal. While financial performance of firms was improving and their savings were growing, the demand for capital goods proved to be increasing from late 1999. This particular tendency intensified in 2000-2001 under the influence of rising demand on the part of export-oriented industries for domestic machine-engineering goods. The output of investment complex grew by one-third over 1999-2001 compared to the 1998 level. Being subject to developed inter-sectoral relations, the production growth in machine engineering industry and the sector for construction materials ensured growth in the associated industries' output. The increase in domestic consumption of construction materials had a positive impact upon production rate growth in metallurgical, chemical and timber industries.

The ongoing tendency to growth in demand in the domestic market compensated for relative deterioration of the situation on foreign markets. If compared to 2000, there was production growth in all the industry branches. Negative factors of output dynamics in some industries manifested themselves in production stagnation in the ferrous metallurgy industry and gas industry, which resulted from export reduction, and the decrease in the medical industry output, which was determined by import expansion. Once the output in machine engineering industry grew by 8,4 % vs. 2000, the output in nonferrous-metals industry accounted for 104,9 % and in oil and gas industry for 107,2 %, and iron-
industry output accounted for 99,8 %. The engineering industry share in total

industry output growth in 2001 accounted for 35%, as well as iron industry share was 20 %.

Table 2.

The dynamics of gross output within industries, 1998-2001 (in percent)

	1998	1999	2000	2001
Industry	98,4	108,1	109	104,9
Fuel-energy industry	97,5	101,7	104,0	104
Ferrous industry	93,5	111,3	113,4	102
Chemical and timber industry	95,3	119,8	112,3	104,2
Investment complex	92,8	114,6	114,4	106,2
Consumer complex	97,1	108,7	108,6	107,8

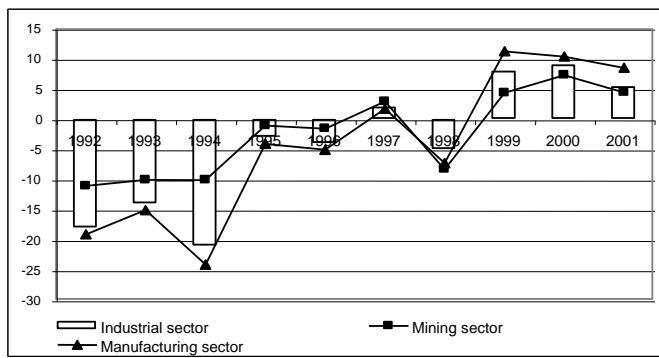
Source: according to Goskomstat data

Processing Industry Sector

The changes in the state of domestic and foreign market determined major structural changes in production. The distinctive feature of industrial growth in 1999-2001 consists in the excess of processing industry growth rates over those of the mining industry. Processing industry output increased by 38,2 % in comparison with 1998, as well as mining industry output growth accounted for 16,6 %. Since 1999, processing industries' share in industrial production structure has been rising.

Fig. 4

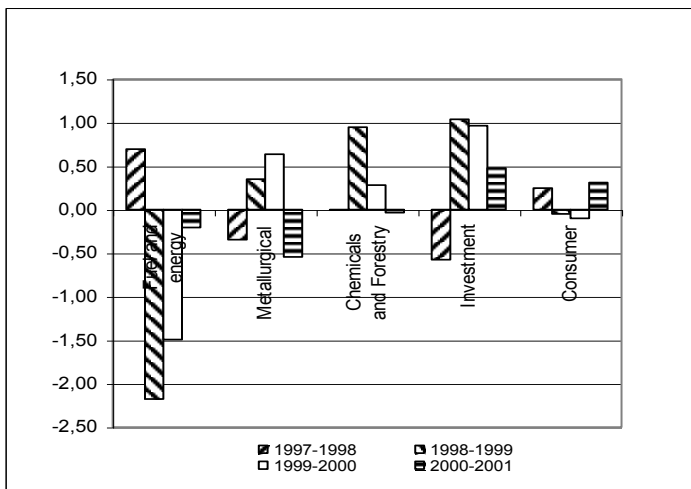
Change in dynamics of manufacturing and mining sectors, as % to the prior year



Investment demand growth offered an additional incentive to the development of intermediate goods industries.

Fig. 5

Change in the structure of industrial output, as % for the respective period, in comparable prices



The rise in capital-making industries' share in the manufacture structure exerted a positive influence upon total investment infrastructure in national economy. There is an evident growth in output produced in almost each engineering industry. Instrument –making industry, communication industry, heavy engineering industries supplying the market with investment goods for transport, agriculture, oil industry are developing at the top speed. The rise in competitive capacity of domestic engineering industry, if compared to the analogous foreign industries' price level, facilitated the increase in output of equipment for consumer industries. Ongoing production capacity optimization, restructuring of company's assets, certification, and mastering new equipment allowed for the increase in output of such machinery as is necessary to substitute imported commuter cars, passenger cars, and electric engines.

Table 3**The Dynamics of Output Production in Engineering Industries (in percent to the previous year)**

	1995	1996	1997	1998	1999	2000	2001
Total industry	97	96	102	94,8	108,1	109,0	104,9
Engineering industries (total)	91	95	104	92,5	115,9	115,5	107,2
which totals from:							
Railcar engineering	73	97	81,1	87	108,9	107,4	126,0
Metallurgy industry	95	93	85,2	70,6	91,8	130,2	86,1
Electrical industry	93	79	93,5	85,7	127,0	130,1	112,6
Chemical and oil engineering	96	76	95,6	96,1	120,7	119,5	121,6
Machine-tool and tool-making industry	87	66,6	84,9	82,3	99,6	111,5	99,4
Instrument-making industry	110	70	105,8	103,4	140,8	118,4	98,0
Car industry	97	100,2	112,6	88,5	114,7	103,3	101,7
Communication industry	42	33,5	123,2	93,7	95,7	330,0	90,0
Tractor and agricultural engineering	64	59	91,9	70,7	159,3	148,4	129,1
Engineering for light and food industries and household appliances	65			90,6	115,8	109,5	107,1

—Source: Goskomstat of the RF (State Statistics Committee)

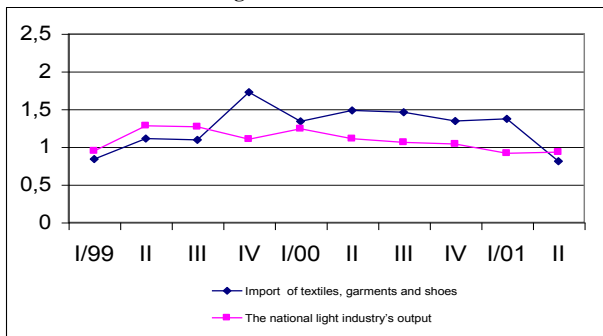
However, in spite of all the positive tendencies in the development of engineering industry mentioned above, its share in industrial output production growth rates is much lower than that of raw materials sector. It can be explained both by retrospective development trends and state-of-the market characteristics over the last years.

The rise in consumer demand is reflected in the optimization of the output produced in light and food industries.—Goods saturation of the consumer market proves to be steady and entirely corresponds to the paying capacity of the population. The increase in output produced in light industry in 2001 accounted for 5,0 %, and in food industry there was a rise of 8,4 %. But even under such conditions the import share in the total value of merchandise inventory of retail trade turnover has a tendency to rise. One should pay attention to the fact that, while domestic manufacturers are holding strong position in foodstuffs turnover, the situation

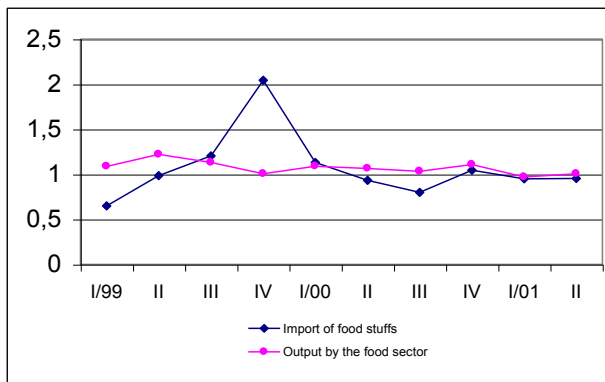
in nonfoods market is determined by the intensive import expansion. A short-term excess of the light industry output growth rates over the dynamics of textile goods import and nonfoods turnover occurred till III Quarter 1999. Subject to changes in competitive environment and increase in import efficiency, the tendency to ousting domestic goods from the market is enhancing.

Fig. 6

Dynamics of import of textile garments and the output by the domestic light industry, as % to the respective quarter of the prior year; the turnover of the retail trade with non-food goods = 1



Dynamics of import of food stuffs and output by the national food sector, as % to the respective quarter of the prior year; the turnover of trade with food stuffs=1



The growth rates of the output produced in fuel and energy industries and export-oriented raw materials industries accounted for 104,9 % and 103,6 % respectively. The slowing-down of the growth in raw materials industries reflects the tendency to the decline in physical export. In 2001, the export share in total sales of product accounted for 23,3 % against 32,2 % in the previous period. The tendency is growing alongside with competitive import expansion, which might have a negative impact upon the development of economy guidelines. In 2001, import increased by 18,9 %, when industrial goods output rose by 4,9 %.

Since the second half 2000, the factors facilitating the slowing-down of growth rates in processing industry have strengthened their influence. The exceeding growth in prices of the primary energy resources, real ruble exchange rate growth, and intensive increase in wages determined the competitive environment changes in home market. As a result, since IV Quarter 2000 the slowing-down of income rate growth and final demand industries investments, as well as the decline in physical export have been fixed. Alongside with the given market performance, there have appeared more drastic limitations. The possibility of further output growth has been severely restrained by the performance characteristics of stockholders equities and lack of equipment.

The analysis of manufacturing facilities shows that most part of the equipment can't be employed in manufacture considering its physical and moral depreciation. Manufacturing facilities utilization differentiates greatly. In raw materials industries characterized by quite a small share of the value-added, capacity utilization proves to be much more intensive than in processing industries. Even within different manufactures of one and the same industry manufacturing facilities are utilized to a different extent. Though active employment of spare manufacturing facilities determined the recovery of economic activity, there are certain limits to capacity utilization.

In general, the demand in raw materials industries can be satisfied by employing available facilities since the quality of raw materials is not a subject to drilling mechanisms. New technologies therein facilitate costs reduction, labor productivity growth, increase in the complementary products output, etc. However, in mining industries the combination of severe depreciation and intensive utilization indicates that the equipment withstands excessive duty.

In processing industries, especially in high-tech manufactures, manufacturing growth potential is determined by the equipment performance and implemented technologies. Severe stockholders equities depreciation in processing industries proves to be a reason for a lower rate of manufacturing facilities utilization as well as an impediment to further output growth.

The correlation between depreciation rates and capital stock age structure displays an insistent need for activation of renewal process. The engineering industry is rated among the worst in respect of production capacity utilization. A long-term investment pause lead to the conservation of engineering industry structure, and within the framework of transition to the investment-based economic growth model, the dearth of equipment and machinery appeared to be a factor limiting output growth in economy. The situation is aggravated by the fact that engineering industry, being inconsistent with market performance criteria, fails to achieve such a sales level as is necessary to make solid investments in re-equipment of own manufacturing facilities.

The change in the dynamics and structure of domestic demand was accompanied by the competition enhanced among domestic manufacturers, as well as

among domestic and foreign substitution goods. The situation is getting more complicated under the conditions favorable for growth in consumer and investment goods on the basis of per capita income growth, on the one hand, and decline in competitive advantages of domestic goods price level, on the other. The existing situation entails the slowing-down of growth rates in processing industry, the latter being subject to the investment dynamics and innovation development strategy. Depreciated inventory, old production technologies, and low rates of labor productivity sufficiently restrain the rise in aggregate supply as well as any change in its structure. Under such conditions, foreign manufacturers enlarge their share in the Russian market regarding high market capacity and gradual paying capacity recovery. In the event that domestic manufacturers reduce their investment activity, they might lose their hard-won positions and competitive environment may change.

Oil and Gas Sector

The price range in the world oil market determined oil sector performance in Russian economy in 2001. Since 60 % of total oil production output is exported as crude oil and domestic final sales prices are much lower than those in the world market, world market price appears to be the major factor regulating income and Russian oil production industry financial performance. During the most part of 2001, the world oil market performance was characterized by high prices for oil and oil products, which significantly exceeded the price level of the last decade. During I-III Quarters 2001, average oil basket price in OPEC approached the middle of oil price target zone, established by OPEC at \$22-28 US per barrel. OPEC managed to maintain the prices by means of considerable reduction in oil supply. The mechanism of the target price level support could secure the reduction in OPEC's oil production by 500,000 barrels per day if oil prices fell below \$22 US per barrel, and would provide the increase in oil production by 500,000 barrels per day if oil prices exceeded \$28 US per barrel in 10 working-days. In IV Quarter, however, there was a dramatic fall in the world oil prices. Brent oil price grew down to \$19,4 US per barrel and OPEC average oil basket price fell down to \$18,3 US per barrel. The price of Russian oil in the world market averaged \$24,4 US per barrel in I-III Quarter 2001, but in IV Quarter it dropped down to \$18,8 US per barrel (Table 4, picture 7).

Table 4**World oil prices, 1997-2001 (\$ per barrel)**

	1997	1998	1999	2000	2001 I Q	2001 II Q	2001 III Q	2001 IV Q	2001
Oil price, Brent, Great Britain	19,12	12,72	17,97	28,50	25,79	27,38	25,30	19,42	24,44
Oil price, Urals, Russia	18,33	11,83	17,30	26,63	23,68	25,39	24,12	18,78	22,97
OPEC oil basket price	18,68	12,28	17,47	27,60	24,42	25,67	24,13	18,33	23,12
Average price of oil imported in the USA	18,50	12,08	17,22	27,72	24,12	23,85	23,04	17,06	22,06

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

The main reasons for the decrease in the world oil prices in 2001 consisted in a dramatic slowing-down of world demand for oil and direct reduction of the latter in some major industrialized countries accompanied by ongoing oil production growth and accumulation of ultimate reserves. The decline in the world oil demand resulted from evident fall in the world economy growth rates occurred in 2001. By International Monetary Fund estimates, GDP annual growth rates fell from 4,7 % in 2000 down to 2,4 % in 2001. With all this going on, GDP decreased at a higher rate in major oil consumer countries. Thus, in the US, which consume more than ¼ of the world total oil output produced, GDP growth rates fell from 4,1 % in 2000 down to 1,0 % in 2001, and Japan went into an economic recession. By the estimates of ~~the U.S.-DeS.~~ Department of Energy, total economic growth rates in OECD countries decreased from 3,3 % in 2000 to 0,9 % in 2001. The terrorist acts committed in the USA on September 11, 2001 stipulated for the decline in demand in IV Quarter entailing, in particular, the reduction in aviation fuel demand and shortening of warm heating season in ~~the eU.-S. U.S.~~ (in comparison with average annual rate).

As a result, by OECD International Energy Agency estimates, the world oil demand growth rates fell from 0,9 % in 2000 down to 0,1 % in 2001, when in North and South America, as well as in OECD countries of Asian-Pacific Region direct decline in demand occurred. The total fall in demand in OECD countries in 2001 accounted for 0,3 %. The most dramatic fall in demand among highly industrialized countries occurred in Japan, it was a decrease of 1,6 % relative to the previous year. There was a decline in demand in the USA, Canada, Mexico,

South Korea, Brazil, and India. By estimates of the ~~eU.S. -DeS.~~ Department of Energy, the demand for oil in the ~~eU.-S. U.S.~~ rose by 0,9 % in 2000 but grew down by 0,3 % in 2001. The financial crisis in Argentina caused a detriment to demand for oil in South America. As a result, 2001 became the year of the lowest growth rates of the world oil demand in the period from 1985. By the international Energy Agency estimates, the growth in oil demand in 2001 equaled zero regardless of the countries in post-soviet region (Table 5).

Table 5
The structure and dynamics of world demand for oil in 2000-2001

	Demand		Annual change		Annual change, %	
	Mln. bbl. per day		Mln. bbl. per day			
	2001	2000	2001	2000	2001	2000
World total	75,99	0,64	0,10	0,9	0,1	
North America	24,00	0,33	-0,10	1,4	-0,4	
Europe	15,89	-0,12	0,08	-0,7	0,5	
OECD countries of Asian-Pacific Region	8,55	-0,04	-0,11	-0,4	-1,2	
China	4,88	0,30	0,09	6,7	1,8	
Post-soviet countries	3,69	-0,05	0,07	-1,2	2,0	
The Middle East	4,52	0,09	0,14	2,1	3,1	
Other Asian countries	7,31	0,10	0,00	1,4	0,0	
Africa	2,39	0,01	0,02	0,3	0,8	
South America	4,77	0,01	-0,09	0,3	-1,8	
Reference data: world demand exclusive of post-soviet countries						
OECD countries	72,30	0,70	0,00	1,0	0,0	
World total	47,71	0,16	-0,13	0,3	-0,3	

Source: OECD International Energy Agency.

The decline in the world oil demand was accompanied by ongoing oil production output growth. At this, OPEC countries reduced real oil production (though not to the extent it was supposed to under OPEC agreement) in order to maintain the targeted oil price level in the world market. According to International Energy Agency estimates, oil production output in OPEC countries fell from 30,80mln. bbl. per day down to 30,16mln. bbl. per day in 2001 or decreased at 0,64mln. bbl. per day. At the same time, a significant rise in oil production occurred outside OPEC, first of all, in Russia, where the growth in oil production rates was the highest. An evident increase in oil production output could be observed in Mexico, Norway, China, and Brazil. Total growth in oil production in

non-OPEC countries in 2001 accounted for 0,73mln. bbl. per day. Thus, the reduction in oil production output pursued by OPEC was actually neutralized by the increase in oil supply provided by non-members (Table 6). As a result, the aggregate share of OPEC in the world oil production dropped from 40,1% down to 39,3 % in 2001.

Table 6.

**The structure and dynamics of the world oil production in 1999-2001
(mln. bbl. per day)**

	1999	2000	2001
World total	74,20	76,72	76,81
Increment (reduction) relative to the previous year	-1,40	2,52	0,09
OPEC countries	29,40	30,80	30,16
Increment (reduction) relative to the previous year	-1,40	1,40	-0,64
Non-OPEC countries	44,80	45,92	46,65
Increment (reduction) relative to the previous year	0,00	1,12	0,73

Source: OECD International Energy Agency.

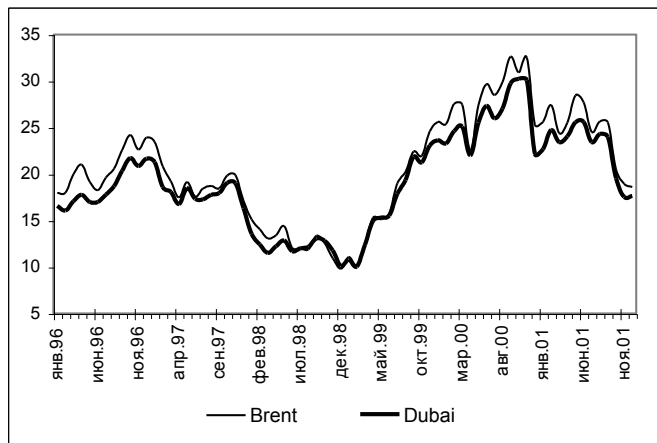
Excessive oil supply in the world market resulted in a drastic growth in its ultimate reserves. By the end of III Quarter 2001, oil reserves in OECD countries had reached the top level in the last five years. Oil reserves growth marked OECD countries in all regions. The high level of oil reserves added to the constraints oppressing oil prices recovery.

The dramatic fall in the world oil prices fostered OPEC members to make a decision dated November 14, 2001, on another reduction in oil production output by 1,5mln. bbl. per day since January 1, 2002. However, OPEC, being concerned with the decrease in its world oil market share, put the implementation of this decision as dependant on non- OPEC oil suppliers for their readiness to total decrease in oil output by 500,000 bbl. per day. In this connection, Russia declared

intentions to cut back oil supplies to the world market by 150,000 bbl. per day starting from the beginning of 2002 (in I Quarter 2002). Norway claimed a reduction in oil output by 150,000 bbl. per day (in I Quarter 2002). Mexico promulgated decrease in oil export by 100,000 bbl. per day (also in I Quarter 2002). Oman and Angola also declared a cut back in oil output, albeit to a minor extent (by 40,000 bbl. per day in Oman, by 22,500 bbl. per day in Angola). At the end of December 2001, a meeting was held among OPEC members Ministries to confirm OPEC decision on contracting oil production daily output by 1,500mln. bbl. within 6 months starting from January 1, 2002. Thus, OPEC focused its effort on price stabilization and short-term revenue provision, which is supposed to follow up with further reduction in the world market share.

Fig. 7

International oil prices between 1996 to 2001, USD/barrel



Source: International Monetary Fund.

High oil prices observed in the world market in 2000 – the most part of 2001 created extremely favorable conditions for Russian oil sector. Significant

increase in output, revenues and investments within oil industry was a distinctive feature of 2000-2001. In 2001, total oil and gas condensate output reached the level of 348,1mln., i.e. grew up by 7,7 % relative to the previous year (in 2000, oil output growth rate was 6,0 %). The production volume of primary oil refinery rose by 3,2 % (in 2000, by 2,7 %). Motor petrol production increased by 0,6 %, diesel oil production grew by 2,0 %, and fuel oil production rose by 4,2 %. Unlike 2000, oil production growth was attained mostly by starting up new oil wells, i.e. resulted from the investments made in 2000-2001.—Oil production carried out in temporarily shut-in wells that were set in operation in 2001 accounted for 5,7mln. tn., or 23,5 % of total annual oil production growth (in 2000, oil production in temporarily shut-in wells set in operation provided for 68,3 % of total oil production growth). Shut-in wells share in operating well stock went down to 24,3 % at the end of 1999, 22,5 % at the end of 2000 and 21,5 % at the end of 2001. The investment activity kept growing: the volumes of production drilling and exploration drilling for oil rose respectively by 8,4 % and 15,6 % (in 2000, by 67,5 % and 27,8%), implementation of new oil wells increased by 18,6 % (in 2000, by 53,7 %). These showings indicate a real boom period for investments in oil sector.

Quantitative and qualitative characteristics of oil refining also improved to a great extent resulting from the implementation of programs on oil refining capacity modernization.—Production capacities employed for primary oil refinery in 2001 accounted for 6,5mln.tn. (in 2000 it was 0,35mln.). The level of oil refining grew from 68,7 % in 1999 up to 71 % in 2000 – 2001. Mineral oil production employing well sinking technologies increased by 12 % in 2000 – 2001. The share of lead-free motor gasoline in total output went up from 89,3 % in 1999 to 95,4 % in 2000, and 97,9 % in 2001; high-octane gasoline output increased from 40,3 % to 41,2 %, and 46,7 % respectively.

Table 7
Production, consumption, and export of energy resources in Russia, 1995-2001

	1995	1996	1997	1998	1999	2000	2001
Oil, mln.tn.							
Production	306.8	301.3	305.6	303.4	305.0	323.2	348.1
Export, total	122.3	126.0	126.9	137.1	134.5	144.5	160.4

Export to non-CIS countries	96.2	105.4	109.8	117.9	115.7	127.6	137.8
Export to CIS	26.1	20.6	17.1	19.2	18.8	16.9	22.6
net export	113.8	117.2	119.0	129.2	128.5	138.7	155.4
Domestic consumption	150.4	131.3	132.2	125.1	120.5	123.0	124.0
Net export in % to production	37.1	38.9	38.8	42.4	42.1	42.9	44.6

Table 7 (cont'd)

	1995	1996	1997	1998	1999	2000	2001
Oil products, mln.tn.							
Export, total	47.0	57.0	60.6	53.8	56.9	61.9	69.0
Export to non CIS countries	43.5	55.0	58.4	51.2	53.9	58.4	66.4
Export to CIS	3.5	2.0	2.2	2.6	3.0	3.5	2.6
Net export	42.6	54.4	56.6	51.0	50.3	61.5	68.7
Oil and oil products, mln.tn.							
Clear export of oil and oil products	156.4	170.0	173.4	178.3	184.5	200.2	224.1
Net export of oil and oil products in % to oil production	51.0	56.4	56.7	58.8	60.5	61.9	64.4
Natural gas, mln.tn.							
Production	595.4	601.1	571.1	591.0	590.7	584.2	581.5
Export, total	192.2	198.5	200.9	200.6	205.4	193.8	179.3
Export to non-CIS countries	121.9	128.0	120.9	125.0	131.1	133.8	130.7
Export to CIS	70.3	70.5	80.0	75.6	74.3	60.0	48.6
Net export	188.3	193.9	196.4	197.6	201.3	189.7	175.3
Domestic consumption	407.1	407.2	374.7	393.4	389.4	394.5	406.2
Net export in % to production	31.6	32.3	34.4	33.4	34.1	32.5	30.1
Totals							
Oil and gas production, mln.tn..	842.7	842.3	819.6	835.3	836.6	849.0	871.5
Net export of oil, oil products and gas, mln. t....	325.9	344.5	350.2	356.1	365.7	370.9	381.9
Domestic consumption of oil and gas, mln. t...	516.8	497.8	469.4	479.2	470.9	478.1	489.6

Net export of oil, oil products and gas in % to oil and gas production	38.7	40.9	42.7	42.6	43.7	43.7	43.8
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Source: State Statistics Committee, RF Ministry of Energy, State Customs Committee of the RF, IET estimates.

—At the same time, unlike the situation in 2000, the increase in domestic demand didn't lead to the rise in oil and oil product's prices in the home market (on the contrary, there was a downturn both in real and nominal terms), which was an evidence of some overproduction of oil in the country. The domestic prices for oil in dollars fell from \$56-58US/tn. at the beginning of the year down to \$49,9US/tn. in December. The petrol price, which reached a peak of \$200US/tn. in IV Quarter, 2000, exhibited a pronounced falling tendency during the whole year and till December dropped to \$151,1US/tn. As a result, the domestic price for petrol fell below the pre-depreciation level (Table 8). It resulted in the considerable gap between the levels of domestic and world market prices for oil displayed during the whole year. The correlation between domestic oil prices (producer's prices) and export prices accounted for 33-34% during three quarters. In IV Quarter, due to the fall in world market prices the correlation between domestic and export prices grew up to 40-42%.

Table 8
Domestic prices for oil, oil products and gas, in dollars, 1997-2001

(average wholesale prices of production companies, \$/tn.)					
	1997 Dec.	1998 Dec.	1999 Dec.	2000 Dec.	2001 Dec.
Crude	63,1	16,4	37,0	54,9	49,9
Gasoline	169,6	63,4	171,9	199,3	151,5
Diesel	170,0	52,9	125,0	185,0	158,5
Black oil	73,8	22,0	46,1	79,7	47,1
Gas, USD. Thos. cub.m.	6,6	2,1	2,2	3,1	4,8

Source: calculated upon Goskomstat data

Total export of oil and oil products increased from 206,4mln.tn. in 2000 up to 229,4mln.tn. in 2001 or by 11.1% (there was a rise in oil export by 11% and in oil products by 11.5%). Within the structure of oil export the share of crude oil export accounted for 70% of total export of oil and oil products. The major part

of oil export fell to the share of diesel oil and fuel oil. In 2001, the share of export in diesel oil production was 51.8%, fuel oil's share was 19.6%, and motor petrol's share accounted for 12.9%. There was a decrease by 7.5% in natural gas export (mostly resulting from the supply reduction for CIS countries). Most part of energy supply (86% of oil, 96% of oil products, and 73% of gas) was provided for the countries outside CIS.

During I-III Quarters 2001, the growth of physical export volume actually allowed to compensate for some downturn in oil prices in the world market relative to the previous year. Thus, gross revenues received from oil export in January-September, 2001, rose by 3.7% as compared to the relevant period of the previous year in spite of the decrease in world market prices. It allowed for keeping a high level of the oil sector ratio to Russian export (oil and oil product share in Russian export accounted for almost 35% in 2001, 33.2% in 2000).

Alongside with that, owing to the ruble depreciation and high prices in the world market, the decline in light oil products import, which had begun at the end of 1998, continued. At the same time the decline in import slowed down. Thus, motor petrol import in 2001 fell by 27% relative to the previous year (in 2000, by 56%), while the import ratio to total petrol production dropped by 0.4% (compare: in the first half of 1998, i.e. before the depreciation, the import ratio to total petrol production accounted for 8.7%).

The analysis of Russian oil export dynamics over a long-term period shows that in spite of tending to increase, total clear export of oil and oil products still remains much lower than that of the end of 1980-s, the beginning of 1990-s; it fell by 9%, i.e. from 246,3mln.tn. in 1990 down to 224,1mln.tn. in 2001. At the same time, the sharp decline in domestic oil consumption (by our estimates, it dropped from 269,9mln.tn. in 1990 to 124mln.tn. in 2001, i.e. more than twice) resulted in the increase in oil and oil products export ratio to total oil production from 47,7% up to 64,4%. Owing to the decline in clear gas export observed over the last two years, its level in 2001 practically returned to the level of the beginning of 1990-s, albeit the ratio of clear export of gas to gas production is still a little higher than that of the pre-depreciation period (30.1% against 28%).

The total clear export of oil, oil products and gas still remains at a lower level than that of 1990. By our estimates, the ratio of this variable decreased from 407,7mln.tn. of oil equivalent in 1990 down to 381,9mln.tn. of oil equivalent in

2001, i.e. by 6.3%. At that, clear export ratio to the total production of oil and gas grew from 37.3% to 43.8%. From this viewpoint we can declare the augmentation of export orientation in oil sector as compared to the Soviet period, though we should keep in mind that it has nothing to do with the increase in absolute export volume but with the decline in output of carbohydrates resulted from the decrease in the domestic consumption, the downturn in supply for CIS countries, and the degradation of production conditions.

Table 9**Financial Showing in Oil Industry, 1997-2001 (as USD bln.)**

	1997	1998	1999	2000	2001 (11 months.)
Proceeds from export of oil and petroleum derivatives	21,09	13,96	18,82	34,89	31,28
Profit (balance sheet financial results)	3,52	0,60	6,32	10,42	7,64
Accounts payable outstanding (as of end of the year)	6,79	2,41	1,61	1,35	1,09
Including to the budget	2,53	0,66	0,43	0,27	0,13

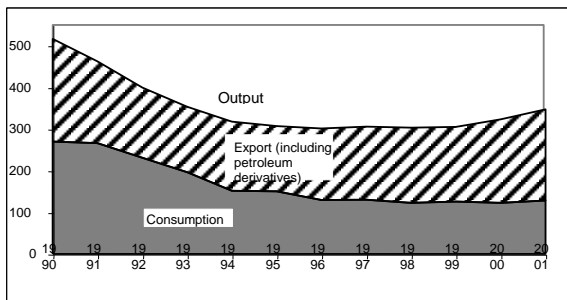
Source: calculated on the basis of Goskomstat.

The high level of oil prices in the world market in January-September, 2001, determined the high level of revenues in oil sector of economy. Total revenues (balanced financial account) of oil industry including oil-producing industry and oil-refining industry accounted for \$7,64mld US in January-September, 2001. At that, the share of oil industry revenues in total revenues of the Russian industry was 39.5% and the share in the Russian economy, as a whole, was 21.6% (in 2000, the given rates were 40.4% and 27.8% respectively). Oil sector revenues provided a high level of tax revenues for the federal budget and allowed oil production companies to increase their investments and reduce the amount of their accounts payable. By the end of November, the overdue debts of oil industry to the budgets of different levels had reached a low point of 0,13bln.tn. over the last years (Table 9).—In IV Quarter, however, the situation in the oil industry got worse due to the fall in oil prices in the world market.

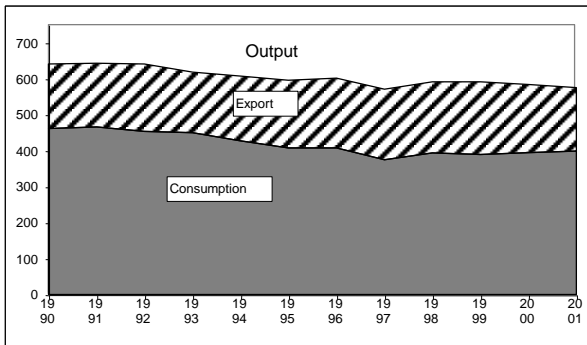
The change in major variables of oil sector development characterizing production, sale in domestic and foreign markets, prices, investment activity, and payments and accounts is reflected in Pictures 8-12.

Figure 8

Oil output, consumption and export in 1990 to 2001, as mln.t.



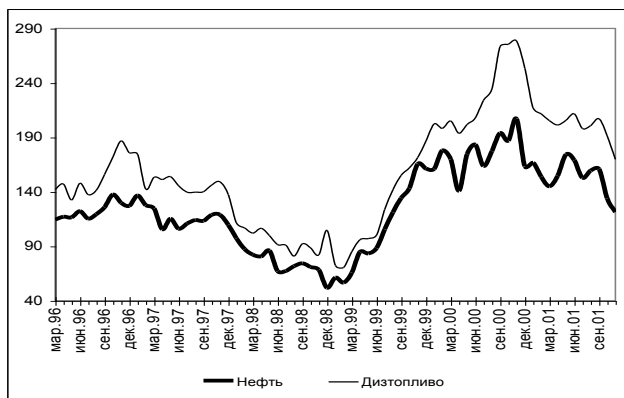
Oil output, consumption and export in 1990 to 2001 as c.m. bln.



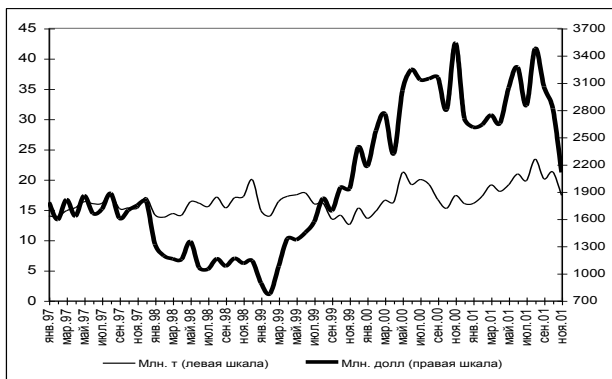
Source: Goskomstat, the RF Ministry of Energy, the State Customs Committee, International Energy Agency, Источники, ИЕТ calculations

Figure 9

Average export prices for oil and diesel fuel between 1996 to 2001, as USD/t.



Export of oil and petroleum derivatives in natural and value equivalents in 1997 to 2001, as m.t., USD. Mln.



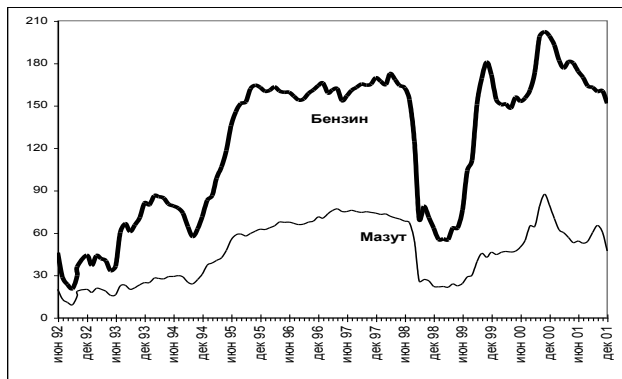
Source: calculated basing on Goskomstat data

Figure 10

Average produce prices for oil and gas in USD equivalent in 1992 to 2001, as USD/t., USD/c.m.



Average producer prices for gasoline and black oil in USD equivalent in 1992 to 2001, as USD/t.

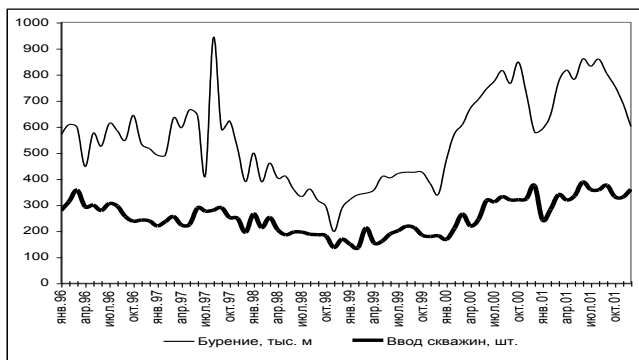


Gasoline Black oil

Source: calculated basing on Goskomstat data

Figure 11

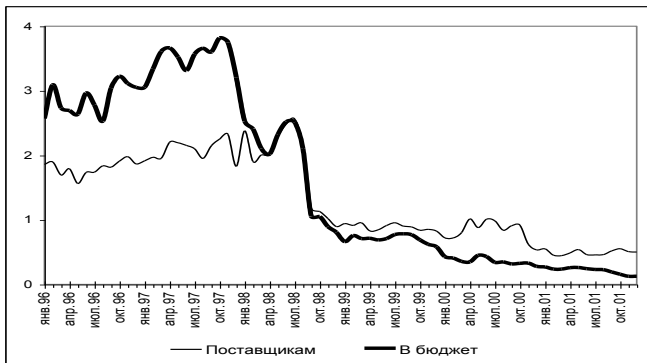
Operational drilling for oil and placement of wells in operation in 1996-2001



Drilling, thous.meters, Wells placed in operation, units .

Source: Goskomstat of Russia

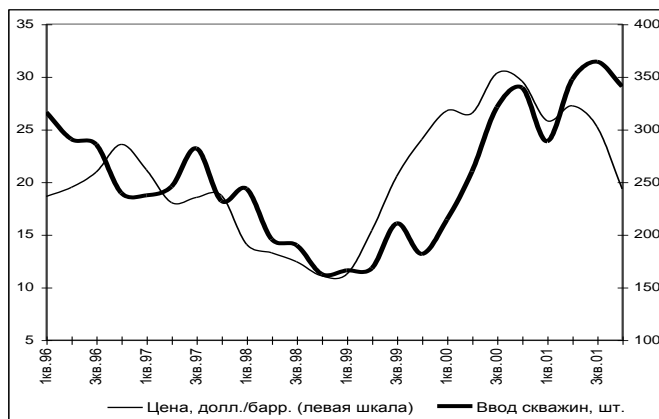
The oil sector's accounts payable to suppliers and budgets of all levels in 1996-2001, as USD bln.



Source: calculated basing on Goskomstat data

Figure 12

International oil prices and placement of new oil wells in operation in 1996-2001



Source: Goskomstat, the IMF.

The Changes in GDP formation structure in respect of revenues and economic efficiency of the production

The ruble devaluation and the increase in world market prices for Russian export goods effected changes in the dynamics and structure of GDP formation in respect of revenues in 1999-2000. In 2000, total revenues in economy accounted for 1186,8bln.rbl., which is 1.62 times more than those in the previous year. However, in 2001, the situation changed.

The revenue dynamics, as viewed since the beginning of 2001, was marked by gradual slowing down in all economic sectors from 124.5% in January to 92.8% in January-November, while in industry the rates were falling from 104.5% to 83.6% respectively. In January-November 2001, the balanced financial account totaled 1030,7bln.rbl., inclusive of 562,4bln.rbl. in industry. The

income rates in industry dropped from 18.0% in 2000 down to 14.1% in 2001. Such a decline in income rates was determined by the increase in production costs resulted from a rise in wholesale prices and physical resources rates, the changes in prices for industrial output being smooth and wages growth rates being higher than those of final product prices. Besides, relative depreciation of the foreign market's state in respect of some Russian export items also affected the income rates. In the event that the given tendency develops, we will hardly be able to account on the increase in investments. Moreover, it should be noted that, according to the annual totals, the revenue share in total investments allocated for manufacture development has grown. It reflects some changes in priorities and motivation of economic activity. Domestic manufacturers associate prospects for expansion and preservation of the positions they hold in the domestic and foreign markets with technical innovations and re-equipment of the production facilities. Out of total number of innovation-oriented manufactures almost 1/5 manufactures assume physical costs reduction, the decrease in power consumption and replacement of outdated products to be the targets of prospective development, and almost 1/3 aim at the increase in quality and conformity with modern standards.

If in 2000 the rise in investment demand was based upon the increase in revenues of export-oriented industry's sector, in the current year the investment revival is fostered by investment and consumption industries and non-manufacturing businesses. Whereas the revenues of fuel industries fell by 17.5% as compared to January-November 2000, and in metallurgy the decrease was twice as much, in the engineering industry the revenues grew by 19.3%, in the construction materials industry they rose by 37.2%, and in the construction industry by 27.5%. The peculiar feature of investment demand consists in its structural shift to engineering industry products, which supported manufacturing equipment production simultaneous with the increase in demand for construction services.

There is no doubt that the tendency to the slowing down of the inflation proved to be a positive factor facilitating business activity.

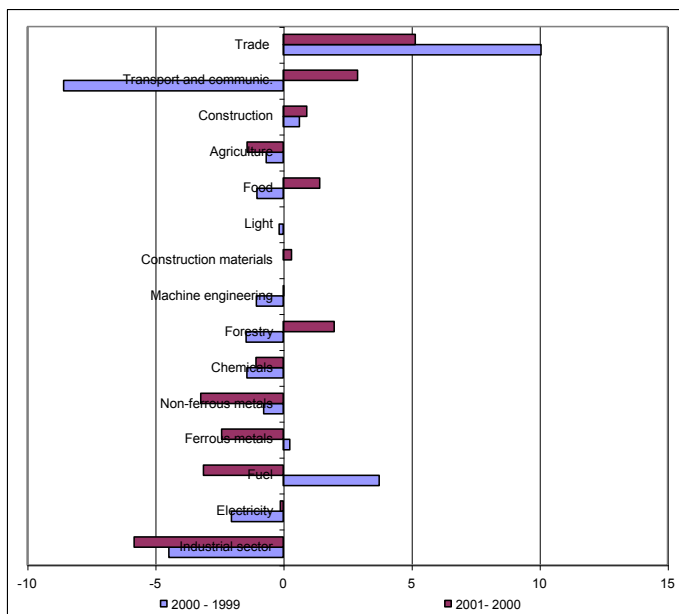
Output growth and a rise in revenues have provided the improvement in manufacture accounts structure, as well as the increase in tax revenues received by the budget system. The share of clear production tax and import tax in GDP grew by 1.5% as compared to 1998.

Subject to the exceeding output growth rates in the construction and market infrastructure industries, the share of industry in total revenues of all economic

sectors fell to 43.6% against 60.4% in 2000. The major point of structural changes in industry gross revenues in 1999-2000 consists in the increase in the latter within fuel industries and raw materials industries. By estimates, the producing industries share and primary processing share in industry revenues rose by almost 35.0%.

Fig.13

Change in the structure of balance financial results across sectors of the economy and the industrial sector between 1999 to 2001, as % to the prior year



The sufficiently high level of output profitability in export-oriented producing industries and raw materials primary processing manufactures is determined

by the state of the world market. Under the current correlation between domestic and world prices, a considerable part of the revenues received due to the increase in ruble prices for the product, which was sold for foreign currency, turns into income. Last year, owing to the change in prices in the world market, the fuel industry share in total currency revenues transferred to companies' running accounts dropped to 17.1% against 21.8% in 2000, however, the share of ferrous metallurgy grew up to 18.9% against 6.0%. If in 2000 the two industries shared 27.8% of total currency revenues transferred to running accounts, in 2001, their share accounted for 36.0%. The tendency to the exceeding increase in intermediate goods prices, if compared to final goods growth rates, was developing in the same direction in the domestic market.

Table 10
GDP formation structure relative to revenue source, in % to total

	1995	1996	1997	1998	1999	2000	2001
GDP – total, including:	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Labor compensation, including hidden one	45,2	49,6	50	47,2	40,6	40,2	44,9
Net taxes on production and import	11,9	13,5	14,5	15,1	16,1	17,1	16,6
Gross profit of the economy and gross mixed revenues	42,9	36,9	35,5	37,7	43,3	42,7	38,5

Source: Goskomstat, the RF Ministry of Economic Development and Trade

Subject to the current profitability, fuel and metallurgy industries have an opportunity to facilitate intensive investment activity by employing their own funds and exploiting internal and external credit resources.

For processing industries oriented to the home market the situation is less favorable. Whereas the material costs level is high and the profitability is low, the industries are being affected by the deficit in own working capital, which has its impact upon the level of manufactures' paying capacity and investment activity.

The comparison of structure and dynamics of output rates, investments, and labor displays overall reallocation of resources within a limited number of capital-intensive producing and raw materials primary processing industries.

It should be noted that in 2000-2001 there was a slight increase in employment within oil producing and oil refining industries, as well as in ferrous and non-ferrous metallurgy. At that, the production was growing against the background of augmented differentiation between remuneration of labor in producing and processing sectors of industry.—It resulted in the decline in the remuneration of labor in processing industries and non-manufacturing businesses. Taking into account that processing industries and non-manufacturing businesses employ almost 90% of economically active population and employees' wages equal 80% of the total income of the population, low paying capacity of the given categories of citizens appears to be an essential factor constraining economic growth rates.

In 1999, the revenues in major economic industries increased almost three-fold on the rise of ruble devaluation, while nominal payroll grew by 1.4 times. In 1999, the share of gross income of economy in GDP rose up to 43.1% against 37.7% in 1998, while the share of remuneration of wage earners dropped relatively down to 40.9% against 47.2%. In 2000, income growth rates exceeded wage growth rates by 1.2 times. Under the policy of restrained population income growth and the development of consumption prices as compared to producers' prices in industry and construction, the share of wage earners' remuneration in GDP remained at approximately the same level in 2000 relative to the previous year. In 2001, subject to pursuing active social policy, the wage growth rates exceeded income growth rates by 1.3 times. In 2001, the tendency to the increase in remuneration of labor clearly revealed itself within the GDP structure.

The changes in the labor-market situation and growing confidence of the population in new employment opportunities had a positive impact upon social and physiological atmosphere in 2001. During 2001, the number of the unemployed as estimated by ILO decreased by 0,6mln people and accounted for 6,4mln people at the end of the year. The number of vacancies submitted by manufacturers to the employment agencies accounted for 887,000 people at the end of 2001 against 751,000 people in December of the previous year. The burden imposed by the unemployed population on one vacancy was relieved.

GDP: factors and tendencies

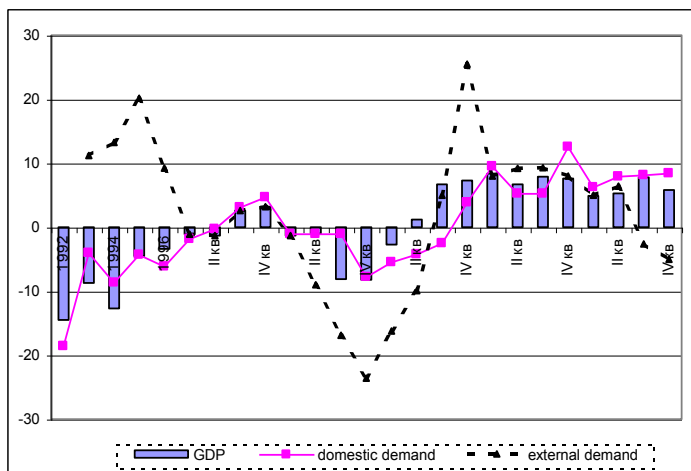
External demand

Actual growth rates of real economy sector considerably exceeded the level of planned variables, which had formed the basis of the budget for 2001. The exceeding growth in domestic demand in relation to external demand appears to be one of the main features of the economy development in the current year. The share of domestic demand in the GDP structure rose up to 86.7% in 2001 against 79.6 % in the previous year.

The increase in domestic businesses' activity allowed for assumption that the GDP growth in 2001 would be within the range of 103-104% other things being equal. However, in spite of the relatively less favorable state of the world market in respect of raw and fuel energy resources, if compared to 2000, the dynamic development of domestic demand served as additional incentive to domestic economy growth. The comparative analysis of the changes in the GDP structure and dynamics in the period of reforms shows that, if the external demand growth revealed itself as a factor compensating for the shrinkage of the domestic market in 1992-1996, in the following years the situation changed.

Figure14

Change in dynamics of GDP, domestic and external demand in the national economy in 1992-2001, in comparable prices, as % to the respective period



Source: IET calculations basing on the data of Goskomstat and the RF Ministry of Economic Development and Trade

The distinctive feature of Russian economy growth in 1999-2001 consisted in the simultaneous increase in both domestic and external demand. In the course of open market economy development, the influence exerted by external factors keeps growing. On the one hand, almost twofold decline in import, if compared to the pre-crisis period, provided space for intensive expansion of domestic production and rise in the income of goods manufacturers and services producers. On the other hand, export revenues had a strong impact upon the changes in the dynamics and structure of final demand in the economy.

Table 11**The change in the dynamics of GDP performance, by constituents, in % relative to the previous year**

	1998 r.	1999 r.	2000 r.	2001 r.
GDP	-4,9	5,4	9,0	5,0
Spending on final consumption by:	-1,5	-2,4	7,4	6,2
households	-2,4	-4,4	9,3	8,7
Public entities	0,6	3,0	1,4	-1,0
Gross accumulation	-28,7	8,5	31,9	17,0
Capital assets accumulation	-11,2	2,4	15,0	6,5
Net export	111,0	72,3	-6,2	-10,1
export	-0,3	9,4	8,7	2,0
Import	-11,0	-15,6	12,7	8,6

Source: the RF Ministry of Economic Development and Trade, the RF Customs Statistics of Foreign Trade

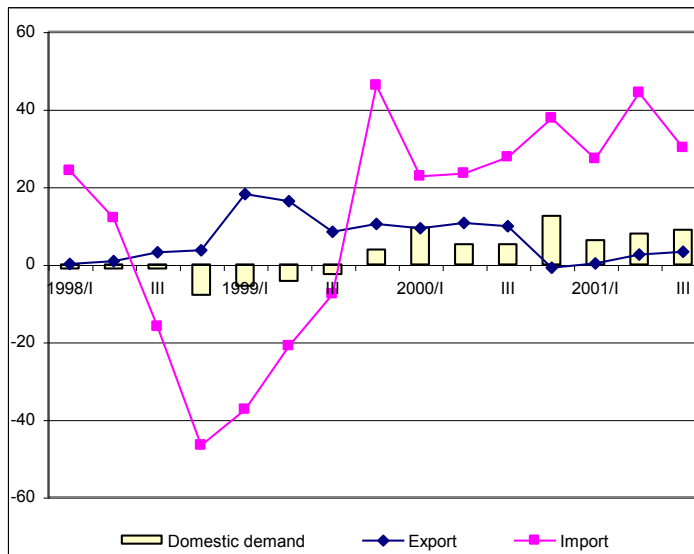
When analyzing the sustainable state of the Russian economy, it should be emphasized that the correlation between external factors, which determined the output growth in 2000 and 2001, was different. If in 2000 the increase in prices for energy carriers and non-ferrous metals in the world market was the major factor of output growth, in 2001, there was a gradual decline in external factors' effect. Since 2000 the exceeding growth rates of physical import volumes have been fixed again, if compared to the export dynamics and GDP performance. At that, the decline in growth rates of physical export volumes by the end of 2000 could be explained by the state of the world market of raw materials, as well as the intensive import growth over 2001 was connected with purely domestic problems.

The analysis of trading sector development allows us to state that it has failed to make new goods niches for domestic output both in the world and home markets. The increase in domestic demand in 2000-2001 fostered by export-oriented industries was based upon inertial output growth within a rather narrow sector of national economy.

One of the reasons for low competitiveness of domestic products is that economic growth used to be oriented mostly to the increase in the utilization and

employment of spare production capacities for production purposes. The fact that no sufficient changes resulted from the employment of new production capacities didn't allow for successive implementation of import substitution policy and diversification of export flow. Since the beginning of 2000, the enhancing tendency towards increase in import share has been observed within the structure of goods stock in the consumer market and the materials and machinery market. As a result, by estimates of the RF Ministry of Economic Development, clear export accounted for 89.1% in 2001 relative to the level of the previous year. For the Russian economy it is an alarming signal since, as a rule, the decline in clear export results in the decrease in economy growth rates.

Figure 15
Change in dynamics and physical volume of export, import and domestic demand in 1998-2001, as % to the respective period of the prior year



Domestic demand: final consumption

The growth in economy income exerted a considerable influence upon the proportions of final consumption in GDP. In 2000-2001, among all the elements of final GDP usage the accumulation of stock capital was growing at the highest rates. Subject to the increase in business activity, the investment demand growth provided almost ¼ of total physical GDP volume growth. But in reallocation of GDP resources in favor of the investment constituent the tendency towards the decrease in the expenditure share in final consumption of material comforts and services keeps growing.

Table 12.

The structure of GDP usage in 1998-2001, quarterly, % to totals

	1999				2000				2001			
	кварталы											
	I	II	III	IV	I	II	III	IV	I	II	III	IV
GDP, consumed	100	100	100	100	100	100	100	100	100	100	100	100
Spending on final consumption by	74,7	67,9	61,2	71,3	63,6	62,5	56,8	67,0	64,8	66,8	60,3	65,1
households	61,4	50,6	46,7	51,1	48,1	45,0	42,3	49,2	49,9	48,1	45,6	49,6
Public institutions	11,1	14,9	12,6	17,7	13,7	15,3	12,7	15,5	13,0	15,9	12,7	14,9
Gross accumulation	10,9	17,9	24,0	6,9	12,0	16,5	26,0	13,1	16,1	19,6	28,3	22,0
Gross accumulation of capital assets	13,4	13,9	15,5	19,4	12,7	16,0	18,2	23,4	14,3	17,6	19,2	17,7
Net export	14,4	14,2	14,8	21,8	24,4	21,0	17,2	19,9	19,1	14,0	11,4	12,9

Source: preliminary data of the RF Ministry of Economic Development and Trade, Goskomstat

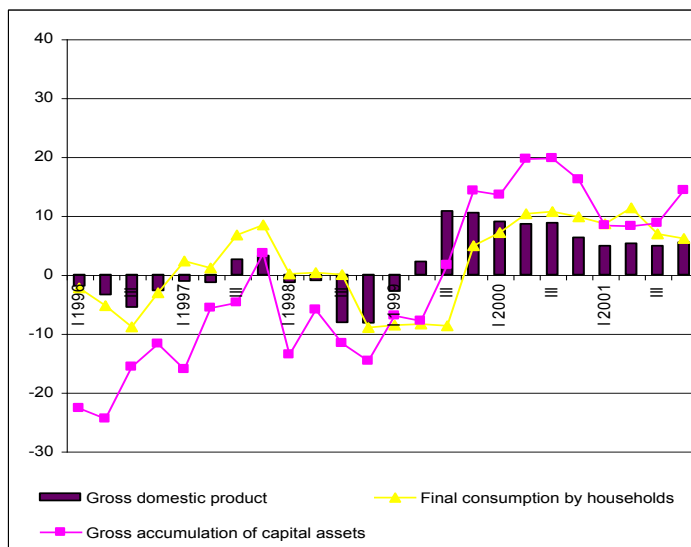
In 1999, the production was expanding against the background of low consumption demand resulted from a dramatic fall in population's spending due to

ruble devaluation. Real income of the population in 1999 accounted for 72.2% relative to the pre-crisis level of 1997. The current level of solvent demand in the consumption market limited the possibilities of further increase in goods and services production. As a result, the total final consumption spending dropped by 3.5% during the year. In the given situation the successive implementation of governmental policy aimed at the increase in wage and pensions had a positive impact upon the character of economic development. Since IV Quarter 1999 the dynamics of final consumption spending of households is characterized by sustainable tendency towards growing. The shift in priorities of economic policy towards increase in domestic demand was initiated by the changes in the state of the world market.

The increase in economy income gained from the export exerted a considerable influence upon the character and proportions of production and final consumption. The growth potential created by means of intensive investment activities, as well as business revenue growth allowed for solving accumulated social problems.

Figure 16

Change in dynamics of consumption of GDP across components of GDP between 1996- 2001 in comparable prices, as % to the respective period of the prior year



In 2001, with regard to a regular tendency towards an increase in wage and pensions, real income of the population grew by 5.9%. The share of final consumption spending increased by 3.7%, which was fully motivated by a dramatic rise in total for household spending. Almost 3/5th of the 2001 GDP growth ratios are accounted for by the increased consumption spending. The analysis of the Russian economy dynamics as observed throughout the last decade proves remarkably that household consumption spending attained the pre-reform 1991 level under the situation. The share of those raising a lower income than the average for the living wage decreased by 15.0% as compared to III Quarter, 2000. Taking into account the growing income in IV Quarter including the risen public employee payroll ever since December 1, 2001, poverty leveled 24.2% of total population as opposed to 26.9% in 2000.

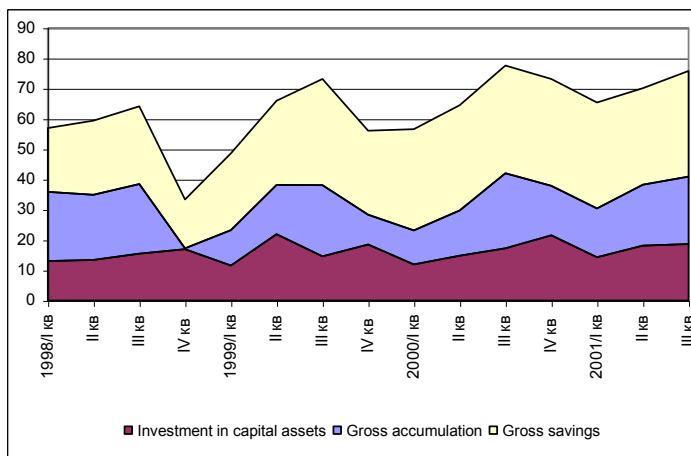
The dynamic retail turnover growth and the increase in domestic consumer goods output serve as the best evidence of positive changes in living standards of the population. In 2001, final consumption spending growth in households is estimated at the level of 8.1%. If compared to 2000, retail turnover grew by 10.8%. Along with population income rise, the non-foods consumption is rapidly increasing. Retail turnover for foodstuffs rose by 7.4% in 2001 as compared to the relative period of the previous year, and the non-foods turnover grew by 13.7%. While consumption performance is being gradually restored, trade businesses turnover is exceedingly increasing as compared to the retail turnover in food and non-food markets. Intensive consumer demand growth had a positive impact upon the dynamics of retail profitability and investment within the given sector of economy.

The favorable state of the domestic market fostered the motivation for production growth and expansion. The 1999 to 2001 economy revenue growth provided meeting such liabilities as are necessary for timely financing budget expenditures and managing the national debt resorting to no unbudgeted loans in either the domestic or foreign assets markets. The increased investment in stock capital still retains a dominant impact upon production performance. The GDP gross savings share steadily exceeds the level of 2000.

Despite the investment positive dynamics, it still proves insufficient to pursue an active industrial policy, with regard to the technology, reproduction and age structure of stock capital formed. Taking into account the high income concentration common for export-oriented sector and the absence of any mechanisms for inter-sectoral capital flow, it is hardly reasonable to expect any radical changes in structure of stock capital reproduction. The situation within investments sector is affected by the fact that economy needs not only the augmentation of investments but also guidelines for investments strategy aimed at the industries, which traditionally lack competitive production capacities. Industries with production capacities deficit, such as oil refining industry, chemical industry, ferrous and non-ferrous industries, engineering, food and light industries, appear to be most vulnerable. The dearth of a developed mechanism of capital flow and turning savings into investments proves to be a factor constraining economic growth rates.

Figure 17

The shares of gross savings, gross accumulation and investment in capital assets in GDP between 1998 to 2001, as % to result



Domestic demand for investments

The distinctive feature of 2001 consists in the exceeding investments growth if compared to GDP performance. The sustainable positive production performance and the increase in external and domestic demand have changed the situation in investment sector. Subject to profitability growth, businesses started up a more intensive allocation of moneys for implementation of investment projects. The investment performance is a striking evidence of contradictive totals for 2000-2001.

The investments growth in 2000-2001 resulted mostly from favorable external conditions for Russian exporters. Consequently, the share of fuel-energy industries and transport in the structure of the investment spending on stock capital reproduction is rising. The investments demand growth revealed that domestic engineering industry is quite incapable of filling in the market with material and

technical facilities of high quality. A considerable reason for limited industrial growth consists in the dearth of modern equipment. The rise in competitive import of machines and equipment has become characteristic of 2001, while the tendency to purchasing second-hand technical facilities has been clearly outlined.

Taking into account a poor investment activity of the past, it should be admitted that investments in stock capital do not correspond to the real needs for re-equipment and modernization of production facilities, which affects the efficiency of economy. The problem of restructuring investments in favor of the industries producing goods and services with a higher value added, which are able to provide competitiveness for the Russian economy, has not been solved yet.

The increase in savings in economy aggravated the problem of savings transformation. Under very slow reformation performance within financial sector the share of bank capital in real sector investments remains very small. Manufacturers' own assets are still the main source of investments since the mechanism of inter-sectoral capital flow and accumulation of gross savings for the purpose of development of competitive economic sectors does not work.

The investment performance was affected by low income of the population. The current level of domestic solvent demand in consumption market limited the opportunities for goods and services production to grow. Besides, the downturn in income growth rates and considerable rise in prices and tariffs for goods and services of natural monopolies began to exert negative influence upon investments activity performance since the end of 2000.

In spite of a favorable combination of competitive prices in the world market and devaluation effect, the investment climate did not change in 2001. The absence of structural reforms did not allow for balancing the cooperation between financial and real economy sectors. The instability of legal field determined high risks and unfavorable business and investment atmosphere. The dearth of legal standard acts, which might guarantee the protection of property rights, perfection of corporative management, facilitation of administrative control over the markets, and a higher transparency of economic operation, proved to be the factor constraining investment activity of both domestic private and foreign capital.

In this situation in 2001, investment activity was formed under the influence of diametrically opposite tendencies. On the one hand, the high investment growth rates and the augmentation of domestic sources of financing have been fixed, but, on the other hand, the estimates show that the capital outflow ratios in Russia have not decreased in 2001.

Under the conditions of economic growth it has become clear that investments management has not been correlated with the dynamic process of restructuring Russian economy. The formation of investment model for the development of Russian economy within long-term governmental strategy for 2000-2001 is oriented towards the elimination of the given negative factors.

2.2 The situation in the industrial sector¹

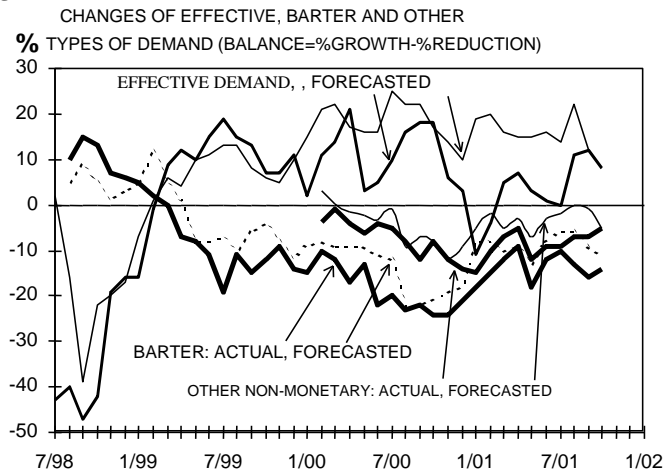
The dynamics of the principal types of demand for the industrial product in the year 2001

The year 2001 became yet another year of a relatively favorable development of domestic industry after the 1998 default. On the whole the effective demand and the industrial output were still growing, the non-monetary realization schemes continued to be displaced by other schemes, and the actual financial and economic situation of Russian industrial enterprises was being improved. However during the past year domestic manufacturers were forced to go through three unfavorable periods relating to the problems with sales. The first occurred in January-February when surveys for the first time since the beginning of the year 1999 demonstrated an absolute reduction in the sales of industrial products for money. A slowdown in the effective demand growth began as early as in No-

¹ This section has been prepared on the basis of the results of surveys involving the managers of industrial enterprises that have been conducted monthly by the IET since September 1992 and covered the whole territory of the Russian Federation. The panel includes 1400 enterprises with over 20% of the total of the workers employed in industry. The panel is biased toward large enterprises by each of the 61 specified sub-branches. This is consistent with the international practice and ensures highly representative results on the whole, on the branch and sub-branch levels. The questionnaire return rate is about 70%.

ember 2000, and in three months its growth rate fell by 29 balance points - to -11%. Only in March 2001 the sales growth rate again became positive but did not reach its previous figures. And in May a new slowing of the growth began which resulted in a complete halt in the sales growth in June-July 2001. This was the second period when the problems with sales occurred in Russian industry. As a result, the first half of the year turned out to be the worst period ever for Russian industry after the 1998 default (see Fig.18).

Figure 18



In the third quarter Russian industry overcame the negative trends that had been growing during the first half of the year. In August the dynamics of the effective demand was reversed in principle: the surveys registered an upward surge in the sales rates. Nothing like this had been seen during the preceding 9 months. The sales rate growth was noted in all the branches except for nonferrous metallurgy. But even there only a slower growth was observed, while none of the branches demonstrated an absolute reduction in the effective demand in August. In September the growth rate of the sales of industrial products for money continued to go up. The balance increased by another 4 points and reached the maximum value for the preceding 11 months. In October the growth rate of the sales of industrial products for money were demonstrating almost no changes. By the

end of the year, Russian industry for the third time experienced problems with sales. First, in November, the growth of the sales of industrial products for money was halted. The share of the responses about growing sales for money became the same as the share of the responses concerning lowering sales. At the same time, 71% of the enterprises stated that their volume of sales for money remained as before. A reduction in the monetary demand was registered in all branches except the timber, woodwork, pulp and paper and food industries. As for metallurgy, the chemical, petrochemical and construction materials producing industries, the sales for money demonstrated an absolute reduction. This situation had already been forecasted in September when the surveys reflected the most moderate expectations concerning the growth of this parameter in 2001. In December the negative trends in the dynamics of the sales of industrial products for money became even more pronounced. While in November the responses concerning the growth and reduction of sales were approximately equal in number, in December the share of the responses stating a lowered effective demand went up dramatically and became considerably higher than the share of the answers stating that the sales for money had been on the rise. As a result, during the two months the balance of responses fell by 20 points and became negative - the effective demand began to go down. And the rate of sales lowering turned out to be the same as at the beginning of the year when business activity slows down during the New Year festivities.

The beginning of the year 2002 did not bring any cardinal changes into the actual dynamics of the basic indices characterizing the situation in industry. In January the reduction in effective demand that had begun one month before continued to develop further. The rate of the reduction of this parameter increased by another 4 balance points and reached -16%. This is the worst figure as compared to the three preceding years. The growth of sales for money was preserved only in the electric power industry while in other branches the effective demand was going down. The reduction in sales was especially rapid in the chemical and petrochemical industries, ferrous metallurgy and the construction materials producing industry.

Despite the obvious slowing or halting of the growth in the effective demand, Russian enterprises were preferring to reduce the volumes of their non-monetary transactions. Throughout the year 2001 the number of the answers reflecting a reduction in barter, bill and set-off operations was greater than those reflecting their growth. This situation was occurring in all branches except the construction materials producing industry. Thus, in July a slight growth in barter was registered. At the same time the month-to-month changes of these indices

look more alarming. In the first half of the year the surveys were registering slowing rates of the reduction in barter, bill and set-off operations. In April the balances of the changes of these indices demonstrated the slowest reduction rate as far as these types of transactions were concerned. In face of the falling sales rates this looked quite natural - barter and other surrogates had already helped out Russian industry before. In May the rates of the reduction in the volumes of non-monetary transactions showed a dramatic growth (mostly due to seasonal fluctuations) but later again became slower. The most consistent changes were demonstrated by bill and set-off operations despite the resumed growth in sales for money in August-September.

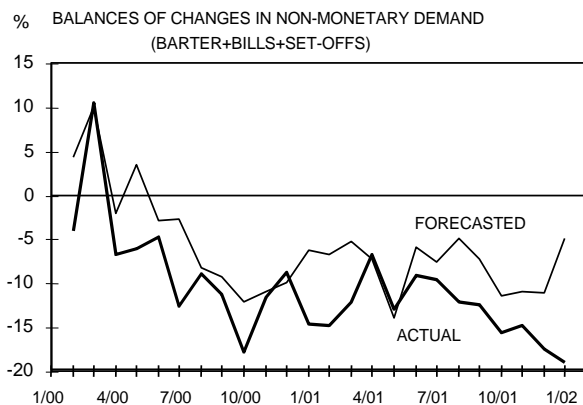
The attitude of enterprises toward non-monetary transactions also changed. Before January 2001, there had been a stable prevalence of the answers "above the norm" when estimating the barter volumes. In April 2001 the balance became negative - the enterprises began to feel the deficiency of the barter channels for realizing their completed products that had not been sold for money. The volumes of bill and set-off transactions had been considered insufficient since April 2000 (when this index was first monitored). In July 2001 the insufficiency of the volumes of these transactions reached its maximum. Only the metallurgical enterprises considered their volumes to be excessive.

On the whole, the volumes of all non-monetary operations in Russian industry continued to decrease. The summary balances of the changed volumes of barter, bill and set-off transactions relating to the sales of products can be obtained on the basis of two questions included in the monthly survey questionnaire of the IET. The first question deals only with the barter volume changes, the second - with the changing volumes of bill and set-off transactions. Let us explore a matrix of contingency $M(X_t, Y_t)$ where X_t represents the actual changes in barter demand in survey t , Y_t - the actual changes in bills and set-offs, (+) means growing index, (-) decreasing index, (=) no changes:

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

The sum of the elements above the second diagonal of the matrix defines the share of those enterprises that experienced the growth of either both types of demand or the growth of either one of them while the other remained non-decreasing. The sum under the second diagonal defines the share of those enterprises that experienced a reduction either of both types of demand or of either one of them while the other remained non-increasing. The resulting sums are analogous to the answers to the question about the changes of the summary non-monetary demand: "increased", "did not change", "decreased". Now the calculation of the traditional balances of changes is obvious (see Fig.19). On the whole, the intensity of the decrease of the volumes of non-monetary realization schemes throughout the year 2001 turned out to be more stable than in the preceding year. The balances of changes of this index stayed within the interval -10..-15%, and only in December became lower than -17%. In January 2002 the intensity of the decrease in non-monetary transactions grew even more and resulted in growing forecasts of the changes of such operations. The enterprises signal their preparedness to turn to barter, bills and set-offs once again if sales for money should go down.

Figure 19



The matrix approach to the analysis of the results of conjecture surveys makes it possible to evaluate also the interaction of the two types of demand (monetary and non-monetary) at the microlevel. In this case the matrix of contin-

gency between the questions about the changes of the effective demand and the total non-monetary demand is constructed - $M(X_t, Y_t)$, where X_t represents the actual changes in effective demand in survey t , Y_t - the actual changes in total non-monetary demand, (+) means growing index, (-) - decreasing index, (=) - no changes:

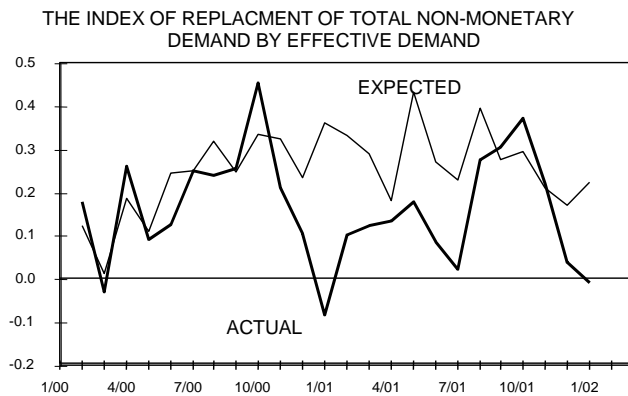
		Y_t		
		+	=	-
$M(X_t, Y_t):$	+	++	+=	+-
	=	=+	==	=-
	-	-+	-=	--

The sum of the elements above the main diagonal of the matrix defines the share of those enterprises where the effective demand replaced the non-monetary demand. The sum below the main diagonal defines the share of enterprises with a reverse replacement - of effective demand by non-monetary demand. On the basis of the extradiagonal sums the replacement index can be calculated which is analogous to the coefficient of the shift in forecasts suggested by Kawasaki and Zimmermann². The replacement index is calculated as the ratio of the difference between above-the-diagonal and below-the-diagonal elements to their sum and can acquire the values within the interval between -1 and +1. Positive values demonstrate a replacement of the non-monetary demand by the effective demand, negative values - a reverse process. The greater are the absolute values of the coefficient, the more intensive is the replacement process. The changes of the replacement index for the years 2000-2001 (when the monthly data on the dynamics of all types of demand are available) are shown in Fig. 20. The most intensive ousting of non-monetary operations in Russian industry occurred in October 2000. Then non-monetary transactions were replaced by monetary ones in 36% of the Russian enterprises while a reverse ratio was seen in 14%. After that the growth rate of the effective demand began to fall dramatically which resulted in January-February 2001 in an absolute reduction of the sales of the industrial

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

products for money. The replacement index fell by 0.53 points in three months and in January acquired a negative value – the normal monetary demand again began to be replaced in Russian industry by non-monetary transactions. In spring the situation returned to normal though not for a long time: the zero sales growth rates in June-July again dramatically reduced the intensity of the replacement of non-monetary transactions. The August leap in the intensity of sales growth revived the positive trends, and in October the most intensive replacement of non-monetary operations in the whole year 2001 was registered. The negative tendencies in the demand area produced a dramatic fall of this index in November-December. In two months the index fell by 33 points but remained positive, i.e. non-monetary operations were being replaced by normal transactions. In January 2002 the index became negative, just as it had been the year before.

Figure 20



The share of non-monetary transactions in the realization of industrial products in 2001 displayed a stable tendency for reduction, especially in the first half of the year. As a result, the share of barter, bills and set-offs by the end of the year went down to 20-25%. For cash, 75% of the product is realized (see Table 13).

Table 13

The share of cash, barter, bills and set-offs in total realization of product in the year 2001 in industry as a whole (%)

Shares of	01	02	03	04	05	06	07	08	09	10	11	12
Cash	66	71	72	71	73	75	74	73	73	75	73	76
Barter	16	13	12	14	12	10	12	11	12	11	11	9
Bills and set-offs	16	14	14	13	14	13	13	14	13	12	14	11

Source: Surveys conducted by the IET.

The leader in the ousting of barter is the electric power industry which increased the share of money from 52% in 2000 (September) to 90% in 2001 (the average for that year). The second place, as far as this index is concerned, is occupied by the construction materials industry (a growth from 31 to 57%). It can be noted that the latter value is the worst among the branch-by-branch indices in the year 2001 (see Table 14).

Table 14

The share of cash in product sales in 2001 by branches (%)

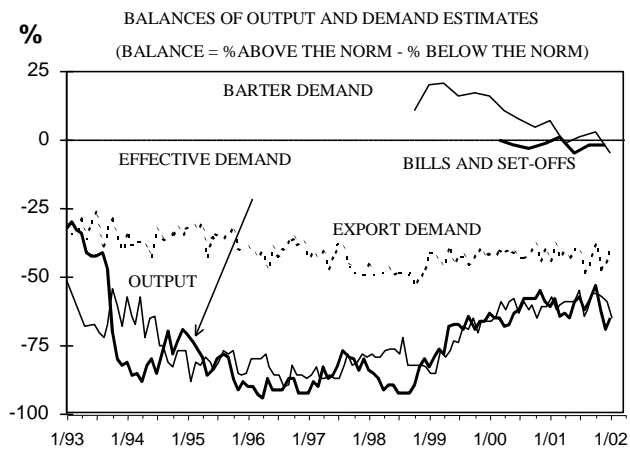
Branches	01	02	03	04	05	06	07	08	09	10	11	12
Electric Power	85	91	90	90	87	97	94	82	95	91	95	88
Ferrous metallurgy	74	74	84	84	85	79	64	76	68	86	82	89
Non-ferrous metal- lurgy	77	85	71	83	82	83	74	67	72	85	67	45
Chemical and petro- chemical	64	64	74	68	71	72	74	73	79	73	73	70
Machine-building	62	69	71	67	68	71	71	70	76	72	69	74
Timber, W/W and PULP/PAPER	65	67	66	64	70	63	68	69	61	64	62	69
Construction mate- rials	51	49	55	56	57	54	63	57	69	60	62	65
Light	68	76	72	73	75	80	78	78	82	77	80	79
Food	81	72	68	76	75	80	77	82	76	79	79	84

Source: Surveys conducted by the IET.

Thus, the problem of barter and other non-monetary surrogates which once used to be one of the most burdensome for industry as well as for society as a whole is receding into the past. The industrial growth that has already been going on with varying degrees of intensity for three years is acquiring a more and more

normal, “monetary” character. However, for several more years it will probably be impossible to do away completely with barter, bills and set-offs in the turnover of industrial enterprises. And one of the reasons for this is the tremendous industrial potential that has been accumulated in the times of planned economy is still preserved and burdens the enterprises’ management. This can be clearly gleaned from the estimates of the effective demand and production volumes made by the enterprises according to the scale “above the norm”, “normal”, “below the norm” (see Fig. 21).

Figure 21



In industry, as far as these indices are concerned, there has always been noted a stable prevalence of the answers “below the norm”. The industrial growth of the years 1999-2001 has not resulted in any drastic changes in the estimates’ ratios. Of course, by now the answers “normal” have become more numerous. In industry on the whole the share of these answers is 40%. But others (i.e. the majority) consider both the demand and output to be insufficient. It can be presumed that it is the insufficient volumes of the effective demand that force the enterprises to resort to barter transactions. To test this hypothesis we are going to apply the data on the estimates of output volumes (effective demand) and the changes in the volumes of barter transactions (actual and forecasted). The question about the volume estimates is put in the questionnaire in the following way: “How do

you estimate the current physical volume of production at your enterprise?" The variants of the answer are: "above the norm", "normal", "below the norm". The same wording is used in the question about the estimates of the physical volumes of the effective demand for products. As possible answers to the question about the changes in the barter demand, the following three variants are offered to the respondents: "growth", "no changes", "lowering". Let us consider two simple loglinear models with linear interactions between the factors included. The first one estimates the interaction between the estimates of effective demands and the actual changes of barter demand. The second model represents the interaction between the estimates of the volume of production and the actual changes of barter demand.

As the question about the changes in the barter demand was included in the questionnaire in August 1998, calculations can only be made for a short (as compared to the whole of the surveys conducted by the IET) period which regretfully for most part does not overlap with the times when barter was growing. Only the first few points in the table relate to the last months of the year 1998 when the surveys were registering a slowing barter growth in Russian industry. The models' coefficients for this period are positive which does not in any way fit our assumption because it means a decrease of barter in face of insufficient monetary demand. However from January 1999 onward the coefficients had acquired negative values and became statistically significant. In other words, since the beginning of a normal (due to sales for money) industrial growth the enterprises have been taking advantage of the barter demand in order to bring the volumes of their production to a normal level. Similar results were obtained when forecasted barter changes were applied in the calculations. In this case the peculiarities of the enterprises' behavior are expressed most graphically because the calculations include their subjective estimates of demand and output and similarly subjective forecasts (hopes, plans) of the enterprises.

The peculiarities of the industrial dynamics in 2001

The dynamics of industrial production in the year 2001, just as the dynamics of the effective demand, was of an unstable character. Until the end of last year the enterprises had been maintaining high production growth rates although sales growth began to slow down as early as in November-December 2000. But nevertheless in January 2001 the manufacturers were forced to correct their output rates because there has already occurred an absolute reduction of the sales of industrial products. By March the surveys had registered the resumption of the former high rates of production growth. In April the rates went down, and in May

became zero. After the May holidays the output growth rates began gradually to go up, and in September again acquired rather high values. Production had not been displaying such rapid growth for the 6 preceding months. The rates of output growth increased in all branches except metallurgy and the construction materials producing industry. This rapid output growth resulted in dramatically improved estimates offered by the enterprises as regards their output volumes. The share of the “below the norm” answers fell to 56% which represents the best value out of all the 112 surveys conducted since March 1992. In “the worst times” the share of such answers was 91%.

Despite the dramatic reduction in the sale of products for money, in November the industry continued to boost up its output. Production growth rates increased by several points as compared to October. However in December the enterprises reacted to a reduction in demand. During the month the output growth rate went down in the industry as a whole by 21 balance points. Production growth in December as registered by the surveys occurred only in the electric power, fuel, machine-building, timber, woodwork and timber and pulp and paper industries. In other sectors output was decreasing.

The effective demand remained in the year 2001 the principal type of demand defining the output changes in industry. This is demonstrated by testing the loglinear models where the interaction between the changes in output and the three types of demand (effective, barter and other non-monetary) was studied. Insofar as the question about the dynamics of the transactions involving bills and set-offs was included in the questionnaire only in February 2002, calculations involving all the three types of demand can be made only for the two past years. Both the data on the actual changes of the indices in question and the forecasted data are tested. In the latter case the analysis is focused on the preferences expressed by the enterprises.

The first model with the participation of the actual changes of output and demand had a high quality of fitting: the observed significance level on the average was 0.6284 and in some cases reached 0.99. The model's coefficients were always positive and statistically significant only for the effective demand. The non-monetary types of demand had sometimes positive and sometimes negative coefficients which always (except in February 2001) were statistically insignificant. Thus, Russian industrial enterprises during the past two years have been persistently orienting their output at a normal monetary demand. The surrogate types of demand no longer have any influence over the output dynamics in Russian industry.

The second model applying the forecasts made by the enterprises had a similarly high fitting quality (on the average 0.5448). The only exception when the significance level went below 0.05 was the period of September-November 2000. As in the first model, the coefficients were always positive and statistically significant only for the forecasted effective demand. Other types of demand do not influence the forecasted outputs of the enterprises.

As the dynamics of the barter demand for industrial products has been followed by the surveys since August 1998 the influence of the two types of demand (effective and barter) on output can be estimated over a longer period of time. The models utilizing money and barter had a lower fitting quality than those utilizing all the three types of demand. The observed significance level only very rarely and slightly exceeded the threshold of 0.05. The model's coefficients were always positive and statistically significant only for the effective demand. The coefficient for the barter demand had both positive and negative values and over time tended to lose statistical significance. The values of the latter were lower than the coefficients for the effective demand. Thus, even within the framework of this truncated model the assumption about a "normal" (monetary) character of production in Russian industry cannot be overruled. At least for the past three and a half years Russian enterprises have been orienting their output (both actual and forecasted) toward the effective demand.

Yet another model capable of demonstrating the peculiarities of the behavior of Russian industrial enterprises connects the forecasted changes of the employment rate (a dependent variable) to the forecasted changes of demand (independent variables). The forecasts of the employment rate to a certain extent reflect the presence of excessive employment in Russian industry. In the year 2001, 10% to 20% respondents believed that the number of the employed was more than enough as far as the expected effective demand for their products was concerned. And this occurred despite the fact that beginning with the second quarter of 1999 positive forecasts of the employment changes have been registered, i.e. the enterprises have been planning to hire more staff. Thus, the enterprises preserve excessive numbers of some categories of employees and insufficient numbers of others needed for manufacturing their vendible products. It is hiring the latter that became necessary for Russian enterprises in the past three years. If this assumption is true the plans for increasing the numbers of the employed must be correlated to the forecasted increases of the effective demand.

The fitting quality of the model which includes the forecasted changes of the employment rate and the forecasts of all the three types of demand has turned out to be very high. The observed average significance level was 0.7096 for the past

seven months and in the past three quarters never went down below 0.9. The model's coefficients were positive and statistically significant only for the effective demand. The non-monetary types of demand had both negative and positive influence on the forecasts made by the enterprises, this influence always being statistically insignificant. I.e. the assumption about the normal market nature of the plans to hire employees in Russian industry cannot be rejected on the basis of the results demonstrated by the surveys conducted.

A more lengthy succession of observations on the dynamics of barter demand has allowed us to estimate the effect of the forecasts of the effective and barter demands as seen since the end of the year 1998. Now the model incorporated the forecasts of the changes of the employment rates and the forecasts of two types of demand. The fitting quality in most cases turned out to be unsatisfactory and only on three occasions exceeded the threshold of 0.05. Again, only the coefficients for effective demand were found to be always positive and statistically significant. The forecasts of barter had both negative and positive influence on the forecasts of the employment rate, sometimes were statistically significant and always susceptible to the influence of sales for money.

The current industrial growth and the high percentage of enterprises with excessive (as compared to the expected demand) capacities have emphasized the question about the quality of the industrial growth. In other words, by means of which particular capacities the production growth has been achieved by Russian enterprises after the 1998 default. If this has been done by utilizing the old machinery installed back in the Soviet times that had been temporarily out of use during the 1990s, then we witness the growing output of clearly non-competitive products. They can be sold, of course, under the conditions of a low exchange rate of the rouble and availability of low-income consumers. But it is quite another matter if the production growth is achieved by utilizing some new machinery. In this case Russian industry increases the competitiveness of its products and to a lesser degree depends on the national currency exchange rate.

To test the hypothesis on the quality of the post-crisis growth in Russian industry, let us utilize the data on the plans for production changes, actual purchases of machinery and equipment and current production estimates provided by the surveys. The first and the third of the above-mentioned variables can be traced throughout all the monthly surveys conducted by the IET. The question about the actual and expected purchases of machinery and equipment was included in the questionnaire in 2001 and since then has been offered quarterly. Therefore our calculations will be limited to the past year only. Within the framework of this model we intend to assess the dependence of the planned output changes (a de-

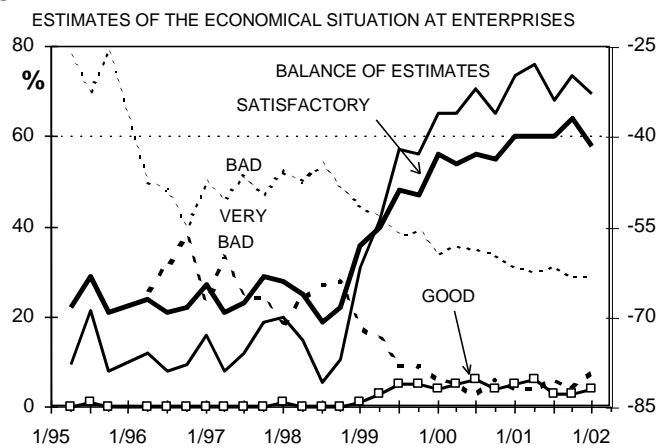
pendent variable) on the previous actual purchases of equipment and the estimated current output. The presence of a positive connection between the purchases of equipment and the planned output increases would mean output growth at the expense of new equipment and production of more competitive goods. If the planned production increase is defined mostly by the dissatisfaction of an enterprise by the level of utilization of its existing capacities it would mean an increased output of non-competitive products by means of old equipment.

The estimates of this model were made for the four quarters of 2001, and in the majority of cases the observed significance level was above the threshold of 0,05. The model's coefficients were always positive and statistically significant for the purchases of equipment. The output estimates always had negative coefficients which were not statistically significant in the first quarter of 2001. Thus the actual direction of the influence of the two factors under study on the productions plans is the same as forecasted. Output growth in Russian industry is based both on the purchases of new equipment and on the utilization of the machinery that has been temporarily out of use. However insofar as the absolute level of the coefficients of the first factor is higher it can be said that the enterprises nevertheless make plans for increasing their output to a greater extent on the basis of new equipment than on utilizing old machinery.

The actual financial and economic situation at Russian industrial enterprises

The financial crisis of 1998 has changed the situation in the Russian industry in principle. For the first time since 1993, the surveys registered an absolute growth of the effective demand and a decrease of barter, and for the first time a prolonged and relatively stable production growth began. And, most importantly, the financial and economic situation (FES) at the enterprises has changed in principle. The share of the answers "satisfactory" became three times higher having increased from 20 to 60% (see Fig. 22). Only 8% of the respondents in the year 2001 were expecting the situation at their enterprises to become worse. And none of the respondents expected any critical deterioration of the situation.

Figure 22



The estimates made by the enterprises as regards their financial and economic situation during the independent surveys, in our opinion, has provided the most accurate reflection of their situation. This circumstance is very important under the present conditions in Russia since the official reports submitted by enterprises are not reliable because of intentional or unintentional distortions, and their utilization may result in incorrect conclusions³. The results of one of the special surveys conducted by the IET in 2000 have already confirmed this stipulation⁴. A quarter of the enterprises surveyed were then able to clearly admit that their official reports (on the whole) did not reflect their true situation, and they knew it for sure. Since in the year 2000 this question was concerned about the full scope of reporting on the part of the enterprises, in the commentaries it was

³ See, for example, Earle, J.S. and Estrin, S. (1998), 'Privatization, Competition and Budget Constraints: Disciplining Enterprises in Russia' SITE Working Papers No 128, March, Stockholm; Moers, L. (1999), 'What Determines Enterprise Performance in Russia? A Survey of the Evidence', Tinbergen Institute Discussion Paper, No99-077/2, September, Amsterdam.

⁴ Tzykhlo C. An analysis of the factors influencing the actual financial and economic situation at Russian industrial enterprises. - M.: IET - 2001.

suggested that had this question been formulated in a detailed manner the financial reports of an enterprise would have certainly be characterized as the least reliable. This assumption was fully confirmed during a similar survey conducted in 2001. This time the respondents were asked to estimate the five principal types of an enterprise's official reports. The results fully confirmed our assumptions: the financial reports turned out to be the least reliable (see Table 15).

Table 15

Can official reports of an enterprise be applied in the analysis of the actual situation in industry

Types of reports and branches	yes, they can be applied	no, better not	difficult to estimate
On output and shipment	85	6	9
On employment and payroll	65	19	16
On finances and payments	44	27	29
in ferrous metallurgy	34	51	15
in the chemical and petrochemical industries	40	31	29
in machine-building	48	23	29
in construction materials production	40	29	31
in the light industry	50	29	21
in the food industry	60	18	22
On capital investments	66	10	24
in ferrous metallurgy	80	5	15
in the chemical and petrochemical industries	56	21	23
in machine-building	70	7	23
in construction materials production	49	12	39
in the light industry	68	6	26
in the food industry	68	11	21
On stock distribution	43	19	38

Source: September (2001) survey of the IET, %.

The obvious improvement of the situation in industry that has been occurring since the beginning of the growth in the effective demand and output has cast some doubt on the thesis that barter and other monetary surrogates are beneficial for enterprises because in this way they can avoid paying taxes, take assets out of the control of private creditors and outside shareholders⁵. As Russian in-

⁵ Karpov P.A. "On the reasons for low tax collection (non-payments to the fiscal system), the general causes of the "non-payments crisis" and the possibility for restoring the sol-

dustry has been existing under the conditions of growing effective demand for three years already we can now test several hypotheses about factors that influence the real financial and economic situation at Russian industrial enterprises.

Firstly, we are going to deal with simple models of the interaction between the actual estimates of the FES and certain separate components of the total demand for industrial products - the effective, barter and other non-monetary types. Testing of the hypotheses of their independence has shown that the actual estimates of an enterprise's FES do not depend on any changes of barter and other non-monetary types of demand. For these types of demand, the observed significance level during the whole period of monitoring was above the 5% threshold. Thus the actual situation at the enterprises, most probably, is not defined by the dynamics of barter or other non-monetary types of demand for their products. A different situation can be observed in the sphere of the effective demand. The independence hypothesis cannot be applied during almost all those surveys that include the estimates of the FES. The only exception can be represented by the results of the January surveys when the independence hypothesis probably cannot be rejected. But this exception is explained by the seasonal peculiarities of the changes in the sales of industrial products. Every year in January the surveys register a dramatic decrease in business activity, and all the relations between various indices that are traditionally observed during the other periods of the year are disrupted. The tested hypothesis of the independence of the FES simultaneously for all the three types of demand was not confirmed either. The observed significance level was persistently zero. Similar results were obtained also for the model where only the indices of the effective and barter demands were included.

At the next stage of analysis, the model was augmented by the linear interactions between the main types of demand and the FES. This more complicated model resulted in a better fitting quality. Acceptable significance level values were obtained for the effective demand. A comparison of the two models with the participation of the effective demand (with and without the exclusion of linear interaction) confirmed the feasibility of this more complicated version. The increment of the probability ratio with simultaneously decreasing number of degree of freedom per unit turned out to be considerable. Thus the hypothesis that the changes of the effective demand influence the actual situation at Russian industrial enterprises cannot be rejected. As far as the barter demand is concerned, the more complicated model turned out to be feasible only in one case (April 2000);

vency of Russian enterprises". Report of the Interdepartmental Balance Board. Moscow, 1997; OECD (2000), Country Study: Russia.

in twelve cases the addition of the linear interaction between the changes of barter and the FES was not found to be feasible because only a relatively small improvement of the model's fitting quality was obtained. A similar situation emerges with the bill and set-off realization schemes. Their interaction with the FES turned out to be necessary only in two cases.

The coefficients of linear interactions have confirmed the conclusions resulting from the analysis of the models' fitting quality. Firstly, the coefficients in the model of the interactions between the changes of effective demand and the FES of the enterprises turned out to be always positive and almost always (except in January 2000 and January 2001) statistically significant. Secondly, the coefficients for barter and other non-monetary types of demand are almost always negative and statistically insignificant. I.e., the growth of non-monetary schemes of product realization in a great majority of cases does not improve the situation at the enterprises. Only the effective demand always (during the periods of considerable barterization as well as at the time when monetary transactions prevail) allowed the enterprises to consolidate their real financial and economic situation.

At the next stage of the analysis we are going to consider the model that simultaneously includes all the three types of demand and the estimates of the enterprises' real FES which will be treated as a dependent variable. The fitting quality turned out to be very good – the observed significance level was 0.9922-1.0000. The model's coefficients (see Table 16) were always positive and statistically significant only for the effective demand. For the barter demand they were positive but in the majority of cases statistically insignificant. They were found to be significant only in January and July 2001 when the enterprises were stating that they were no more selling their products for money. I.e., barter had come to "rescue" Russian industry. And besides, for bills and set-offs the coefficients turned out to be negative. Thus, only the hypothesis of a positive influence of the effective demand on the FES of Russian industrial enterprises in 2000-2001 cannot be rejected.

Table 16

Estimates of the influence of the changes of the three types of demand on FES in model including simultaneous influence of the factors in question

Date	Effective demand		Barter demand		Bills and set-offs	
	β	SE	β	SE	β	SE
4/00	0.2837	0.0850	0.0181	0.0962	0.1214	0.1089
7/00	0.4005	0.0936	0.0448	0.1171	-0.0495	0.1246
10/00	0.3535	0.1023	0.1590	0.1104	0.0549	0.1203
1/01	0.2019	0.0896	0.2449	0.1187	-0.0318	0.1278
4/01	0.4298	0.1025	0.2200	0.1404	-0.1951	0.1531
7/01	0.3785	0.0943	0.2618	0.1306	0.0171	0.1274
10/01	0.2763	0.1212	0.1484	0.1569	0.0128	0.1756

Note. β coefficients estimating linear connection (association) of the ranges of each factor with FES and standard errors are applied here.

The lengthier chains of observations of barter demand have made it possible to assess how the FES has been influenced by effective and barter demand since quarter IV of the year 1998. The fitting quality of the model utilizing linear interactions of the effective and barter demands with the actual FES estimates of the enterprises was lower than the fitting quality of the previous model but reliably higher than the 5% threshold. The model's coefficients for the effective demand were positive and (except for the two January surveys) statistically significant. The coefficients for the barter demand were mostly negative and always statistically insignificant. And again the calculations confirm that the effective demand can be regarded as the sole factor positively influencing an enterprise's situation.

Now let us turn to the plans and forecasts of enterprises. In this case we are going to test the models where the formation of the expected changes in the FESs (again, the real, not the reported ones) occur under the influence of the forecasted values of changes in demand. The application of forecasted values, in our opinion, must more accurately reflect the enterprises' own preferences. In this case the harsh market reality in a less definite manner influences the connections under study.

At first we are going to assess the model where only effective and barter demands are included. To achieve good fitting quality of the model with the participation of the expected FES changes, the current FES estimated must be en-

tered⁶, without utilizing any interactions including the participation of this variable. The model's fitting quality turned out to be exceptionally high: the observed significance levels in the majority of cases were close to 1 (see Table 17). The influence of the barter demand forecasts was found to be stable, positive and statistically significant during the whole period under analysis. The influence of the effective demand forecasts was positive until the second quarter of 2001 but became significant only in late 1998 - early 1999. Nevertheless the influence of the effective demand on the FES was twice as high. Beginning with the second quarter of the past year, Russian industrial enterprises did not mention barter as a means to improve the values of their business activity even in their forecasts.

Table 17

Characteristics of the influence of forecasted effective and barter demands on the expected changes of the enterprises' FES

Date	Characteristics of model's fitting quality			Model's coefficients			
				effective demand		barter demand	
	G ²	df	Sig	β	SE	β	SE
10/98	152.1469	127	0.0636	0.6007	0.0867	0.2799	0.0850
1/99	119.2811	127	0.6745	0.7723	0.1118	0.3262	0.1147
4/99	116.4677	127	0.7382	0.8791	0.0995	0.0879	0.1047
7/99	87.7935	127	0.9968	1.1099	0.1187	0.1401	0.1001
10/99	86.0843	127	0.9979	0.9600	0.1049	0.0739	0.1164
1/00	90.4826	127	0.9940	1.0157	0.1207	0.2216	0.1239
4/00	130.2608	127	0.4034	1.1752	0.1122	0.0998	0.1122
7/00	88.8699	127	0.9959	1.1374	0.1340	0.0075	0.1242
10/00	82.7119	127	0.9992	0.8934	0.1115	0.0973	0.1042
1/01	88.8818	127	0.9959	1.0020	0.1197	0.1041	0.1170
4/01	54.2137	127	1.0000	1.2547	0.1217	-0.0341	0.1154
7/01	92.4163	127	0.9909	0.9664	0.1288	-0.0269	0.1187
10/01	64.1866	127	1.0000	0.9648	0.1466	-0.0085	0.1438

Note. This table presents: G² - probability ratio; df - degrees of freedom; Sig - observed significance level; β coefficients estimating the linear connection (association) of the ranges of each factor with FES, and standard errors (SE).

⁶ Tzikhlo S.V. An analysis of factors influencing the real financial and economic situation at the Russian industrial enterprises - M.: IET. - 2001.

Finally, we are going to consider the models where all the types of the demand function as independent variables. The fitting quality turns out to be very high (see Table 18). The model's coefficients are positive and statistically significant only for the effective demand. The forecasted values of other types of demand do not statistically significantly influence the expected changes in the FES of Russian industrial enterprises. The coefficients for non-monetary types of demand were sometimes negative.

Table 18

Characteristics of the influence of forecasted effective, barter and other non-monetary types of demand on the expected changes of the enterprises' FES

Data	Characteristics of model's fitting quality			Model's coefficients					
				effective demand		barter demand		other non-monetary types of demand	
	G ²	Df	Sig	β	SE	β	SE	β	SE
4/00	153.2533	396	1.0000	1.2206	0.1367	0.2838	0.1702	-0.0788	0.1912
7/00	107.3261	396	1.0000	1.2025	0.1648	-0.0570	0.2036	0.3144	0.2196
10/00	117.4724	396	1.0000	0.7667	0.1388	0.1697	0.1717	0.2761	0.1920
1/01	115.9058	396	1.0000	0.9010	0.1366	-0.1445	0.1743	0.4545	0.1939
4/01	76.8033	396	1.0000	1.2257	0.1411	0.0885	0.2027	-0.0040	0.2262
7/01	110.0419	396	1.0000	0.9202	0.1493	0.1077	0.1958	0.0232	0.2118
10/01	73.9390	396	1.0000	1.0281	0.1763	0.2775	0.2362	0.0395	0.2658

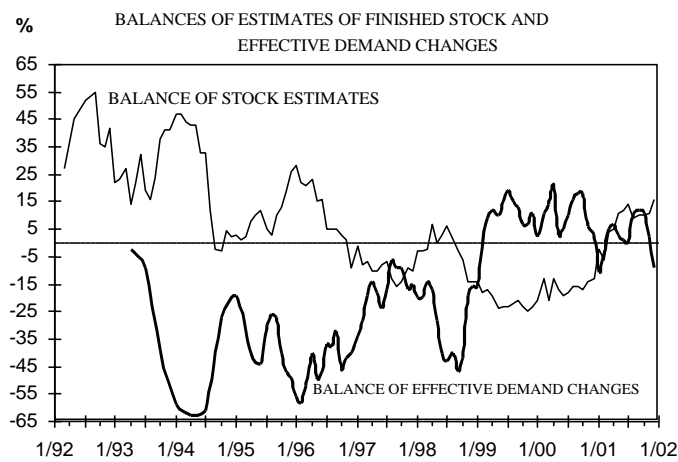
Note. This table presents: G² - probability ratio; df - degrees of freedom; Sig - observed significance level; β coefficients estimating the linear connection (association) of the ranges of each factor with FES, and standard errors (SE).

The evolution of the utilization of finished stock in Russian industry

In the year 2001 the behavior of one of the most important indices characterizing the situation in industry - the finished stock index - underwent changes that were probably of a decisive nature. For several years previously a sufficiently clear interdependence could be traced: the growing rates of the decrease in the effective demand resulted in the growth of surplus finished stock. When this decrease slowed down and later the sales began to grow the enterprises changed their estimates to opposite values (see Fig. 23). At the same time the "peaks" of surplus finished stock was becoming lower and lower over time. If the first one registered in September 1992 was +55%, the second (January-February 1994)

became +47%, the third (January 1996) - only +28%, the fourth (July 1998), finally, went down to the negligible +6%. As for the “downfalls” of effective demand, their differences were much smaller. This has made it possible to assume that the Russian enterprises began to control the state of their finished stock and to prevent extreme overstocking from reaching the extreme degree that had been typical of the first half of the 1990s.

Figure 23



The August 1998 default has cardinally changed the situation in Russian industry as a whole, and in particular that regarding finished stock. The basis for this was provided by the growth of the effective demand for the products of domestic enterprises. Virtually in a few months the balance of changes in the sales for money rose from -47% to +9%. As a result, industrial enterprises got rid of their surplus finished stocks and by mid-1999 had the highest ever shortage of stock reserves (-24%). This situation persisted, despite the fluctuations in effective demand growth rates, until the middle of 2000. Then the enterprises began gradually to increase their stocks and brought them in 2001 to a sufficient surplus level. This level was higher than the surplus of 1998 when sales of products were declining very rapidly. In 2001 the effective demand, on the contrary, was growing though not so intensively and persistently as in the two preceding years. This

has provided the grounds for the second assumption: in 2001 the Russian industrial enterprises began to utilize their finished stocks in the same way as is typical of the manufacturers in the countries with stable market economies, i.e. as a buffer for leveling the leaps in demand and/or supply. In other words, domestic enterprises have acquired faith in the stability of normal (i.e. monetary, effective) growth of the domestic economy. In order to study in detail the behavior of Russian industrial enterprises as far as the utilization of their finished stocks is concerned, the models of stock formation developed by the state-of-the art economic theory can be applied.

In Western economics, the finished stocks in the warehouses of industrial enterprises are analyzed from the point of view of economic cycles. By the present time two theoretical approaches to the explanation of the movement of finished stocks have emerged. The proponents of the one believe that the stock cycle is defined by demand shocks, the proponents of the other - by supply shocks⁷. Shocks are understood as sudden (unpredicted) changes in demand and supply.

The demand model of stock movement was first suggested by Metzler⁸ who assumed that the required (desirable) finished stock level is proportional to the expected sales volume. This means that companies utilize (keep) finished stocks in order to lower the probability of a situation when they might be unable to meet a suddenly increased demand. Then the unpredictable though positive demand shock is compensated at once by decreasing finished stock volumes. This in its turn increases the probability of exhausting finished stocks and makes the enterprises at the next step (the step of decision-making) to increase production in order to restore their stocks. In this case the changes of demand and stock are heterodromal. Stocks are used as a buffer for demand. As a result a finished stock cycle is formed: the investments in stock are negative at the first stage and are positive at the second.

The second model places an emphasis on expenses. It states that a positive but temporary shock of the production function results in reducing expenses and induces companies to increase their output while the expenditures are low. The additional output accumulates as finished stock and is sold later when output decreases due to temporarily increasing expenses. The company's sales volume in this case does not change.

⁷ Flood, D. and P.Lowe (1995), "Inventories and The Business Cycle", *The Economic Record*, vol.71, No.212, March 1995.

⁸ Metzler L. (1941), "The Nature and Stability of Inventory Cycles", *The Review of Economics and Statistics*, XXIII, 113-129.

An analysis of the stock formation model suggested by Flood и Lowe⁹ had led to the following conclusions. Firstly, if an economic cycle is regulated by demand shocks and warehouse stocks act as a buffer there must exist a negative correlation between the changes of demand and the changes of stock. Secondly, the influence of the stock cycle on the economic cycle depends upon the stability (duration, steadiness) of the demand shock, on the company's desire to smooth the dynamics of its production, as well as on warehouse costs. If marginal costs are constant and output smoothing does not matter, the warehouse stock cycle enhances the economic cycle. If, on the contrary, marginal costs grow rapidly with the rise in production, the stock cycle, most probably, will smooth down the amplitude of the economic cycle.

In the study by Carlson and Dunkelberg¹⁰ a wider range of hypotheses is tested as defined by the opening sentences: "The theoretical speculations as to how companies adjust their stocks, prices and employment in response to the changes in market conditions allow a large number of predictions. What happens in reality is subject to empirical studies." The authors on the basis of quarterly surveys involving small-scale enterprises in the USA and conducted by the National Federation of Independent Businesses have followed the changes of costs and demand for the necessary (desirable) volume of finished stock. The growth of current demand must produce opposite changes of the desirable finished stock volume because companies satisfy some of the demand by the available stock. Similar consequences must be produced also by the current growth of costs. But if we take the next period of time the connection must be positive. If the enterprises foresee a growth in demand in the future they must designate higher "target" stock volume by the end of a current period and the beginning of the next one wherein the sales growth in question is expected. In this case they will possess higher finished stock volumes by the time when the sales or costs growth is expected.

Prices can also depend on planned finished stock changes. In addition to the prices growing in response to rising demand and costs, their growth might also be contributed by the desire to increase warehouse stocks because more stock can be accumulated by way of lowering current sales due to increased prices. The dependence of output on demand is similar: with growing demand, output also grows. As for the growing costs, they, according to the traditional theory, must

⁹ Flood, D. and P.Lowe, *Op. cit.*

¹⁰ Carlson, J.A. and W.C.Dunkelberg (1989) "Market Perceptions and Inventory-Price-Employment Plans", *The Review of Economics and Statistics*,.

result in decreasing output. And the planned increase of finished stock must stimulate an output growth.

The survey questionnaire of the IET contains the number of questions sufficient for studying the behavior of finished stock and the factor it is influenced by. Firstly, since September 1992 monthly monitoring of the current estimates of finished stock has been under way. As answers to the question "How do you estimate the current physical volume of finished stock?" the enterprises are asked to choose one of the three following variants: "above the norm", "normal", "below the norm". Secondly, since January 1995 the quarterly questionnaire has been offering the question about the actual changes of the physical finished stock volumes, and since January 1998 – the question about the expected changes. The possible answers are: "growth", "no changes", "lowering". Thirdly, the actual output changes have been followed on a monthly basis since April 1993, the expected changes – since September 1992. The actual effective demand changes have been monitored on a quarterly basis since April 1993, on a monthly basis since July 1995. The expected changes of the sales for money have been registered monthly since October 1995. In August 1998, monthly monitoring of the actual and forecasted changes of barter demand was started, in February 2000 – of other non-monetary types of demand. The question regarding the actual changes of prices was introduced in the questionnaire in October 1994, that about the expected changes – in September 1992.

Insofar as the behavior (management) of finished stock in Russian industry has not been studied, and besides, this index itself does not enjoy the popularity it deserves either with the analysts or with the enterprises¹¹, we believe that it would be feasible to consider the widest possible range of hypotheses.

We are going to begin this analysis with studying the influence of current changes in demand and costs as well as expected (later) changes in demand and costs on the actual changes of finished stock. A loglinear model that included linear interactions of factors with the actual changes in the finished stock volumes had on the whole a good fitting quality (see Table 7). The observed significance level in all cases (except for one) was above the 5% threshold.

¹¹ Tzukhlo S.V., Pugachova M.V. A study of the sources of statistical information and information needs of enterprises in the economies in transition. // *Voprosy statistiki*. – 2000. – No 5.

Table 19
Characteristics of the influence of demand and costs on the changes of finished stock volumes

Date	Characteristics of model's fitting quality			Model's coefficients							
				Actual demand changes		Actual costs changes		expected demand changes		Expected costs changes	
	G ²	Df	Sig	β	SE	β	SE	β	SE	β	SE
7/97	141.4008	156	0.7927	-0.0708	0.0864	-0.0138	0.0902	0.2801	0.0907	0.3987	0.0972
10/97	160.3346	156	0.3894	-0.0486	0.0806	0.1011	0.0831	0.1346	0.0800	0.2694	0.0790
1/98	176.7944	156	0.1218	-0.0023	0.0707	0.0896	0.0717	0.2462	0.0685	0.0957	0.0699
4/98	176.3214	156	0.1269	-0.0269	0.0793	0.1293	0.0776	0.1440	0.0753	0.1473	0.0757
7/98	171.1322	156	0.1927	-0.0508	0.0736	0.0307	0.0785	0.3509	0.0798	0.2910	0.0856
10/98	134.1913	156	0.8960	-0.1878	0.0710	0.1255	0.0839	0.1454	0.0727	0.2791	0.0832
1/99	130.5239	156	0.9320	-0.1186	0.0740	0.1126	0.0796	0.2721	0.0781	0.1710	0.0794
4/99	142.3899	156	0.7752	-0.0312	0.0732	0.1119	0.0710	0.1293	0.0696	0.1845	0.0719
7/99	181.4205	156	0.0800	-0.2137	0.0742	0.0726	0.0716	0.3518	0.0797	0.2488	0.0753
10/99	157.5348	156	0.4505	-0.1725	0.0808	0.2082	0.0822	0.1855	0.0820	0.2298	0.0816
1/00	175.3202	156	0.1381	-0.1974	0.0690	0.0649	0.0736	0.1952	0.0690	0.2642	0.0723
4/00	220.2624	156	0.0005	-0.0264	0.0659	0.0597	0.0683	0.1661	0.0652	0.1412	0.0651
7/00	157.7889	156	0.4449	-0.1781	0.0765	0.1392	0.0816	0.2704	0.0886	0.1868	0.0851
10/00	167.2671	156	0.2544	-0.1237	0.0768	0.0178	0.0840	0.2820	0.0831	0.2284	0.0843
1/01	144.7811	156	0.7301	-0.2098	0.0679	0.1077	0.0748	0.2919	0.0697	0.1490	0.0720
4/01	145.8152	156	0.7094	-0.1162	0.0718	0.1442	0.0722	0.1665	0.0695	0.1978	0.0699
7/01	147.4734	156	0.6750	-0.2257	0.0735	0.1072	0.0765	0.3997	0.0837	0.2694	0.0742
10/01	133.9639	156	0.8986	-0.1740	0.0871	0.1441	0.0832	0.2602	0.0861	0.2113	0.0795

Note. This table presents: G² - probability ratio; df - degrees of freedom; Sig - observed significance level; β coefficients estimating the linear connection (association) of the ranges of each factor with the actual changes of finished stock volumes, and standard errors (SE).

The current changes in demand did have the expected signs. They produced reverse changes of finished stock, i.e. the growth of sales volumes in Russian industry is accompanied by decreasing warehouse stock volumes. Thus, demand in part is satisfied at the expense of accumulated stock, while some of the unsold products remains as stock. This mechanism of utilizing stock has become especially obvious lately when the coefficients reached their maximum negative values and turned out to be more and more often statistically significant. Before the

1998 default no significant values of these coefficients were obtained. The current changes of costs have positive but statistically insignificant influence on the changes of finished stock. Consequently, Russian industrial enterprises prefer to use their stock more as a buffer to level off sudden demand changes than as a buffer for smoothing cost changes. Again we wish to emphasize that these conclusions refer to the current changes of demand, costs and finished stock only.

Table 20

Characteristics of the influence of output, demand and costs on the changes of finished stock volumes

Date	Characteristics of model's fitting quality			Model's coefficients							
				Actual demand changes		Actual output changes		Expected demand changes		Expected costs changes	
	G ²	Df	Sig	β	SE	β	SE	β	SE	β	SE
7/97	140.8559	156	0.8020	-0.2559	0.0937	0.3531	0.0864	0.1787	0.0873	0.3594	0.0805
10/97	178.0193	156	0.1094	-0.1846	0.0926	0.3525	0.0764	0.1194	0.0801	0.2940	0.0715
1/98	191.3076	156	0.0286	-0.2317	0.0853	0.3639	0.0738	0.2147	0.0702	0.1084	0.0633
4/98	188.3887	156	0.0394	-0.1789	0.0868	0.2930	0.0727	0.1130	0.0772	0.2533	0.0668
7/98	163.8651	156	0.3172	-0.1800	0.0854	0.3508	0.0741	0.3275	0.0760	0.3458	0.0745
10/98	145.3716	156	0.7184	-0.3629	0.0818	0.5083	0.0740	0.1416	0.0773	0.2267	0.0730
1/99	143.9276	156	0.7466	-0.1979	0.0810	0.1743	0.0687	0.2173	0.0748	0.2216	0.0697
4/99	143.7626	156	0.7498	-0.2093	0.0838	0.4091	0.0733	0.0253	0.0777	0.1827	0.0634
7/99	173.4077	156	0.1615	-0.4028	0.0876	0.4336	0.0774	0.2585	0.0784	0.3037	0.0713
10/99	167.7357	156	0.2464	-0.2743	0.0869	0.3301	0.0712	0.1952	0.0758	0.2965	0.0693
1/00	155.4751	156	0.4968	-0.3998	0.0839	0.3613	0.0688	0.2031	0.0693	0.2471	0.0632
4/00	224.5139	156	0.0003	-0.0811	0.0767	0.2569	0.0635	0.1708	0.0694	0.1494	0.0577
7/00	177.9549	156	0.1100	-0.2807	0.0898	0.4029	0.0765	0.1714	0.0885	0.3377	0.0777
10/00	175.9442	156	0.1310	-0.2579	0.0881	0.3296	0.0735	0.2678	0.0837	0.2408	0.0692
1/01	187.4343	156	0.0437	-0.2890	0.0772	0.2858	0.0650	0.2992	0.0722	0.1791	0.0664
4/01	168.4937	156	0.2337	-0.1967	0.0808	0.2513	0.0649	0.1282	0.0711	0.2726	0.0628
7/01	177.8322	156	0.1112	-0.2154	0.0847	0.1569	0.0667	0.3565	0.0839	0.3515	0.0703
10/01	161.0161	156	0.3750	-0.3493	0.1026	0.3069	0.0734	0.3604	0.0878	0.2913	0.0763

Note. This table presents: G² - probability ratio; df - degrees of freedom; Sig - observed significance level; β coefficients estimating the linear connection (association) of the ranges of each factor with the actual changes of finished stock volumes, and standard errors (SE).

The future changes of demand and costs will have a stronger and predictable by theory influence on the changes of finished stock. If in the next period of time (quarter in this case) Russian industrial enterprises expect the demand or costs to grow, they increase their finished stock. This is quite a market-oriented attitude.

To further pursue the question of which factors are decisive for any changes of finished stock volumes it seems feasible to study a model where output is also included as an independent variable. Since current changes of costs do not influence the changes of finished stock the production changes will be applied instead. It would be logical to assume that this variable must have a positive influence over the dependent variable. But the most interesting conclusion might result from the comparison between the absolute strengths of the influences of the two following factors: output and demand. Under the conditions of economies in transition the influence of demand and output on finished stock characterizes the conditions of reproduction. A stronger (and, naturally, positive) influence of the output changes on stock would mean that warehouses are being filled with products for which there is no demand. If the influence of demand in absolute values exceeds the influence of output then there emerges a tendency that is positive in terms of economies in transition: the products are met by demand, and warehouses perform the role of a buffer. Besides, production falls behind demand and cannot restore the initial stock – if, of course, the enterprises really need it.

The fitting quality of the model with current changes of costs replaced by current changes of output in most cases turned out to be acceptable (see Table 20). The observed significance level was below the 5% threshold only in 4 of 18 cases, its average value being 0.30. The model's coefficients had the necessary signs and were statistically significant more often than in the previous model. The coefficients of current changes of demand were statistically significant in 17 cases while previously – only in 8. The coefficients of the current changes of output were always significant. The ratio of the coefficients of demand and output was found to be truly interesting. Before the 1998 default the influence of the output dynamics on the finished stock volumes was persistently higher. The stock acted rather as a buffer for surplus production than a buffer for smoothing sudden changes in demand. But since the effective demand coefficients were negative and also statistically significant the stock was also a buffer for demand. After August 1998 the situation has started to change. In the first quarter of 1999 the ratio for the first time began to favor demand: the sales out of stock exceeded the stock replenishment from the output. In the second quarter of 1999 due to high output growth rates (more rapid than the growth of demand) the ratio again began to favor production, but in the second half of the year the situation to a certain

extent straightened out - the leading role of production in replenishing the stocks was preserved but became less obvious than before. In the year 2000 the situation was repeated: in the first quarter the sales were reducing the stock volume at a higher rate than the restocking by production, then later the effect of output increased, but by the end of the year it again dropped. In 2001 the prevalence of output was registered only in the second quarter; in the second half of the year the stock volumes were allowing Russian enterprises to satisfy the effective demand at the expense of their accumulated stock. Thus the manufacturers, encouraged by the sufficiently long period of growth of the effective demand "took the risk" and brought their finished stock volumes in 2001 to such a level that allowed to apply these stocks to quench the sales fluctuations and not only to use them as a "settling tank" for surplus output.

2.3. Investment processes in the real sector of the economy

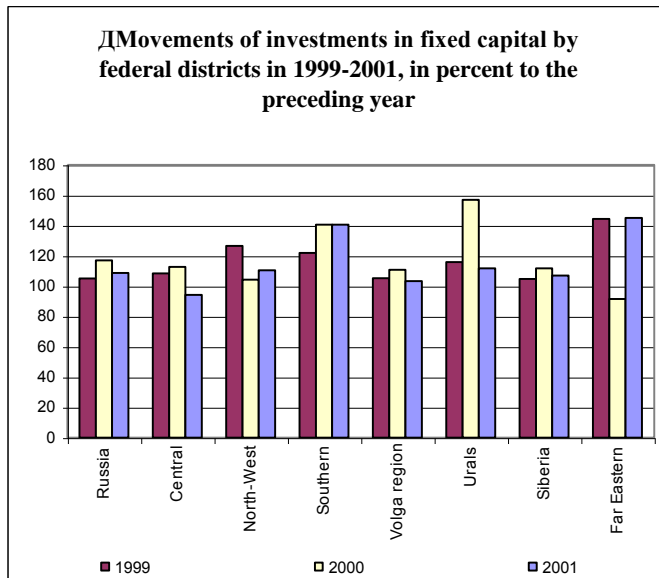
Investment trends

The macroeconomic situation in 2000-2001 was determined by tendencies toward production expansion in all economy sectors and industry. According to expert evaluations of the Fitch international rating agency, Russia is one of most successfully developing countries by macroeconomic indicators. Analysts maintain that the Government has efficiently disposed of the additional revenue received as a result of increased world oil prices over the last two years. The Fitch international rating agency upgraded Russia's rating in July 2001 from stable to positive ("B"). In December 2001, Standard & Poor's also raised long-term sovereign ratings of the Russian Federation in the local and foreign currency from "B" to "B+".

An intensive investment demand growth has become one of the distinguishing features of Russia's economic development over the last two years. A sustainable trend observed over the last two years: growth of investments in fixed capital has outstripped movements in GDP and the output of the basic sectors. The share of investments in fixed capital in GDP in 2001 grew to 17.7 percent against 16.8 percent in 2000. This trend benefited from expanded domestic demand due to increased own and raised funds for investment purposes, a decelerated growth rate of producer prices in industry and construction.

The volume of investments in fixed capital for the account of all sources of financing amounted to 1599.5 bln rubles in 2001, that is 8.7 percent higher than in the previous year. Intensified investment activity in 2001 was accompanied by a growing demand for capital goods and construction services. The volume of work performed by construction companies went up by 9.9 percent compared with 2000, gross output in machine building jumped by 7.2 percent and in construction materials industry – by 5.5 percent. Growth of investments in fixed capital was recorded in all federal districts, except the Central one.

FIGURE 24

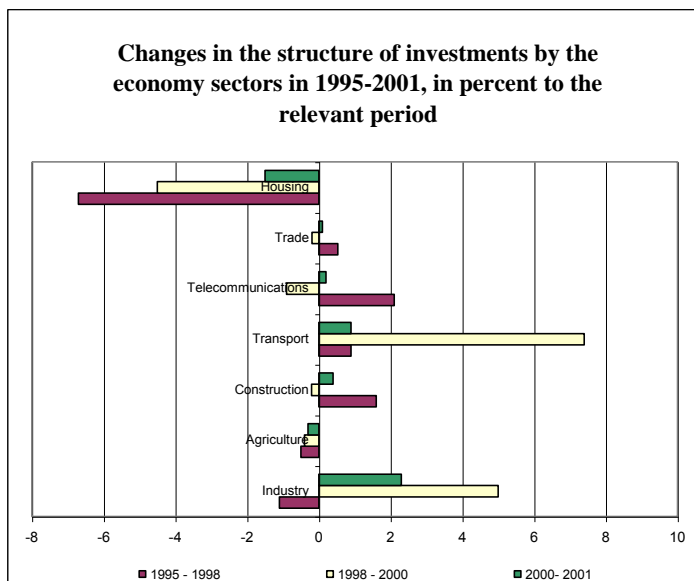


Changes in the sector structure of investments in fixed capital

The investment upturn of 1999-2001 was of a structural character, determined by an aggregate impact of the sector, technological and reproduction shifts in the national economy. Redistribution of investment flows was accompanied by a growing share of infrastructure sectors. In 1999-2001 transport, telecommuni-

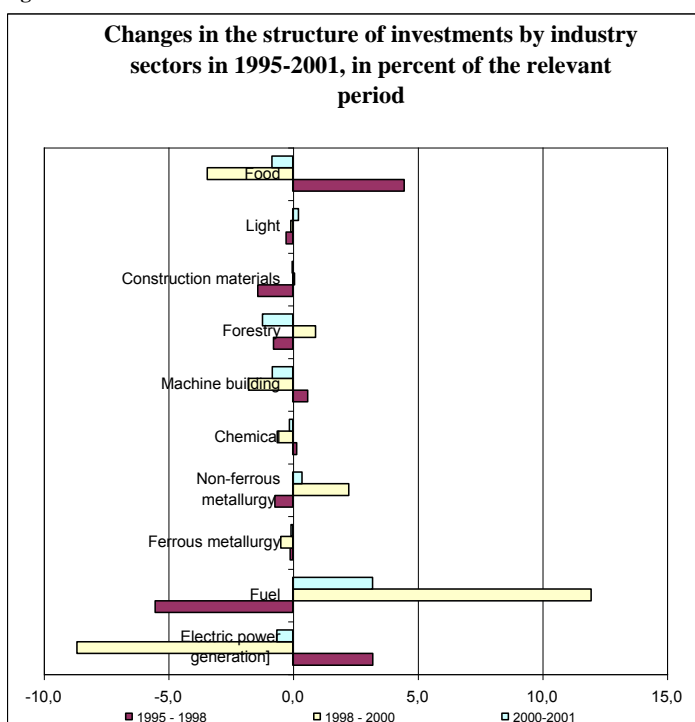
cations and trade accounted, on the average, for ¼ of the total volume of investments in fixed capital against 15 percent in 1992-1996. Increased investment activity in the infrastructure sectors and a growing demand for these sectors' services are indicative of a economic growth potential, even more so since the investment policy in this sector has been mainly geared toward addressing long-term issues. A trend toward an expansion of the market and the structure of the services provided against tariff containment became a characteristic feature of 1999-2001. This enabled entrepreneurs not only to expand their segments in the services market, but also build certain potential for further development. In the conditions of economic growth, the fact that the infrastructure formed during the reform process proved to be fully utilized by the market, indeed became most significant.

Figure 25



In the conditions of economic growth, the investment- in-industry trends were formed under the influence of substantial shifts in the sector structure.

Figure 26



Signs of investment revival became manifest at the end of 1998. Since the 4th quarter of 1998, the growth rate of investments in industry dramatically outstripped production trends in the sector acting as the key generator of economic growth. The year-average growth of investments in fixed capital in 1999-2001 amounted to 12.2 percent, while industrial output went up by 7.3 percent. Growing investments in fixed capital exerted a domineering influence on production

trends and were accompanied by an intensive production growth in all sectors of the investment complex. Production output growth in machine building in 2001 amounted to 50.5 percent compared with 1998, in construction materials industry – 40.0 percent and 27.3 percent in services and construction.

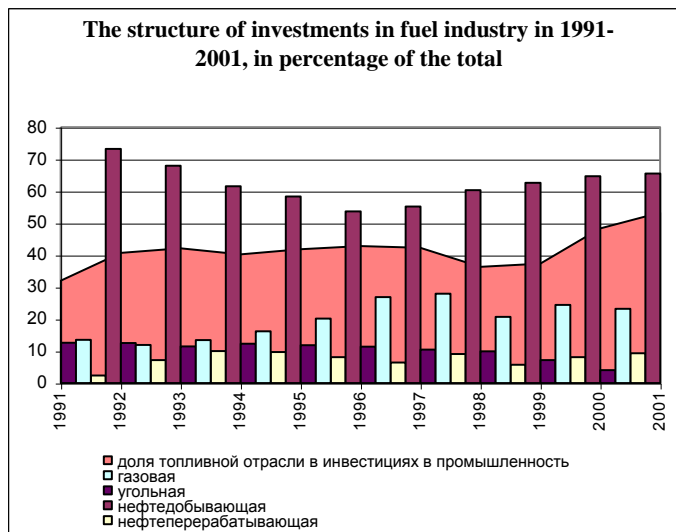
Investment activity triggered off growth of construction materials production. Economic activity revival in the sector is transferred to the sectors and productions geared toward new technologies in construction and, specifically, development of import-substituting product types. It is precisely in these sectors that production restructuring has been accompanied by active production retrofitting on the basis of advanced domestic and foreign technologies, as well as by creation of enterprises with foreign equity. With a changed economic situation and the demand for imported goods plummeting, domestic producers are successfully filling the niches by offering competitive construction materials, price- and quality wise in the domestic market.

Moreover, changes in the ratio between industrial and civil engineering as well as introduction of new technologies of construction and assembly works exert a significant influence on the trends and structure of construction materials production.

In assessing the status and prospects of Russia's economic development, one should take into account that the upsurge of investment activity is largely explained by the market factors. The investment structure was transformed under the impact of a growing demand from the fuel and energy as well metallurgical complexes, whose aggregate share in investments in industry in 2001 exceeded 70 percent.

In fact, the investment demand in 2000-2001 was initiated fully by oil producing industry whose share of investments in industry exceeded 30 percent. Despite the fact that exporters have increased investment expenditure on developing relevant production, however, they exercise great care in investing the uncommitted funds at their disposal in the Russian economy. Thus, a gap between producers (exporters) of energy sources and the bigger part of the rest of the economy is getting wider.

Figure 27



The share of the fuel sector in investment in the industrial sector
 Gas
 Coal-mining
 Oil
 Oil-processing

While 53.3 percent of investments by industry sectors are in the fuel complex, 34.8 percent of this amount going to oil production. Compared with 2000, the share of investments in oil producing industry increased by 2.2 percentage points. However, the ratio between investments in the production and refining sectors of the oil industry is changing with the share of oil production rising. A more conservative trend of investments in oil refining in the current year has resulted in a stabilization of the share of technologies for complete oil refining at the level of 2000.

Growing oil companies' demand for investments triggered off an accelerated production rate of equipment for production of hydrocarbon raw materials. Despite an intensive growth of equipment production for oil industry, the inadequate volumes and irrational structure of the output do not allow to overcome a protracted lagging behind of the development well drilling rate. On the other hand, inadequate investments in oil production and related industry sectors are also holding back the production growth rate.

The changes in the structure of the machine building output were mainly determined by a growing demand of the oil industry sectors, transport and telecommunications. It is precisely in these economy sectors that the highest rates of investment growth in production were recorded in 1999-2001.

Table 21
Production indices by machine building sectors

	Year-average index, in percent	In percent of the preceding year value						
		1991-1995	1995	1996	1997	1998	1999	2000
Industrial sector, total	87	97	96	102	95	108	109,0	104,9
Machine building	83	91	96	103	89	116	115,5	107,2
By sectors								
Metallurgical machine building			93	85,2	70,6	98,1	130,2	86,1
Hoisting and transport machine building	80	87	67	90	70	119	142	121,8
Railway machine building	85	91	98	81	87	109	107,4	126,0
Electro-technical industry	77	90	86	85	86	127	130,1	112,6
Chemical and oil machine building	84	93	78	106	96	121	119,5	121,6
Machine tool and instrument engineering	78	95	67	87	82	99,6	111,5	99,4
Instrument engineering	87	99,9	95	94	103	141	118,4	98,0
Car industry	87	94	100,2	113	89	115	103,3	101,7
Tractor and agricultural machinery engineering	64	70	73	95	71	159	148,5	129,1

Machine building for light and food industry and household electrical appliances	81	82	59	98	91	116	109,5	107,1
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Source: the State Statistics Committee of Russia

The trends and structure of the capital goods output by machine building sectors reflect the Russian businesses prompt reaction to the changing situation in the domestic market. However, despite an intensive output growth, the outdated material and technical base as well as a low investment activity in machine building proper act as the factors holding back the restoration of a sustainable trend in economic growth.

The reproductive structure of investments in fixed capital

A trend to increased major overhaul expenditures also exerts a negative influence on the fixed asset reproduction. Calculations reveal that expenditure on major overhauls in 1999-2001, on the average, made up about 20 percent of investments in fixed capital. The high share of expenditure on overhauls bears out the fact that the investment process is geared toward inexpensive and short-term ways of renovating the production apparatus. This results in a demand for technical equipment components which can be easily replaced without long-term investments in fixed capital, that is for the account of operating capital – a specific feature of the investment process in the Russian economy. However, such practices lead to economic and technological stagnation in the long run. The production apparatus created in the previous decades is geared towards production for a closed economy without competition. The issue of renovating the active part of the fixed assets, qualitatively changing the technological level of production and enhancing its efficiency have become highly topical today.

Analysis of production capacity utilization reveals that most equipment, due to its physical and moral wear and tear cannot be employed in production. Capacity utilization varies substantially. Equipment utilization in the raw materials sectors, characterized by a low share of added value, is significantly higher than in the processing sectors. Even within one sector, but at different production facilities, the extent of equipment utilization varies. Despite the fact that active engagement of reserve capacities determined restoration of economic growth in 1999-2001, however, there is a certain limit to equipment utilization.

An increased demand in raw material sectors can overall be met by engaging the available facilities, however, the reserves for expanded output in the processing and especially high tech sectors are determined by the quality of the

equipment and the technologies applied. Substantial wear of fixed capital in the processing sectors is the cause of the low utilization level as well as a factor limiting potentialities for further production growth.

Table 22

Utilization level of year-average capacity for producing individual industrial products, in percent

	1990	1995	1996	1997	1998	1999	2000
Oil primary refining	87	62	61	65	60	64	68
Coal	93	72	72	70	66	73	84
Cast iron	94	70	70	73	71	84	86
Steel	94	67	68	68	63	71	77
Finished non-ferrous rolling	92	66	65	67	59	63	72
Commercial iron ore	98	84	81	81	81	90	92
Mineral fertilizers	75	50	46	49	47	58	63
Synthetic resins and plastics	84	45	36	40	45	55	62
Paint and varnish materials	74	20	17	17	15	20	24
Car tires	91	43	52	62	59	69	71
Machine tools	81	24	18	16	13	14	17
Forge and press machines	83	13	7,8	7,8	10	10	13
Tractors	81	11	10	9,7	8,4	14	19
Household refrigerators and freezers	98	37	24	27	25	31	39
Electrical vacuum cleaners	82	19	13	14	12	21	20
Households clocks	98	40	22	16	18	28	55
Lumber	69	31	28	27	29	34	39
Laminated plywood	88	52	53	53	67	76	82
Splint-slabs	92	39	27	30	36	47	55
Cardboard	87	41	29	35	38	52	63

Source: Goscomstat

With a continuing trend for declining real savings, production growth is of a temporary nature, determined, as a rule, by a higher utilization level of the operational capacities and active engagement of reserve capacities in production due to upgrading and overhauling the accumulated potential. The sector average capacity utilization in oil refining stood at 68 percent in 2000, while the economically efficient level is 80-85 percent. The capacity utilization factor amounted to 53 percent against 43 percent in 1998 in chemical and petrochemical industry due to the favorable conditions in the international market and a higher domestic consumer demand for the sector products. In machine building and metal working the processes of production capacity optimization, improved quality characteris-

tics of individual types of machines and equipment, implementation of advanced scientific and technological developments and new highly efficient technologies supported the positive trends. However, the capacity utilization both in the sectors and in individual production facilities is characterized by critically low values.

The ratio between the wear and the age structure of fixed assets vividly illustrates a dire need to step up revamping processes. Machine building remains in one of the last places among the industry sectors with respect to the capacity utilization level. The situation is aggravated by the fact that, failing to meet the market quality criteria, machine building is unable to reach a requisite sales volume which would generate funds for massive investments in revamping own production capacities.

The technological structure of investments in fixed capital.

A declining ratio of fixed asset renewal is accompanied by changes in the technological structure of investments in fixed capital. The first stages of the reform witnessed a increasing share of expenditure on construction and assembly works, but since 1995 a growing share of expenditure on machine and equipment purchases has been noted. Increased expenditure on plant and equipment is determined by shifts in the reproductive structure of investments. Expansion of work in enterprise retrofits and overhauls was characteristic of 1999-2001. Spending on plant and equipment went up to 37.4 percent in the total investment volume in 2001 against an average of 22 percent during the 1992-1998 period.

Table 23

The structure of investments in fixed capital by type, in percent of the total

	1998	1999	2000	2001*)
Investments in fixed capital – total	100	100	100	100
Including investments in:				
Housing	16,3	14,3	10,7	10,6
Buildings (except housing) and structures	45,1	41,4	43,6	42,7
Plant and equipment	29,9	36,4	35,7	37,4
Other	8,7	7,9	10,0	9,6

*) Preliminary data from the Ministry for Economic Development
Source: Goscomstat

Over the last two years, investment activity has been determined not only by the scale of the funds used, but also rationalization of resource flows used for

reproduction of fixed capital. In a changing market situation, the enterprises are geared toward expanding their position in the domestic market both by enhancing competitiveness of their products compared with domestic like goods, but also by intensive development of import substituting production. Investment activity motivation is also changing. With financing resources severely limited, investment decisions are determined by the tasks of improving product quality and their compliance with modern standards, expanding a product range as well as the technological aspects of cost cutting.

In the structure of investments in equipment, expenditure on purchasing technological lines and complexes for manufacturing new products amounts to about 10-15 percent, while the main part is spent on purchases of individual installations. It should be emphasized in this connection that such investment structure, determined by the financial constraints, leads to a conservation of outdated technologies, failing to contribute to manufacture of competitive high tech products.

With a revival of investment demand, one can observe an anticipatory growth of machine building compared with the trends in industrial production. This testifies to a fairly flexible and prompt producer response to a changing situation in the domestic market.

The issues of financing investment expenditure

The share of investments in fixed capital in GDP grew to 17.7 percent in 2000 against 14.1 percent in 1998. Insofar, increased investment activity of enterprises against the backdrop of continued shrinkage of budgetary financing of investments has been characteristic of the last three years. Own funds of enterprises remain the key source of financing investments in fixed capital.

Anticipatory growth of investments in fixed capital in 1999-2001 was accompanied by increased profitability of the economy. In 2000, the profitability of products in the economy as a whole grew to 18.9 percent and of the assets – to 7.8 percent. An improved financial position of the enterprises and a growing effective demand became the factors which stimulated an increased share of the accumulation fund in the sources of financing investments in fixed capital. In 1996-1998 profit accounted for less than ¼ of enterprises' own funds used for investments, however, its share surged to 50 percent in 2000-2001.

Table 24**Product profitability by key sectors of the economy and industry, in percent**

	1997	1998	1999	2000	2001*
Total for the economy	6,3	8,1	18,5	18,9	9,3
Industry	9	12,7	25,5	24,7	14,1
Including:					
Electric power generation	14,1	12	13,7	13,5	8,2
Fuel	13,1	15,7	44,5	51,1	27,9
Including:					
Oil producing	14,7	17,6	57,9	66,7	34,2
Oil refining	9,4	12,5	32,1	34,5	20,6
Coal	2,3	0,4	0,7	3,2	
Ferrous	3,6	10,3	28,2	25,6	10,8
Non-ferrous	11,4	33	57,4	51,6	24,0
Chemical	4,3	9,7	22,3	17	9,6
Machine building	8	10	17,4	14,1	10,8
Forestry	-5,5	5	23,9	16,5	9,8
Construction materials	5,6	5,2	8,6	9	7,5
Light	-1,5	0,9	9,5	7,2	6,8
Food	8,4	12,8	13	10,1	7,7
Construction	11,2	6,8	9,2	9,7	8,9
Transport	6,8	10,6	27,3	17,2	16,0
Telecommunications	27,4	29,4	33,6	30,7	24,2
Trade and public catering	2,7	2,6	4,9	18,5	16,9
Wholesale trade in products	2,3	4,9	5,8	3,5	24

*Computed on the basis of preliminary data

Source: Goscomstat

It is noteworthy in this connection that the structure of sources forming investment funds of enterprises has undergone change in the conditions of economic growth. Over the last few years a practice become widespread of non-designated use of the amortization fund for consumer purposes. Productive changes in the economy and an economic growth revival required changing the mechanism of investments in fixed capital reproduction. 2000-2001 witnessed an increased share of amortization deductions in the structure of financing sources.

The Government's further distancing from the capital market became one of the key factors. Investments of Government-run enterprises in the total volume of investment expenditure in the national economy amounted to 23.1 percent in 2001, having dropped by 17 percentage points compared with 1993. Almost 3/5 of investment expenditure was formed by the enterprises and entities with private or joint stock type of ownership. Changes in favor of the non-government sector of the economy were accompanied by a decline in the share of government in-

vestment expenditure in the budgets of all levels. The share of budgetary expenditure of all levels on investments in fixed capital dropped in 1993-2001 from 5.4 to 3 percent of GDP. The budgetary funds accounted for a mere 20.0 percent of the total investments in fixed capital in 2001. It should be emphasized that the shrinkage of budgetary financing was accompanied by a change in the functions of the budgets of all levels in investment program financing. In 1999, the federal funds accounted for 37.6 percent of the budgetary sources of financing, however, their share dropped to 28.0 percent in 2001. Government capital investments, financed for the account of the federal budget in 2001, totaled .041 percent of GDP, or 2.2 percent of the total investments in fixed capital. Most of government capital investments were allocated to resolve topical social issues without alternative sources of financing.

Though own funds of enterprises still retain a dominant position, the share of raised funds among sources of investment financing is gradually growing. The ratio between own and raised funds varies substantially by sectors of the economy and industry. Overall for the economy, less than half investments in fixed capital in 2001 were financed for the account of enterprises' own funds. However, own funds account for $\frac{3}{4}$ of investment expenditure for the reproduction of fixed assets in such highly profitable complexes as fuel and energy and metallurgy. Production profitability in these complexes significantly exceeds this value for the economy as a whole and industry, they generate almost $\frac{1}{3}$ of gross profits in the economy and $\frac{3}{5}$ – in industry. High concentration of revenues in the export-oriented sectors significantly impacts on the nature of investment activity in the processing sector of the economy. Given that the profitability level in machine building and construction materials industry is substantially lower than the average values in industry, the potentialities of financing investments programs for the account of own funds are limited. In the investment complex as a whole, approximately $\frac{1}{3}$ of expenditure on the reproduction of fixed capital is financed for the account of raised funds. Taking into account the high cost of credit resources and the irregular nature of fund transfers from the budgets for financing investment expenditure, the trend, manifested over the last few years, to a dwindling share of investments in this complex in the total volume of investments in the national economy, becomes understandable. The same factors explain a low investment activity in the consumer sector of the economy. Food industry, with highly competitive domestic products and quick payback of investment projects, is characterized by an expanding participation of loaned capital. At the same time, with a potentially high demand for credit resources, the low production efficiency in light industry is an obstacle to attracting investments.

A high level of risk, lack of transparency of the recipients' financial activity and mechanisms of collateral security, as well as inadequate legal protection of such kind of transactions are stalling crediting of investment projects in the real sector of the economy. Enterprises prefer to raise external investment resources in the form of mutual crediting. This type of investment financing ensures about 11 percent of all investment spending in the economy.

Table 25
The structure of investments in fixed capital by sources of financing, in percent of the total

	1997	1998	1999	2000	2001*)
Investments in fixed capital – total:	100	100	100	100	100
According to the sources of financing::					
Own funds	60,8	53,2	52,4	46,1	48,7
Among them:					
Profit (accumulation fund)	13,2	13,2	15,9	23,4	24,9
Borrowed funds	39,2	46,8	47,6	53,9	51,3
Among them:					
Budgetary funds including:	20,7	19,1	17	21,2	20,0
Federal budget	10,2	6,5	6,4	5,8	5,6
Budgets of RF subjects	10,5	12,6	10,6	14,4	13,0

*)Preliminary data

Source: Goscomstat

The role of bank loans in financing the Russian economy is very insignificant. Under high risks, the credit and banking services sector exercise restraint toward investment projects in the real sector of the economy. It has been pointed out in literature on many occasions that one of the causes of the banks' aloof policy is related to the specifics of the formation of the credit institutions system, specifically, to the absence of investment banks proper. Operations in the short-term market play a dominant role in the activities of credit institutions with the share of long-term credit investments amounting to less than 5.0 percent. With a gradual deceleration of inflation in 2000-2001, the commercial bank loans got significantly cheaper, however, even in this case no noticeable demand for bank loans from the real sector is observed. In the structure of the sources of financing investments in fixed capital, the share of bank loans amounted to 3.1 percent in 2001 against 4.2 percent in 1999 and 4.5 percent in 1997. Continued high risks

determine a trend toward a declining share of foreign investments in fixed capital in the total volume of investments in the Russian economy: from 6.6 percent in 1999 to 4.3 percent in 2001.

With the dominant role of own funds of enterprises and entities in the structure of financing sources preserved, it seems premature to define the existing situation as an “investment boom”.

Firstly, in a sustainable growth of gross national savings due to the favorable external economic conditions, the mechanism of transforming these savings into investments in the real sector practically are not functioning. A comparison of the tendencies in savings, gross accumulation in fixed capital and investments in the real sector of the economy reveals that net savings retain a negative trend. Reproduction of fixed capital continues to be financed mainly for the account of amortization funds. It should be emphasized, insofar, that utilization of these funds alone for investment purposes ensures a simple reproduction at best, since an anticipatory growth of prices for investment goods and construction works acts as a factor limiting reproduction of the production apparatus.

Secondly, underdevelopment of investment financial institutions, the capital market and the instability of the legal environment render the process of raising borrowed funds and bank credits more complicated. In fact, a mechanism of inter-sector capital flows had not been formed in the economy, which makes investment activity at the level of enterprises, sectors and regions more complicated. In the conditions of economic growth it has become evident that investment management is not coordinated with the dynamic processes of Russia’s economy restructuring.

And thirdly, experience shows that with savings reserves created, adoption of investment decisions requires a lot more caution and rationalization of investment fund flows. A lack of long-term development policy and activity prioritization acts as a factor reducing incentives for long-term investments.

Foreign investments

2001 was characterized by a more dynamic, than in the preceding period, process of attracting foreign investments. As a result of 9 months of 2001, foreign investments in the Russian economy are estimated at \$9,721 million, which is 23.2 percent higher than a similar indicator in 2000. Upgrading of Russia’s sovereign credit rating positively impacted on the investment climate. As of end-September 2001, the accumulated foreign capital in the non-financial sector of the Russian economy without taking into account the agencies for monetary and

credit regulation, commercial and savings banks, including ruble-denominated investments translated into US dollars, amounted to \$34.4 billion.

Table 26

The structure of foreign investments in the Russian economy

	Total, USD mln	Direct		Portfolio		Other	
		USD mln	In percent of the total	USD mln	USD mln	In percent of the total	
1997	12 295	5 333	43,38	681	5,54	6 281	51,09
1998	11 773	3 361	28,55	191	1,62	8 221	69,83
1999	9 560	4 260	44,56	31	0,32	5 269	55,12
2000	10 958	4 429	40,4	145	1,3	6 384	58,3
2001 (9 month)	9 721	2 920	30	292	3	6 509	67

Source: Goscomstat.

In the structure of foreign investments made in the Russian economy in January-September 2001, the highest growth was observed in portfolio investments which went up 5-fold against the same period of the preceding year. A similar indicator for other investments is estimated at 39.2 percent. The direct investment volume declined by 7.4 percent in January-September 2001 against January-September of 2000.

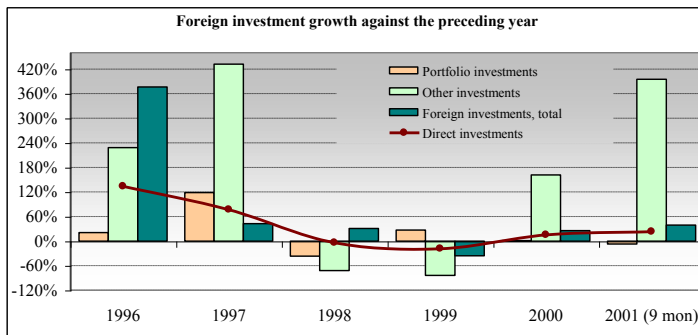
Despite an overall trend of growing investments in the Russian economy, a sum total of foreign investments annually made in the country has been below the pre-crisis level over the last few years.

With portfolio investments significantly rising, most foreign investments in the Russian economy are other types of investments (67 percent) formed mainly for the account of trade credits, credits extended by foreign governments against the guarantees of the RF Government, as well as the loans secured from international financial institutions – the World Bank, the IMF, the European Bank for Reconstruction and Development.

The World Bank's total investments in the Russian economy amount to \$20.5 bln. The Bank's investments in the country's economy rose in 2001 by 5 percent compared with the preceding year. In 2002-2005 the Bank intends to take step in support of the Government program for improving the demographic situation in Russia, the projects in the health care area, projects for enhancing compet-

itiveness of Russia's economy (development of financial institutions, infrastructure, copyright protection, personnel training) as well as environmental programs. The World Bank currently makes investments in Russia in the projects related to the fuel and energy complex, agriculture and environmental protection.

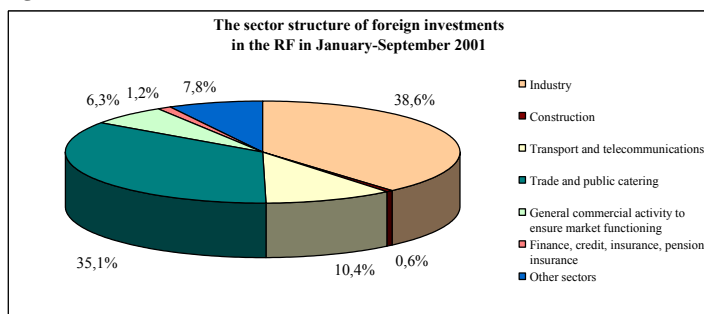
Figure 28



The World Bank's total investments in the Russian economy amount to \$20.5 bln. The Bank's investments in the country's economy rose in 2001 by 5 percent compared with the preceding year. In 2002-2005 the Bank intends to take step in support of the Government program for improving the demographic situation in Russia, the projects in the health care area, projects for enhancing competitiveness of Russia's economy (development of financial institutions, infrastructure, copyright protection, personnel training) as well as environmental programs. The World Bank currently makes investments in Russia in the projects related to the fuel and energy complex, agriculture and environmental protection.

Industry continues to account for the main part in the sector structure of foreign investments in the Russian economy raised in January-September 2001. Foreign investments channeled to the Russian economy during 9 months of 2001 totaled \$3,755 mln, which is 13 percent higher against the same period of the preceding year.

Figure 29



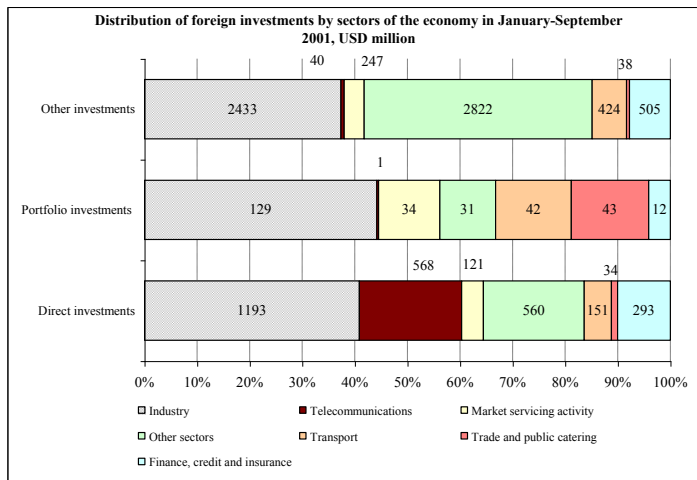
With the absolute investments in industry growing, a drop in its share is determined by higher growth rates of foreign investments in the other sectors of the Russian economy. Thus, foreign investments in trade and public catering during 9 months surged 2.1-fold and in general commercial activity – by 3.6 times. A growing share of these areas in investments testifies to a certain shift of foreign investors' interest to the sectors generating quick paybacks.

In early November 2001 an announcement was made about the Russian-US New Economy Fund (NEF) being set up – a venture fund specializing in investments in the information and science-intensive technologies in Russia. A high entrepreneur interest in this market will enable the Fund to invest over \$100 million in the Russian companies in the coming three years. According to the Fund's founders, the most promising are investments in science-intensive and telecommunications technologies.

The Bank's of Russia reduction, of the minimal amount of the charter capital for foreign banks' subsidiaries being set up in Russia will have a beneficial effect on attracting foreign investments to Russia's banking sector. The minimal amount of the charter capital Russian banks and their subsidiaries being set up has been made equal, established at 5 million euro (earlier it amounted to 10 million euro in the ruble equivalent for foreign banks).

Out of the aggregate direct investments, 19.5 percent was channeled mainly to transport in 2001 (21.4 percent in 2000), 12 percent to food industry (18.5 percent in 2000), 19.2 percent to trade and public catering (18.9 percent in 2000), 10 percent to fuel industry (10 percent in 2000), 6.5 percent to machine building and metal working (4.4 percent in 2000).

Figure 30



Out of the aggregate direct investments, 19.5 percent was channeled mainly to transport in 2001 (21.4 percent in 2000), 12 percent to food industry (18.5 percent in 2000), 19.2 percent to trade and public catering (18.9 percent in 2000), 10 percent to fuel industry (10 percent in 2000), 6.5 percent to machine building and metal working (4.4 percent in 2000).

The sector structure of foreign investments in industry in 2001 is characterized by a lower concentration in the mining sector.

The structure of foreign investments in industry in 2001 corresponds to that of their total volume, characterized by a smaller share of direct foreign investments against the backdrop of growing volumes of other investments. Thus, in 2000 the share of direct investments in industry in the total investments in this sphere amounted to 39.1 percent, portfolio investments stood at 1.4 percent and other at 59.5 percent, but in January-September 2001 the share of the former dropped to 31.8 percent, of the second and the third group went up to 3.4 percent and 64.8 percent, respectively.

Table 27
The sector structure of foreign investments in industry in 1999-2001

	In USD million			In percent of the total			In percent of the same period value in the previous year		
	1999	2000	9 mon. 2001	1999	2000	9 mon. 2001	1999.	2000.	9 mon. 2001.
Industry total, including:	4876	4721	3755	100%	100%	100%	3,8%	-3,2%	13,0%
Fuel	1700	621	591	34,9%	13,2%	15,7%	-9,5%	-	39,4%
Metallurgy	928	1094	1148	19,0%	23,2%	30,6%	79,5%	17,9%	53,7%
Machine building and metal working	395	470	404	8,1%	10,0%	10,8%	н/д	19,0%	12,2%
Food	1415	1786	1038	29,0%	37,8%	27,6%	-3,7%	26,2%	-
Wood processing and pulp and paper	193	257	176	4,0%	5,4%	4,7%	н/д	33,2%	-3,8%
Other sectors	245	493	398	5,0%	10,4%	10,6%	-	101,2 %	13,4%
							70,5%		

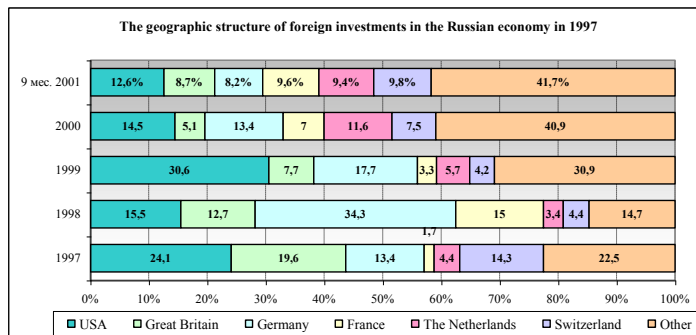
The most direct investments in industry in January-September 2001 (54 percent) went to the fuel and food industry (24.6 and 29.4 percent, respectively). The share of metallurgy and food industry constituted 66.7 percent (38.6 and 28.1 percent, respectively) in the structure of other investments in industry.

2001 witnessed continued differentiation of the Russian regions in volumes of foreign investments in the economy of the RF subjects. For example, the volume of foreign investments attracted to the region's economy in 2001 doubled in the Sverdlovsk oblast. Most active in the Urals market are European and US investors. Foreign investments flow mainly to metallurgy, processing and foods industries.

\$293.8 million of foreign capital were invested in the economy of the republic of Tatarstan during 9 months of 2001, which is 5.3 times more than in the same period of 2000.

Funds from 107 countries were invested in Russia's economy in January-September 2001 (from 108 countries in 2000 and 96 countries in 1999). The leader is the USA with 12.6 percent, followed by Switzerland with 9.8 percent of the total volume.

FIGURE 31



As a result of 9 months of 2001, the leaders in the total volume of accumulated foreign investments are the USA, Germany, Cyprus, France and Great Britain with a 70 percent share (73.1 percent in 2000). The top five investor countries also account for 64.5 percent of direct investments (69.3 percent in 2000), 90.7 percent of portfolio investments (48.4 percent in 2000) and 77 percent of other investments (76.1 percent in 2000).

Table 28
Foreign investment inflows from the key investor countries to the Russian economy in 2000-2001

Country	Accumulates as of		Key investment areas	Invested in USD million	
	End of 2000	October 1, 2001		2000	9 months of 2001
Total	32 005	34 418		10 958	9 721
USA	7 030	5 547	Total	1 594	1 226
			Including: industry	690	457
			Transport and telecommunications	647	367
Germany	6 529	5 951	Total	1 468	793
			Including: food	195	149
			Telecommunications	383	n/a
			Finance, credit, insurance, pension insurance	102	34
			Management	297	-

Table 28 (cont'd)

Country	Accumulates as of		Invested in USD million		
	End of 2000	October 1, 2001	Key investment areas	2000	9 months of 2001
Cyprus	4 230	5 452	Total	1 448	1 874
			Including: food	257	137
			Transport	171	103
			Management	381	-
France	3 353	3 749	Total	743	938
			Including: machine building and non-ferrous metallurgy	235	100
			Management	250	-
			Agriculture	10	n/a
Great Britain	2275	3 367	Total	599	845
			Including: construction	15	14
			Trade and public catering	n/a	500
The Netherlands	1436	2 423	Total	1231	914
			including: food	636	363
			Transport	276	165
			Finance, credit, insurance		
			Pension insurance	82	n/a

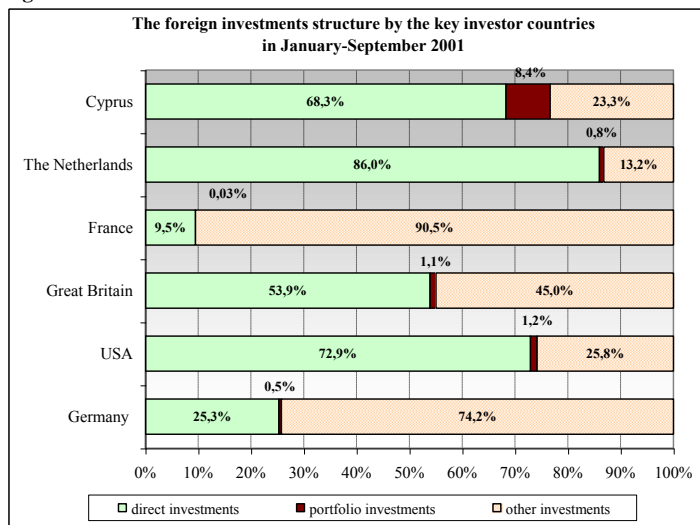
Source: Goscomstat

The largest investments in industry came from Switzerland during 9 months of 2001 (21 percent of all investments in industry) with their largest chunk going to chemical and petrochemical industry (59.3 percent), ferrous metallurgy (52 percent) and the fuel industry (17.8 percent).

Compared with 2000, the structure of accumulated investments by key investor countries underwent changes related to the growth of direct investments share and shrinkage of the share of other investments, while the relevant indicator of portfolio investments has remained unchanged. Thus, 51.6 percent of the investments accumulated by the end of September 2001, were direct ones with 49.6 percent attributed to the 10 major investor countries.

An exception is the USA where the share of direct investments in their aggregate accumulated investments in the Russian economy in 2001 contracted by 5.1 percent. The biggest changes in the structure of accumulated investments in 2001 were observed in the investments coming from Great Britain, where the direct investments share went up by 10.7 percent with the other investments shrinking.

Figure 32



Foreign investors, while displaying interest in investing in the Russian economy, at the same time point out the need to enhance legislative guarantees, market transparency as well as getting opportunities for obtaining information about the condition of the Russian enterprises.

To enhance Russia's investment attractiveness, some amendments to the current legislation were adopted to come into force as of January 1, 2002. The Code of Corporate Conduct has also been elaborated.

Thus, for example, the RF Government approved, in November 2001, the Law "On Incorporating Amendments and Amplifications in Part II of the RF Tax Code, Revocation and Incorporation of amendments in Some Other Legislative Acts of the RF". The draft Law changes the system of taxation in executing Product Sharing Agreements (PSA). Specifically, separate Chapter 24 "Taxation System in the Execution of PSA" is expected to be included in the "Tax Code", which will allow to ensure stable working conditions for the investors while ensuring the interests of the State. If the procedure of paying taxes and charges as well as the time limits for submission of tax returns changes during the term of a

PSA, the payment of the taxes and charges shall be effected pursuant to the legislation in effect on the moment of signing the Agreement. Additionally, this draft Law provides for recovery of VAT under PSA within shorter time periods compared with the norm of effective legislation, and also specifies the composition of reimbursable costs. The value of already signed contracts which the regime of the Law "On Product Sharing Agreements" has been applied to, is about \$30 billion.

Federal Law "**On Investment Funds**" N 156-FZ of November 29, 2001 is designed to attract investments in the real sector of the economy. The Law introduces uniform standards of regulating relations in the collective investment area and removes some hurdles to placing uncommitted funds in organized capital markets. It establishes specifics of creating and a legal status of joint stock companies in the investment sphere, licensing of the activity of joint stock investment funds, liquidation thereof and other issues. It regulates the issues of creation and operation of unit investment funds, specifically, establishes requirements to management companies, specialized depositories, assessors, agents for placement and redemption of investment units. It specifies the procedure for placement and redemption of investment units of unit investment funds, calculation of investment unit value. It also establishes the procedure for calculation of the net asset value of investment funds, requirements to asset composition, disclosure of information about the activities of investment funds and management companies, as well as the powers of the Government agency regulating the securities market in the sphere of the activities of the professional participants to the collective investment system.

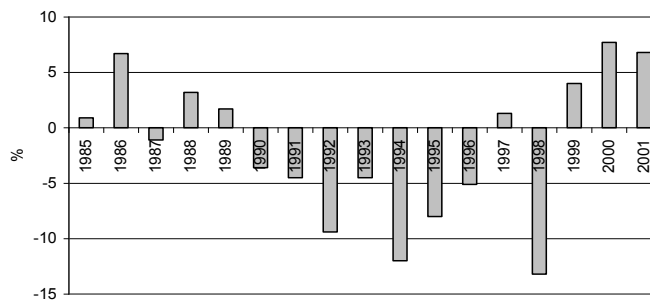
2.4. Russian Agrifood Sector

General performance

Growth in the Russian agricultural production continued for the third year round. According to preliminary estimates its 2001 index amounted to 106.8% pulling up the 1999-2001 average to 106.2% (while in the 5-year period preceding the reforms it was slightly over 100.1% (Figure 33)). The major contributor to this growth was crop production (e.g. grain output was up 30%). Favourable weather conditions have surely been an important but not the single factor thereof.

Figure 33

Change in the Russian agricultural output (1985-2001)



Source: State Committee for Statistics of the Russian Federation.

The 2001 food production index equalled 108.4% (107.1% in 2000).

Growth in the agrifood sector continues along with notable increase of imports being a sign of narrowing price advantages of basic domestic food products. In other words, the import substitution drive is fading. Given expanding imports the rise of population's real disposable incomes by 5.9% is only a partial explanation for the agrifood sector's recovery. The country seems to clear up its specialization in the international division of labour after the ruble devaluation: in some food segments it becomes a net importer, in other - a stable exporter. The

expansion of exports is the second by importance (after the restoration of the population's purchasing power) factor of agrifood production growth.

The restructuring of Russian agriculture goes on. The share of large farms is growing, external investors continue to actively invest in agricultural production, the amount of bank credits to agrifood sector is up 6 fold. The restructuring of agricultural producers' debts in the second part of 2001 will help the sector to get rid of failed farms. An unconditional collection of agricultural producers' former debts started by some regional authorities and the growth of direct foreign investments in the Russian agriculture will foster farm restructuring as well.

As to the agrarian policies, a remarkable progress has been achieved in creating the legal basis for agriculture's development. First of all, it applies to land legislation. Besides that, in 2001 agrarian policies concentrated on two major problems: the restructuring of agricultural producers' debts and protection of domestic agrifood markets. Budget policies in the sector remained actually unchanged.

Agricultural production

In 2001 the crop structure of cultivated lands changed: larger areas were planted in grains and smaller - in sunflower (Table 29). This is a natural result of higher grain profitability. The expected introduction of 20% export tariff on sunflower seeds could also count as well as the need to return to normal crop rotations neglected in regions-sunflower growers for several years. The introduction of tariff quotas on raw sugar import didn't help to enlarge sugar beets plantings.

Table 29

Areas planted in basic agricultural crops, million ha

	1995	1996	1997	1998	1999	2000	2001
Grains	54,7	53,4	53,6	50,8	46,8	45,9	47,6
Sunflower	4,1	3,9	3,6	4,1	5,5	4,6	3,8
Sugar beets	1,1	1,1	0,9	0,8	0,9	0,8	0,8
Potatoes	3,4	3,4	3,4	3,3	3,3	3,2	3,3
Vegetables	0,8	0,7	0,7	0,7	0,8	0,8	0,8

Source: Social and economic situation of Russia, corresponding years.

The grain crop in 2001 is estimated at 85 million tons net weight including 47 million tons of wheat. This volume is below the 1991-1995 average gross output and the 1997 record crop but fully covers the country's demand for grain.

According to the traditional balance about 5-7 million tons could potentially be sold to foreign buyers but experts fear that poor development of export delivery infrastructure (sea ports capacities, shortage of railroad cars, etc.) will constrain sales. Growth was observed in production of almost all grains except for corn (its gross output fell nearly 2 fold), buckwheat, rice and millet. The output of fodder crops is up (that of legumes - by 50% and that of barley - by 40%) evidencing recovery in the livestock sector. The growth of gross output of grains is due to higher yields (up almost 1/4) rather than larger planted areas.

The output of potatoes and vegetables grew as well (by 2.6% and 5.5% respectively).

The output of sugar beets was up 3.5% despite contraction of planted areas. Still, the latter shows that the introduction of tariff quota on raw sugar imports failed to encourage sugar beets production.

The gross output of sunflower seeds fell by 1/3 due to both smaller planted areas and lower yields. It was below the annual average for the pre-reform 5-year period demonstrating the still persisting extreme reactions of producers to market fluctuations (in stable economies similar drops in output are usually due to natural disasters).

The production of flax fiber notably increased (by 13%) and nearly regained the 1994 level.

In 2001 areas planted in winter crops enlarged by 10% as compared to the previous year. The fact potentially raises expectations for next crop since winter plantings are most productive.

Livestock and poultry breeding performance was far less successful. Still, the trend in livestock numbers was most positive of all the reform years. Cattle numbers continued to decrease although at a slower pace. The number of sheep and goats stabilized. Poultry and pig numbers grew by about 4% and 1.4% respectively. The output of basic livestock products was slightly up (Table 30). Poultry production demonstrated unprecedented growth rates - in agricultural enterprises they were as high as 20%.

Table 30

Production of basic livestock products as % of the previous year

	1998	1999	2000	2001
Livestock and poultry, live weight	96,2	89,8	104,0	100,2
Milk	97,6	96,6	99,1	101,8
Eggs	102,7	100,5	102,9	102,9

Source: Social and economic situation of Russia, corresponding years.

As sales in livestock sector grow faster than production, one can assume that greater share of output is marketed while barter and shadow turnover are losing ground¹². Livestock productivity grows in line with decreasing number of animals.

In the coming season the supply of feeds will be better than in the previous year and, besides, prices for coarse grains fell notably. Both these factors can serve the basis for improving livestock productivity.

Agricultural enterprises are the major contributors to growth in livestock and poultry production. Private farmers' engagement therein is minor while household farming is shrinking as economy stabilizes. As a result the share of household plots in the gross agricultural output decreased.

Food industry

Food industry continues to grow for the third year round. Dynamics of selected foods' production change (Table 31). The production of vegetable oils fell after being record high in 2000. This drop might be a response to overproduction: in 2001 smaller areas were planted in sunflower.

Production of basic meat and milk products continues to grow, and its pre-crisis¹³ level has been restored.

Good grains crop triggered growth in flour and groats production that was declining a year ago.

It's noteworthy that growth rates in meat and milk industry (over 10%) are well above those of milk and meat sales by agricultural producers (3.7% and -1.1% respectively). Moreover, the official statistical data do not include output of small food enterprises, and thus the actual growth in meat and milk processing may be even higher. This is an evidence that the increase of respective production volumes results from expanding use of imported raw inputs. Since the after-devaluation price gap is shrinking (Figure 34) hopes for substituting domestic meat and milk for imports vanish.

¹² However, higher growth rates of eggs sales as compared to their production are rather an evidence of some statistical problem.

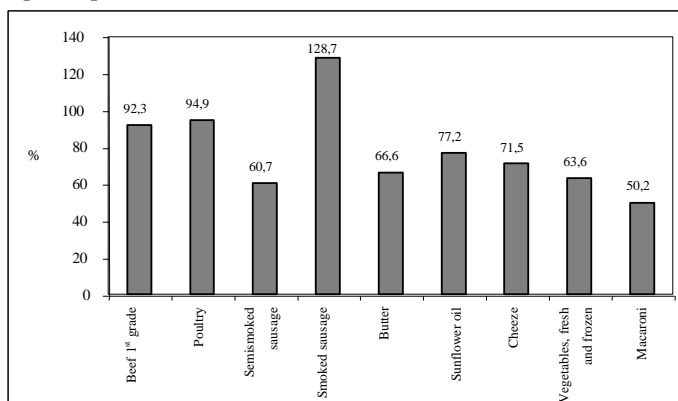
¹³ August 1998 financial crisis.

Table 31
Production of basic food products as % of the previous year

	1999	2000	2001	2001 в % к 1999
Meat	84,4	112,4	104,0	18,1
Sausage	93,2	113,2	111,8	52,0
Butter	93,2	101,4	100,6	32,0
Whole milk products	99,0	110,1	109,6	32,4
Vegetable oils	112,8	174,4	90,1	105,2
Sugar powder	182,2	86,5	108,1	174,3
Flour	107,1	94,3	99,0	56,9
Groats	85,3	99,5	105,3	33,4
Macaroni	132,6	96,0	108,5	72,2
Margarine	182,2	120,7	108,8	61,2
Canned meat	169,0	82,7	106,4	5,7

Source: Social and economic situation of Russia, corresponding years.

Figure 34
Average consumer prices for selected domestic products as % of prices for imported products, June 2001



Source: Data of the RF State Committee for Statistics.

Production of agricultural inputs

The growth in agricultural inputs production became slower and tractor building even dropped. This is a sign of shorter agrarian sector's demand for domestic inputs. There are several reasons for that. First, in 2001 the system of federal leasing was reorganized and purchases of agricultural machinery were notably reduced. Second, domestic agricultural machines began to lose their price advantage over Western machinery, the import of which respectively grew. Besides, large external investors in the agrarian sector prefer imported machinery and equipment, have financial resources for buying them and don't need state leasing. The share of such vertically integrated agrarian holdings in the Russian agriculture steadily grows. Accordingly, the demand for domestic agricultural machinery declines. The after-devaluation price gap did not last long enough to reorganize this sector as well as others.

Table 32

Production of agricultural inputs as % of the previous year

	1999	2000	2001
Tractors	148,3	137,2	78,8
Tractor ploughs	99,9	170,8	113
Tractor seeders	в 2,3 p.	166,9	122
Tractor cultivators	69,4	165,9	118,5
Grain harvesters	188,5	в 2,2 p.	174,3
Tractor mowers	109,7	100,4	547
Mineral fertilizers	124,9	106,2	106,9

Source: Social and economic situation of Russia, corresponding years.

Production of mineral fertilizers was up 6.9%, their export - 7% while in 2000 the latter grew slower than production. Since Russian agricultural producers actually do not use imported fertilizers, this trend evidences lower rates of application growth in 2001. Still, the application of mineral fertilizers expanded, especially in the production of most profitable crops (e.g. in the production of grains it was up 5 fold)¹⁴.

¹⁴ Data of the RF Ministry of Agriculture: <http://aris.ru>.

Situation on agricultural and food markets

Domestic markets

In 2001 the situation on domestic agrifood markets was shaped by higher population's real disposable incomes (up 5.9%) and trends in import supplies.

Higher population's incomes enlarged food consumption. In 2001 the turnover of retail food trade was up 7.4%, that of food service - 8.6%. In the preceding years real incomes grew faster than retail food sales. The reversal of this trend can mean that smaller volumes of food fall out of statistically recorded turnover (e.g. the ones sold by street vendors, produced and consumed by households, etc.).

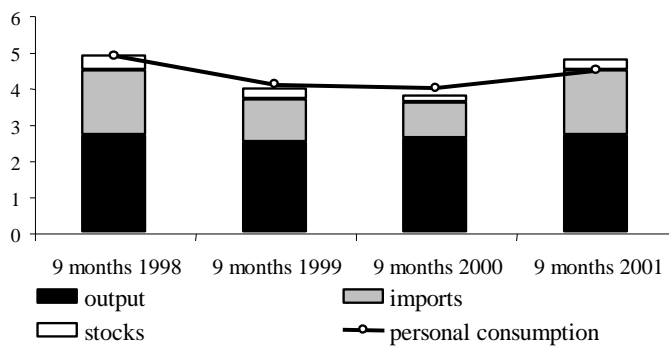
The growth of incomes resulted in bigger demand for such income elastic items as meat and milk products. It almost attained the pre-crisis level: the per capita consumption of meat amounted to 98% of the 1998 level and that of milk products - to 92%.

Retail sales of other income elastic food products in January-September 2001 grew as well: those of confectionery - by 9.9% as compared to the corresponding period previous year, of dry milk, cream and mixes - by 16.2%, of sausage - by 4.2%, of margarine products - by 13.3%, of fruits, berries and grapes - by 9.0%.

The rise of retail prices for meat products (by 28.5% as compared to December 2000) exceeded the inflation rate (consumer price index was up 18.6%). Their real growth shows that demand expands faster than supply. The rise of retail prices for milk and eggs was below the inflation rate.

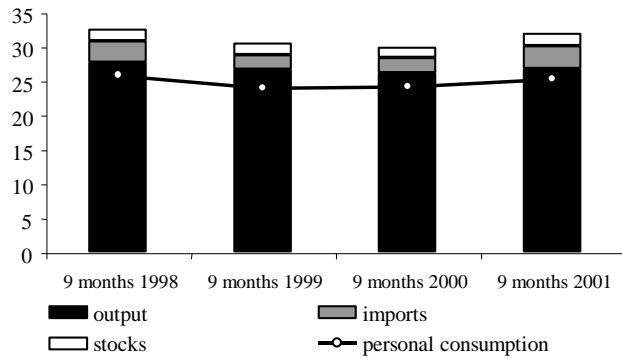
According to supply and utilization balances for meat and milk products (Figure 35 and Figure 36) in 2001 the share of their imports in the total supply became bigger. Moreover, the imported volumes were even larger than in 1998. In 10 months 2001 the share of imported meat in its total supply amounted to 37.5% as compared to 30% in 10 months 2000 and was 36.7% above the corresponding 1998 indicator. The trend in supply of milk is similar: the share of imports therein in 2001 was 10.3% as compared to 7.3% in the two preceding years and exceeded the 1998 level by 9.5%.

Figure 35
Supply of meat and meat products, million tons



Source: Social and economic situation of Russia, January-November 2001.

Figure 36
Supply of milk and milk products, million tons



Source: Social and economic situation of Russia, January-November 2001.

The structure of consumer demand for meat products is changing: the demand for sausage and other processed meat items relatively falls while that for unprocessed meat grows. The Institute of Nutrition of the Russian Academy of Medical Sciences finds this to be a sign of better population's food ration.

Despite the introduced restrictions on raw sugar import, the domestic sugar market remains saturated. The inefficiency of import quota became obvious already in the first half of the year. Although restricted by 3.65 million tons annual tariff quota and 30% customs duty on volumes bought in excess of the quota, the raw sugar imports in January-November 2001 were 23.5% above the corresponding 2000 level (when supplies were regulated only by import duty). Imports of white sugar within the same period fell by about 13.5% most likely due to the imposed high duties: 30% in the first half of the year and 40% beginning from July 1, 2001. Low rates of retail prices' growth prove that domestic sugar market is saturated.

Situation on the grain market was shaped by the volume of beginning stocks and the envisaged state interventions. During 7 months 2001 grain prices' growth equalled inflation rate. Their fall really started only in August (bringing them below the corresponding 2000 level) when harvesting was in full swing and the output could be already estimated.

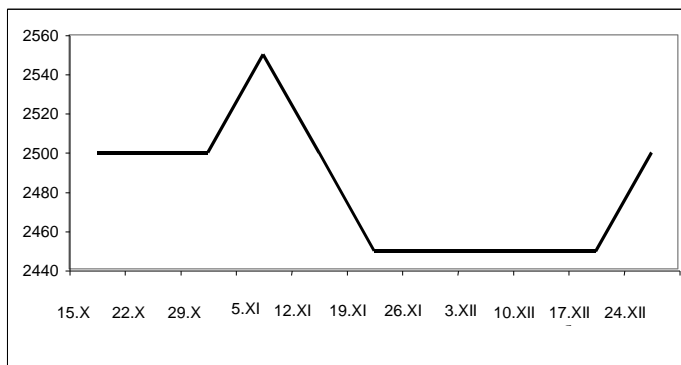
The grain market entered new 2001/2002 marketing year with large beginning stocks. According to the Russian Grain Union's data their total volume in agricultural, procurement and processing enterprises as of July 1, 2001 was above the corresponding 2000 level by 63% (in agricultural enterprises - by 38%). Large beginning stocks and good new crop conditioned drop of domestic prices for grain that transmitted into lower prices for flour.

Purchase interventions undertaken in November 2001 did not have the anticipated effect on grain prices (Figure 37).

Sharp drop in domestic output of sunflower seeds given steady demand for them and smaller world production triggered growth of domestic purchase prices. According to the EFKO company data they continued to rise in September-November, i.e. during the period of harvesting and supply of the new crop to the market. By the end of November they amounted to 8 thousand rubles (US\$ 263) per ton, by the end of the year - to 9 thousand rubles (US\$ 300) per ton (the level corresponding to the world prices). High domestic prices will entail cut in export sales that won't exceed 50 thousand tons. The bulk of produced sunflower seeds will be processed inside the country.

Figure 37

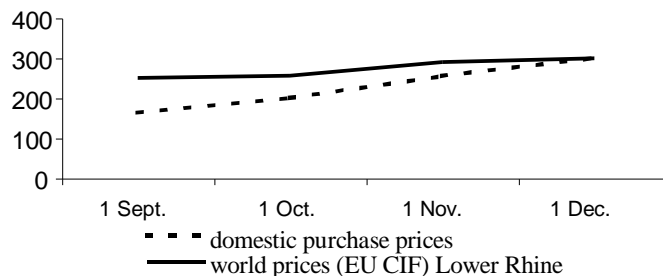
Prices for wheat #3 during the period of grain purchase interventions (November 14-21, 2001), rubles per ton



Source: Grain Union's Herald, 2001, No. 20, 22, 23.

Figure 38

World and domestic prices for sunflower seeds, US dollars per ton



Source: EFKO <http://analytic.efko.ru/fact.php3?art=14&sec=1&ord=-1&old=-1>

An additional factor supporting domestic prices for sunflower seeds was the growth of prices for sunflower oil both on the Russian and the world markets. In November 2001 sunflower oil was sold on the domestic market at US\$ 690 per

ton while the world price for it ranged from US\$ 550 (Ukraine) to US\$ 615 (Europe).

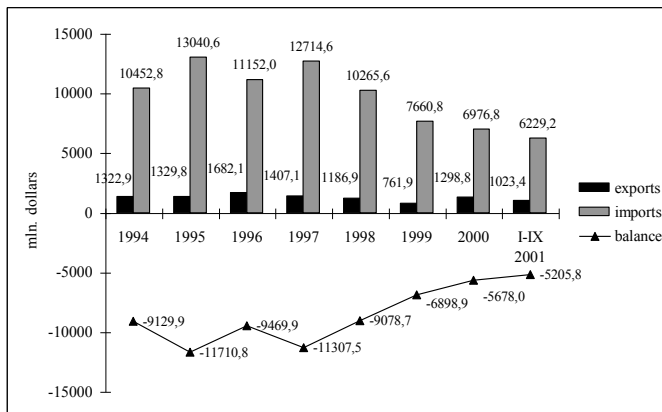
*Foreign trade*¹⁵

The process of agrifood import substitution is fading. Growth in the Russian agrifood sector continues along with restoration of agricultural and food products' import. In January-September 2001 its value was 25.9% above the corresponding 2000 level due primarily to larger volumes of import supplies. Growth of agrifood export was slower - only 10.4% to be attributed to the increase of both volumes and prices.

In 2000 the negative balance of agrifood foreign trade was record low for the recent 10-year period: -5.7 billion dollars. However, if the growth of import supplies continues one can hardly expect this trend to persist in 2001 (Figure 39).

Figure 39

Russia's agrifood exports and imports in 1994-2001



Source: Customs statistics of RF foreign trade.

¹⁵ This section primarily bases on the data of Customs statistics of foreign trade of the Russian Federation that may differ from the data of the State Committee for Statistics used in the chapter "Foreign Trade". But key trends certainly coincide.

Russia remains large net importer of raw meat. In 2001 meat imports were rapidly restoring after the lifting of restrictions thereon connected with the unfavourable veterinary situation in some countries in 2000 (Table 33). Volumes of fresh and frozen meat imported in January-September exceeded the 2000 annual total. At the same time imports of processed meat products decreased. Probably, Russia will manage to retain its competitive advantages in this segment of the market.

Imports of poultry in January-November 2001 were record high - 1241.3 thousand tons (up 8% as compared to the previous reform period record in 1997).

Table 33

Imports of basic agricultural and food products in 1996-2001, thousand tons

	1996	1997	1998	1999	2000	Jan-Nov 2001
Beef	448,9	618,1	419,5	531,4	282,3	
Pork	303,9	308,9	282,0	444,4	212,9	788,6*
Poultry	754,4	1146,6	814,5	236,0	687,2	1241,3
Butter	112,8	169,7	79,6	34,3	45,4	125,9
Sunflower oil	174,2	322,1	232,0	300,0	149,5	165,6
Wheat and meslin	2058,8	2143,0	1095,2	4547,1	2631,3	881,3
Wheat flour	720,4	386,9	216,1	124,2	126,8	н.д.
Raw sugar	1696,1	2519,2	4060,2	5773,9	4546,6	5056,3
White sugar	1436,0	949,9	385,1	125,7	271,4	242,8
Citrus fruits	443,8	570,1	541,9	379,6	472,2	474,3
Coffee	25,1	27,8	4,9	9,1	20,3	19
Tea	118,5	158,2	150,2	161,1	158,3	140,1

* - all meat.

Source: Customs Statistics of RF foreign trade, data of the RF State Committee for Statistics.

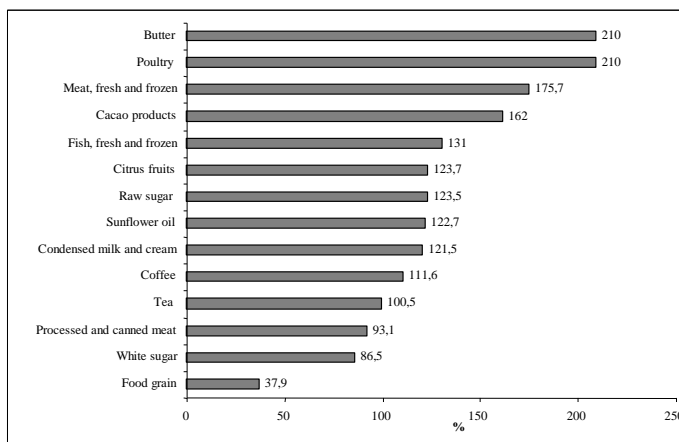
Other basic contributors to 2001 import growth were butter, cacao products and fish (Figure 40).

In recent years the situation on the world market of coffee was characterized by low prices. In 2001 they continued to drop as output largely surpassed consumption. Some producers will probably fail to sustain this "natural selection" and will withdraw from the market. However, these developments didn't influence the dynamics of Russian coffee imports: in 2001 they were up only 11.6%, although given the low world prices one could expect higher growth rates.

The import of white sugar was constrained by high customs duties, on the one hand, and by disadvantageousness of purchasing raw sugar under tariff quota - on the other. In 11 months 2001 sugar imports fell by 13.5% (Figure 40). However, there was no deficit of white sugar on the domestic market and even some stocks accumulated. Home-produced sugar substituted for the imported one.

Figure 40

Imports of basic food products in January-November 2001 as % of January-November 2000



Source: RF State Committee for Statistics.

Relatively good crop and successful harvesting in 2000/2001 marketing year laid the basis for expanding exports and reducing imports of grain. In January-November 2001 the latter was 62.1% below the corresponding 2000 level, while exports of wheat and meslin grew 2.6 fold. As a result the negative balance of trade in grains in the first 9 months of the year shrank by 88%. The expansion of export deliveries led to the overloading of ports' and railroad capacities. Thus, supplies to foreign markets are constrained by the poor development of transport and storage infrastructure. Good grains crop in the recent years helped to build domestic stocks of flour and to expand its export by 23.3% as compared to 9 months 2000.

Markets of the EU countries became more attractive for Russian grain exporters after the decision to lift a special import tariff on grain originating from Eastern Europe and delivered by railroad or through Mediterranean, Black and Baltic Sea ports came into effect. Beginning from November 2001 the corresponding import duty on wheat was reduced from 10.39 EUR per ton to 0.39

EUR per ton, that on barley and rye - from 20.37 EUR per ton to 10.37 EUR per ton.

Table 34

Exports of basic agricultural and food products in 1996-2001, thousand tons

	1996	1997	1998	1999	2000	9 months 2001 as % of 9 months 2000
Frozen fish	89,3	186,7	301,3	229,6	290,6	120,4
Wheat and meslin	359,9	543,3	1523,7	650,8	419,0	278,8
Barley	195,2	1300,0	346,9	99,7	539,4	239,9
Sunflower oil	42,7	25,8	34,5	30,8	194,8	60,8
Sunflower seeds	1779,0	1049,2	1107,2	312,1	1114,9	39,3
Vodka, decalitres 100% alcohol	29525,2	1327,5	475,7	683,3	563,7	134,5

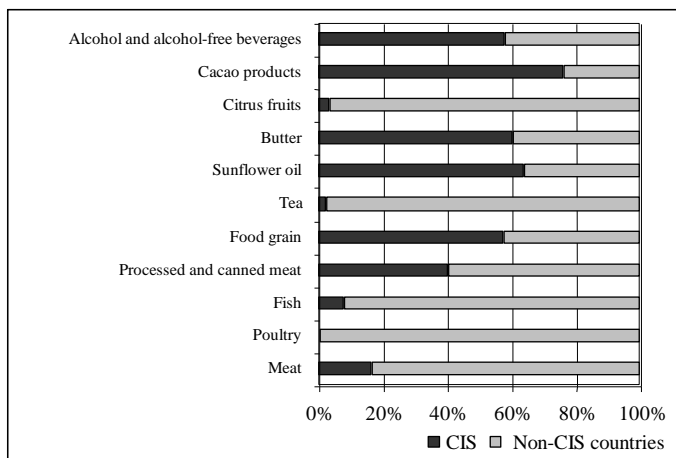
Source: Own calculations based on Customs Statistics of RF foreign trade.

In the first half of 2001 Russia remained a net exporter of sunflower seeds. Still, their exports notably fell (by 60.7%) and exceeded imports 61.4 fold as compared to 96.8 fold in the previous year (Table 34). This drop is due to the seasonal shortening of stocks and relatively small sunflower output in 2000.

Given the above mentioned unfavourable ratio of domestic and world prices for sunflower oil, its import became more competitive as compared to home production and grew by 22.7% (Figure 40). Besides, its structure changed as a result of larger purchases of less expensive palm and soybean oils that increased by 72.7% and 64.5% respectively. Exports of sunflower oil, on the contrary, fell by 39.2% which is quite natural (Table 35). As a result, Russia lost its status of net exporter of this item. In 2001 imports were 25% larger than exports while in 2000 the latter exceeded imports by 23%.

In January-November 2001 the major contributors to imports' growth were non-CIS countries (Figure 41) that accounted for the bigger share of supplied meat and meat products, fish, citrus fruits and tea. The CIS countries' sales to Russia largely consist of butter, vegetable oils, grain, cacao products, alcohol and alcohol-free beverages.

Figure 41
Geographic structure of some food items' imports in January-November 2001, %



Source: RF State Committee for Statistics.

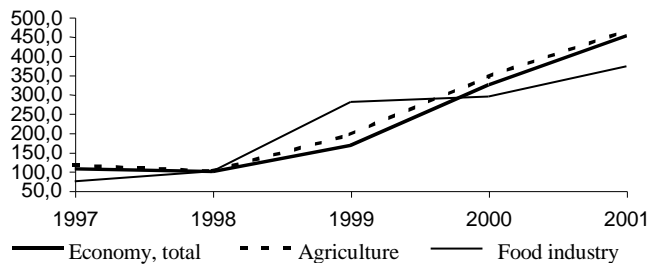
Agriculture's financial performance and budget support to the agrifood sector

The agriculture's financial performance was determined by the positive development trend in the past two years and the start of restructuring debts to the budget. Some segments of the agrarian sector became quite profitable (e.g. the profitability of grains in some regions amounts to 400%). Together with the substantial tax privileges it makes agriculture attractive for investors. Capital comes from external industries, e.g. fuel and energy. Vertical holdings continue to develop in the sector. Adoption of the new Land Code will intensify this process and encourage further inflow of capital to agriculture in the near future.

In 2001 investments in agriculture's fixed capital increased more than 4 fold as compared to 1997 (Figure 42). In the post-crisis years they grew faster than investments in food industry and the general economy.

Figure 42

Fixed capital investments, 1998=100%



Source: RF State Committee for Statistics.

In the first half of 2001 direct foreign investments in the primary agricultural production grew by 1/3 (i.e. by 5 million dollars). The major part of them came from Panama being actually a repatriation of Russian-origin capital rather than real foreign investments.

The outcome of implementing the program of subsidizing interest rate on bank credits to the agrifood sector for the first full year round was the boom of respective credits. They grew 6 fold as compared to the previous year (which was not the worst one in this respect) while the total amount of bank credits in 2001 was up only 2 fold. The envisaged budget spendings on subsidizing the interest rate (1.3 billion rubles) were funded in full. 212 banks granted credits amounting to 16.5 billion rubles to over 8 thousand agrifood enterprises. The major creditor was "Sberbank"¹⁶ that has never before been engaged in crediting the agrarian sector (53% of the total amount of subsidized credits, or 3% of the bank's credit portfolio), then follow "Rosselkhozbank"¹⁷ (7%), Alfa-Bank (4%, or 1.4% of the bank's credit portfolio) and "Vozrozhdenie"¹⁸ (3.2%, or 10% of the bank's credit portfolio)¹⁹. "Rosselkhozbank" actually distributed in the form of credits 1 billion rubles received from the budget (accounting for 6% of the total subsidized credit). Other banks conducted normal banking operations: accumulation of deposits and investment of funds in the form of credits to agriculture.

¹⁶ "The Savings Bank".

¹⁷ "Russian Agricultural Bank".

¹⁸ "Renaissance".

¹⁹ "Finansovye Izvestiya" ("Financial News"), December 25, 2001, p.3.

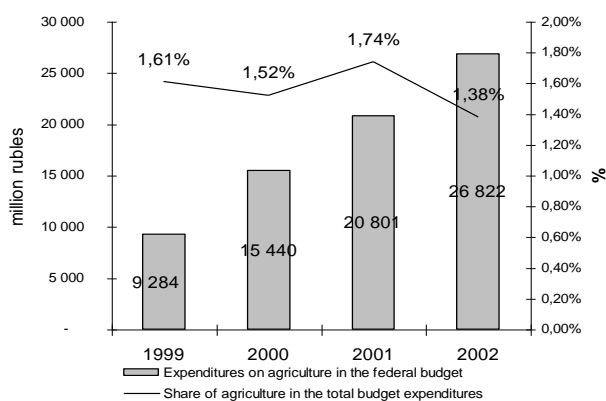
In 2001 the financial performance of agricultural producers continued to improve. In the first of the year the share of loss-making farms declined by 0.4% while the total profits amounted to 14.1 billion rubles (by the end of the year the Ministry of Agriculture estimates them to reach 20 billion rubles, or 6 billion rubles above the corresponding 2000 indicator).

On the other hand, the sector actively gets rid of failed producers. By the end of 2000 bankruptcy proceedings were initiated against slightly over 1 thousand agricultural enterprises and private farms, by May 2001 - against 26.1% more agricultural producers (totally they account for 25.7% of bankruptcy proceedings in the country)²⁰. The restructuring of debts will accelerate the process.

Nominal budget outlays for the agrarian sector grow since 1999. However, in 2002 their share in the total federal budget expenditures is smaller (Figure 43).

Figure 43

Federal budget expenditures on agriculture



Source: RF Laws "On 2000 federal budget", "On 2001 federal budget" and "On 2000 federal budget".

Besides, the amount of federal funds actually received by agriculture is below the budget provisions. In January-September 2001 the federal financing of

²⁰ A.Khristenko. Practices of adjudging bankrupt an indebted agricultural entity in case of property attachment. - *Agrarian Reform. Economics and Law*. No.5 (17), 2001, p.17.

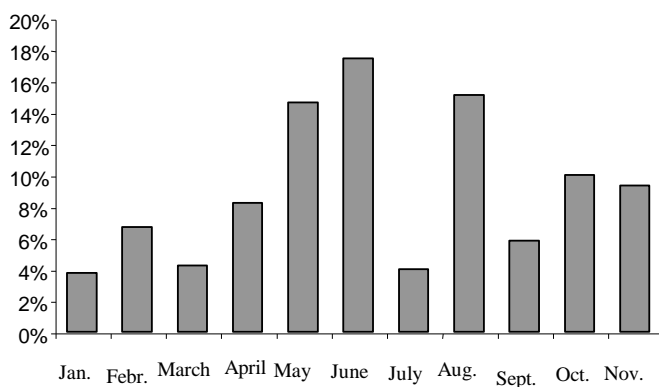
the sector equalled 13.8 billion rubles which is only 63% of the respective amount envisaged in the budget for this purpose. This is quite a low level (as compared to financing of other budget items) resulting from the fact that the Ministry of Agriculture worked out funds' allocation schemes only in April-July 2001 and some of them were adopted as late as November.

In January-September 2001 the share of federal budget in the total budgetary expenditures on agriculture amounted to about 30% as compared to 24% in the previous year. Thus, the federal government regains its positions in regulating the agrifood sector.

Due to the seasonal nature of agricultural production the total amount of budget spendings is not the only thing that matters - equally important is their distribution by months (Figure 44). It's essential for agriculture to get budget funds before seeding. Meanwhile, in 2001 they reached their maximum in May and June. At the year start the financing was scarce and fell again in July. However, by the beginning of harvesting (in August) the sector received a large share of budget funds. Better financing in October-November is due to the adoption by that time of funds' allocation schemes under many programs.

Figure 44

Federal budget expenditures on agriculture by months, %



Source: Ministry of Finance.

In 2001 the types of budget support to agricultural producers remained actually the same as in the preceding years. Financing of soil fertility improvement was prioritized. Crop and livestock production development programs also received almost the full amount of envisaged funds. However, most types of state support are not efficient. Among them is the currently prioritized program of compensating producers' expenses on mineral fertilizers. Special studies showed that it doesn't help to improve producers' performance.

Budget funds are still used to compensate a part of agricultural producers' spendings on seeds of grains and oilseeds despite their being the most profitable crops. The reasons for that are very doubtful since the marginal product in grains and oilseeds production fully covers the marginal cost of purchasing elite seeds, and thus producers are quite able to pay for them themselves.

All the mentioned programs of supporting agricultural producers were preserved in the 2002 budget.

Agrarian policies

Land issues

The most remarkable achievement of 2001 agrarian policies was the adoption of new RF Land Code by the State Duma.

The fate of this law is rather dramatic: its various versions were being discussed in the State Duma since 1996 but only now the adoption of a more or less sound document became possible. Contrary to the common notion there was a Land Code in the country adopted back in 1990. When the new Russian Constitution was enacted, this Code turned out to be quite obsolete and many of its provisions were annulled by the 1993 President Decree. Still, the Code remained in force and together with other normative acts regulated land relations in the country. And what's more, the then operative legislation declared the existence of private land ownership in the country (including agriculture) and permitted to conduct basic land transactions except for farmland mortgage (that was prohibited by the 1998 Law on mortgage). It's essential to keep all this in mind when assessing the true importance of the new Land Code: the document doesn't signify a revolutionary legitimisation of private land ownership in Russia but is a step towards comprehensive and complex land legislation adjusted to the new stage of the country's social and economic development.

In fact, three drafts of the Code were introduced to the State Duma. First, the old version worked out by the Agrarian faction back in 1996 with multiple

amendments introduced later. Once it has already been vetoed by the President. This version was obsolete at the very moment of its initial introduction. And these were not substantial limitations on agricultural lands' transferability that mattered - after all, they could have been abrogated in time, - but the imperfection of the document itself: it was poorly written in legal terms, didn't solve all the problems of land legislation, could not be reasonably amended afterwards and, thus, in time had to be replaced with a new Code. Second, the bill worked out by the Right Forces Alliance faction. By now, this Code is most complex and up-to-date, corresponding to the world trends and at the same time reflecting land transformations that took place in the country during the reform years. Finally, the third bill worked out by the Government. This is a compromise version, although the compromise is attained not by averaging the first two versions but by incorporating the basic provisions of the second version and by laying aside the most serious drawbacks of the first one for further examination. In other words, the Government version accepted the logic of draft Code proposed by the Right Forces Alliance but excluded from it issues relating to agricultural lands' transferability.

The adoption of Land Code in its current version signifies a great progress in terms of politics. All the previous attempts to pass progressive land legislation failed voted down by the agrarian and communist opposition in the State Duma. The passage of the Code by the Duma evidences a new balance of political forces in the country. Moreover, it sends a positive signal to economic agents. Though private land ownership in the country has long been legitimated (as we have mentioned above), virtually both business and officials were temporizing as continuous debates on land legislation made the situation unstable and acquired property rights were not guaranteed. So, this is the first important role of the adopted Code.

Its second role is purely legal: it creates a legal basis for regulating land relations and brings together numerous laws that served this purpose earlier. The procedure of acquiring and transferring land property titles is thus simplified, opportunities for rent seeking therefrom are largely eliminated, owners' rights become better protected.

We find that the Code has two basic shortcomings.

First of all, it is primarily targeted at regulating land relations outside agriculture. At present about 2/3 of farmlands and only 6% of urban lands have been privatized. Agricultural lands were subject to large-scale land reform (here we do not speak of its qualitative outcomes) while lands in cities and towns were not. The major part of urban land belongs to municipal authorities that withhold from

selling it since land property is an important source of local budgets' receipts and a good mechanism for manipulating economic entities, to say nothing of rent seeking in the process of allotting land plots. The new Code's adoption doesn't change the situation: the permission to sell and to buy land in cities (by the way, already being in force) will by no means make city authorities do it at their own will. Thus, the new Code just preserves the existing *status quo* in the urban land problem. In these circumstances the only way to solve the collision is to adopt an efficient law on enforcing the Code that will establish the procedure of privatizing land in cities.

The second problem unsolved by the Code is the determination of lands' category. Beginning from the Soviet period a category of land is determined by the fact of its allotment to some specific use. For example, agricultural lands are lands allotted to farming. Given the state land monopoly it was then logical and operational. But when land is privately owned, plots are no longer allotted - instead, they are acquired by means of civil transactions (purchase, inheritance, etc.). Formally, according to the above mentioned rule the fact of purchasing a plot of agricultural land discontinues its belonging to lands for farming category. But none of the three proposed versions of the Land Code revised the obsolete system of lands classification and this is going to be a notable hindrance to land relations development in the country. An up-to-date land zoning is needed and the solution of this problem could have become a subject of another, auxiliary law that was also passed this summer - the law on land management. But this law is far from being adequate to present requirements.

The year end witnessed extensive debates on farmland transferability law. By now 4 drafts of the bill are introduced to the State Duma, the government's concept has been discussed at several forums.

On the whole, the concept is quite a liberal document taking into account existing land practices in the agrarian sector, giving full scope for further development and lifting some ungrounded and needless restrictions.

In particular, the document deprives regions of the right to set their own restrictions on land property disposal. This provision is already included in the Land Code but there is a danger that it will be once again brought up for discussion when examining the new land law. The government concept defines it as a principal one. This is important since different regional land regimes enlarge transaction costs of agrarian holdings often operating on the territory of several regions.

The second merit of the Concept is the virtual lifting of skill requirements to land property owners. Practice shows that such requirements pose financial rather

than qualification barriers to potential land owners and from the point of view of society as a whole are an additional feeder for corruption.

The right of foreign individuals and legal entities to own agricultural land is restricted in few cases. To our mind, given the permitted land ownership by legal entities, any restrictions of personal foreigners' rights become a fiction since they are easily evaded. Thus, the choice between respective permission or ban is actually the choice between social and psychological appeasement of population (that is known to be generally against foreigners' land ownership) and the international rating of the country²¹.

Still, we find that the most serious bottleneck of the government's Concept is the virtual abolition of land share tenancy practice. In case an owner of a land share wants to rent it, he'll have first to parcel out his physical land plot. To our mind, this will become a dramatic hindrance to land transfer in agriculture that at present goes on primarily in the form of land share tenancy.

The large scale of agricultural production in Russia conditions accumulation of a great number of land shares in one hands (a person or a legal entity). This accumulation can be attained by either purchase or rent, the latter being spread much wider. In both cases the existing practice of conditional shares has advantages. It presumes that an owner of such a share has the absolute right to parcel out a physical land plot, but until he does that the location of his plot is not specified. A land share is a sort of option to be sold, purchased, rented, inherited, etc. This mechanism enables an entity wishing to acquire a large land area for agricultural production to accumulate the needed number of shares and only then to apply for parcelling out a land plot (or several plots). As a result the problem of land plots' consolidation (that is inevitable in case of acquiring physical plots²²) is evaded. Consolidation requires time and funds and thus can avert potential investors from the agrarian sector.

The second advantage of renting a share over renting a physical plot is its preferability for the share owner making him more willing to rent out. In case a share is rented, the tenant can get the corresponding land plot that is most suitably located (consolidated with other rented or purchased plots). After the term of the rent is over, the share owner may wish to parcel out a plot for his own needs. If the location of formerly rented plot doesn't suit him, he can return it to collec-

²¹ For example, the diminishing of residential qualification for foreigners to acquire farmland is currently one of the stumbling stones for Poland's acceptance to EU.

²² This statement is supported by the experience of all East and Central European countries where land was physically distributed (irrespective of the form of such distribution - restitution or compensation).

tive land use and to parcel out another plot. In case the location of a rented plot is specified once and forever, its owner may not wish to rent it out or its location may not suit the potential tenant and he will refrain from renting.

One more shortcoming of the government concept is the setting of upper limits on individual and corporate land ownership. The alleged reason for that is the need to exercise antimonopoly control. But, first, ownership of land doesn't presume market monopoly; second, limits on land ownership will have no anti-monopoly effect given the lack of limits on land tenancy; third, these limits will be hard to control and will become one more source for corruption.

Taxation in agriculture

At the end of December 2001 the President of the Russian Federation signed the Federal Law "On introducing amendments and supplements to Part II of the RF Tax Code and to some other RF legislative acts on taxes and duties". This document authorizes the transition to single agricultural tax, the rationality of which has been debated in the agrarian establishment and the RF Legislative Assembly for several years. Farm producers will now have to pay a special single agricultural tax that replaces the bulk of former taxes and duties and the amount of which depends on land area. Land is appraised on the basis of cadastre values. The single agricultural tax incorporates all taxes (except VAT, personal property taxes, various duties and excises) and transfers to the Pension Fund. The newly set tax period is three months.

In fact, this tax basing on land area in hectares is a sort of presumptive tax. In the world the latter is usually levied on small enterprises. There are few small producers in the modern Russian agriculture. It's true that up to one half of gross (but not commodity!) agricultural output is produced in individual household plots. However, the absolute majority of them are legally not subject to taxation. The share of private farmers in the sector's gross output is only 7-8%. Besides, the most productive private farms are relatively large cultivating thousands of hectares and employing dozens of workers. The basic agricultural producers are large-scale enterprises. Moreover, the number of very large farms incorporated in agrohholdings (controlling hundreds of thousand hectares) in the past 2-3 years notably grew. Now they will also pay the new single tax.

Since Part II of the Tax Code does not envisage any profit tax exemptions for agriculture, this tax is also included in the single tax. The amount of single agricultural tax is based on the previous period performance, i.e. it includes tax that agriculture should have (but legally did not) pay on profits actually received

in 2001. As a result farms that were most profitable last year will now bear the heaviest tax burden.

Moreover, the new law doesn't treat "agricultural entities of industrial type (poultry, greenhouse, fur farms, livestock complexes, etc.)" as agricultural producers despite their being the most intensive ones. This means that beginning from 2002 their tax burden becomes much heavier since they start to pay profit tax and lose social and road tax privileges.

The federal legislation doesn't enumerate "industrial enterprises" - this work is to be done by legislative bodies of the Federation's constituent members. Since inclusion into such a list deprives a farm of noticeable tax privileges, this procedure becomes a rather powerful tool for influencing large agricultural enterprises. By the way, it came up quite in time: in recent years the effectiveness of pulling such strings as commodity credits, leasing arrangements and other subsidy mechanisms in regions greatly diminished and now they are being replaced with the "tax bludgeon".

One more provision of the law also causes concern. It states that the single agricultural tax is imposed on "agricultural land being owned, possessed and (or) used" (i.e. an agricultural producer has corresponding titles to land). In other words, rented land areas are not subject to taxation. But nowadays most agricultural producers rent farmland by renting land shares. Land shareholders are not agricultural producers: they are either employees, or pensioners, or rural social workers, renting their shares to farms. This means that all land rented in the form of shares gets exempted from taxation and an agricultural enterprise pays the single tax only on owned or used land areas the share of which is relatively small.

And finally, the rational for establishing a 3-months tax period is arguable. In case the law-makers really wanted to improve taxation in agriculture, they would have proposed to change the payment period for all taxes rather than to introduce the single agricultural tax to be paid every 3 months. It's a common knowledge that agricultural production is seasonal. Producers get major money receipts in the second half of a year after the crop is harvested and marketed. In the first half of a year they primarily spend their funds. Thus it would be most adequate to collect the bulk of taxes (or the single agricultural tax) at the end of a marketing year. (By the way, this is the case in Ukraine - the only country of the world (except Russia) applying the single agricultural tax). The transition to 3-months period of tax payment in agriculture doesn't improve the situation in this regard and the reasons for altering the traditional monthly period are not clear.

In other words, the special regime of taxing agriculture creates new problems for the agrarian sector rather than solves the existing ones. Thus we dare suppose (and hope) that it won't be effective for long.

Regulation of agrifood markets

The key novelty of market regulation policies in 2001 were grain interventions.

In 2000 in the Program of social and economic development of Russia till 2010 the Government declared its intention to begin interventions on the grain market. At the end of the year the conference headed by Prime Minister approved the program of developing grain production in the country that also incorporated intervention provisions. It was decided to use the receipts from selling raw sugar import quotas (the tender was held in November) for funding the interventions. In other words, grain market interventions no longer raise doubts and therefore since the corresponding Government Resolution was adopted in summer 2000, their procedure rather than expediency is being discussed.

Indeed, the 2001 crop was rather good and prices were consequently falling. It could seem that in this situation state interventions on the grain market are quite justified: it's reasonable to support grain producers when prices slide down. But this is so only at the first glance. Grain was and continues to be one of the most profitable agricultural products. Lower prices will probably reduce profitability of grain production but not to the extent to make it low-profit and threatening the economic well-being of grain producers.

One more argument in favour of interventions is the seasonal nature of grain production. Farms usually have to sell the harvested crop in autumn. Statistics show that by December most agricultural enterprises have no grain stocks. Traders are thus the ones who benefit from higher spring prices. An attempt to more equally distribute returns from marketing grain between producers and traders is quite an acceptable explanation for state purchase interventions. However, they were carried out only in November and therefore benefited grain market operators rather than agricultural producers.

Besides, a purchase intervention irrespective of the way it's carried out supposes the purchase of grain by the state at the intervention price. In case the market price is below the intervention one, these purchases help to raise it up to the set level (the level of intervention price). In case the market price is higher nobody will sell grain to the state. It's obvious that given such a system there should be a guarantee against an unconstrained inflow of imported grain to the domestic market. Otherwise, the grain purchased by the state will be replaced by the im-

ported one, the desirable growth of price won't be attained and the whole operation will lose sense. That's the way the mechanism of minimal guaranteed prices worked in the EU: a variable import tariff on the regulated product was imposed in line with the intervention price. Nothing of the kind is envisaged in Russia: the mechanism of grain interventions is worked out by the Ministry of agriculture, import tariffs are in charge of the Ministry of economic development and there are no coordinated tactics in this domain. It's fortunate that the intervention price was set at a relatively low level and thus didn't encourage penetration of Kazakhstan's grain to the Russian market.

Actually interventions were carried out within 6 days in November. Wheat # 3 was purchased although all experts asserted that the price for fourage wheat (# 4) experienced the deepest drop. The intervention price interval was set at 2300-2700 rubles per ton depending on the region. 250,200 tons of wheat were bought to the total amount of 675.3 million rubles (or 33.76% of the 2 billion rubles allocated for this purpose). Only 3 companies sold grain to the state and did it expectedly at the maximum price and from the stocks that had been built long before the interventions started. Thus, these efforts didn't really influence grain producers.

It's still not clear what the state will do with the purchased grain. In any case, its sale on the market won't affect prices and will only help to return the funds spent on purchase and storage.

Input subsidies

In 2001 the most successful effort in this respect was the support of seasonal credit to the agrifood sector. The program of subsidizing interest rate on bank credits to agrifood producers (initiated during 2000 harvesting) was continued. Two thirds of the Central Bank's refinancing rate as of the date of the credit's granting are reimbursed within the limits of funds envisaged for this purpose by the law. We have already underlined the successfulness of this program (see the financial performance section). Back in March 2000 the state Russian Agricultural Bank ("Rosselkhozbank") was formed for granting soft credits to agricultural producers. But it started to perform these operations only in September 2001. In compliance with the government Resolution by the end of the year the bank is to spend 1 billion budget rubles on crediting harvesting works. According to preliminary estimates the bank succeeded in doing that. But as different from other banks engaged in commercial crediting of the agrifood sector, it distributed budget funds. There is a danger that in case budget transfers to this bank are enlarged, it will start to compete with commercial banks and the process of extend-

ing normal bank credits to the agrifood sector that is currently underway will be hindered.

In June the government adopted Resolution “On improving leasing activities in the agrifood sector”. The need for revising the federal leasing program became evident long ago and we continuously wrote about it. Still, the recently taken decisions aggravate the problem of input supply even more. The Resolution envisages creation of State Unitary Enterprise “Rosagroleasing” whose authorized capital will accumulate all budget funds allocated to leasing support. The former “Rosagrosnab” monopoly is replaced with a new one inheriting all the existing problems. However, the transfer of authorities from one organization to another requires time and seems to be the cause of an actual failure of the leasing program in 2001.

In June the government at last took the long needed decision “On the rules and terms of restructuring agricultural enterprises’ and organizations’ bad debts in 2001”. It sets the rules of restructuring agricultural producers’ debts to the federal budget and non-budget funds as well as fines and penalties imposed on them. In case the terms of restructuring the principal debt are met and the current payments are made in time, all fines and penalties as of January 1, 2001 are written off. This scheme detriments agricultural producers who have settled the principal amount of debt and owe only penalties and fines. Still, we find that this decision will have a strong effect on the agrifood sector’s performance in 2002.

Foreign trade regulation

The regulation of agrifood foreign trade in 2001 remained actually the same as in the previous year: stronger trade protectionism on the one hand and taxation of exports - on the other.

Import duties on caramel and starch were raised. The RF Government Commission on foreign trade protective measures found that the import of these items to Russia (primarily from Ukraine) detriments Russian producers.

As a result of excessive prices for sugar quotas at the 2000 tender, the market position of its winners was worse than that of importers buying sugar in excess of quotas. The government extended sugar import regulation and introduced seasonal 45% (but not less than 0.16 EUR per kilogram) import duties on white sugar beginning from July 2001 till the end of the year and seasonal 40% (but not less than 0.12 EUR per kilogram) import duties on raw sugar beginning from November till the end of the year. In 2002 the tariff regulation of white and raw sugar imports is going to become more rigid. Despite the failure of sugar quota tender sale in the previous year, in 2002 such a tender will be held again. The

customs duties on importing both white and raw sugar are set at 40% (but not less than 0.12 EUR). Seasonal duties will also be raised - to 50% (but not less than 0.15 EUR).

Import duties on rice were also elevated from 5% to 10%. Rice does not play an important role neither in the structure of domestic grain production, nor in the food ration of Russian consumers, nor in agriculture's returns in the major producing region (Krasnodar kray). Respectively, protection against its import is not prioritized.

In 2001 the Customs tariff law was slightly amended in order to simplify collection of customs duties by unifying (reducing) their rates on narrow sub-items. Of all the agrifood products these innovations will be applied only to fruits. Import duties on sunflower, soybean and rape oil will be, on the contrary, elevated. Only the specific component of new import duty on the above oils will grow - from 0.09 EUR per kilogram to 0.14 EUR per kilogram for packed oil and to 0.10 EUR per kilogram for unpacked.

In December non-tariff restrictions were introduced on import of ruminants, their embryos, bone beef, mutton, sub-products and other raw products from ruminants originating from Austria and Finland due to phytosanitarian problems.

The regulation of agrifood export remained rigid. In order to secure raw inputs supply to domestic fat and oil industry given their shorter home output, in April 2001 export duties on sunflower seeds were doubled (from 10% but not less than 15 EUR per ton to 20% but not less than 30 EUR per ton) and those on soybeans and rapeseeds - raised to 20% but not less than 35 EUR per ton. This decision can hardly be called economically reasonable. At the end of 2000 the price for sunflower seeds on the Russian market started to noticeably grow. The basic factors thereof were the rise of world prices for this crop and the seasonal shortening of domestic stocks entailing shorter exports. In the first half of 2001 sunflower oil stocks on the domestic market were 34% over the corresponding level of 2000. In view of the above stronger export restrictions seem unjustified.

In 2002 the list of agrifood products subject of export taxation will include mustard seeds: its exporters will have to pay 10% (but not less than 25 EUR per ton) customs duty.

Short-term outlook for agrifood sector development

The situation in Russian agrifood sector in the coming years will be shaped by two opposite trends.

Agrifood sector's performance in 2001 is still good, but already the next year will be much harder. First, given the current trends the effect of import sub-

stitution will be completely exhausted and it will become clear what Russian products have real comparative advantages on the world market. Second, the initiated restructuring of debts will induce a wave of bankruptcies in agriculture. The clearing of the sector of inefficient producers will eventually bring positive results. But at the initial stage it will rather entail production drop. Besides, the lack of more or less sound rural development policies is likely to increase social tension in regions where many agricultural producers go bankrupt.

At the same time good sector's performance in 2001 laid a certain basis for improving the situation in 2002. Larger areas were planted in winter crops that given favourable weather can result in bigger next crop. Better financial performance of agricultural producers enabled them to improve their technical level. The restructuring of agriculture's debts may lead to further deepening of banks' involvement in financing the sector and to a wider spread of financial leasing.

The balance between these two trends will be determined by external factors: weather conditions, macroeconomic indicators (first of all, the growth of real disposable incomes of population), situation on the world markets of raw materials, etc.

The structure of agricultural production will shift to large holdings while household farming will gradually become less important as macroeconomic situation improves. The progress of vertical integration will imply capital inflow in the agrifood sector although in the near future nominal investments in the primary production won't be large.

Despite the active negotiations on Russia's acceptance to WTO, the agrarian protectionism will strengthen. Due to errors in market regulation additional corrective practices will be introduced rather than inefficient ones will be discontinued. For example, since the RF Ministry of Agriculture started the meat production development program and buys meat breeding animals abroad, one can expect higher import duties on all meat items in the coming years. The non-efficient sugar market regulation will be continued. Thus, Russia can get into "a vicious circle of protectionism".

2.5. The sphere of science and technology

The past year can be characterized as demonstrating every sign of stabilization in the sphere of science and technology. During that year certain minor changes took place in the management and structure of the government executive bodies responsible for the development of the activity in science and technology. A new person was assigned to the post of the Minister of Industry, Science and Technologies, as well as the Council on Science and High Technologies was set

up under the President of the RF to ensure prompt discussion of the problems in the sphere of science with the President of the country.

The replacement of the former Minister resulted in a change of some of the priorities. Firstly, the support of the innovation activity will, most probably, become stronger. Secondly, there exists a high probability that an auditing of the State Scientific Centers (SSCs) will be carried out and the creation of the Federal Centers for Science and High Technologies (FCSHT) will be speeded up. Finally, there has almost been put a stop to the initiative which was one of the priorities for the former Minister - that of "codification of knowledge".

At the present time in the country there are 58 functioning SSCs, and during the past year they underwent a routine certification. Initially the SSCs had been created for the purpose of preserving the most important research structures and directions for research, and this status, as a rule, was granted to institutes with unique and large-scale experimental base. By now it has become clear that this status has become somewhat obsolete because there is no more any vital need for urgent salvation of scientific centers. However to achieve a well-grounded decision concerning the future of the SSCs it is necessary not only to analyze their scientific results (which is done regularly) but also to evaluate the economic effectiveness of their activity. There exists a generalized estimate made by the Ministry of Industry, Science and Technologies according to which to every rouble from the budget the SSCs earn additional 7 roubles. This is an evidence that the SSCs are existing and developing mostly due to their inner resources where not the least role is played by sub-leasing their premises.

The SSCs can be replaced by new structures, and there are several possible schemes for their transformation, one of which is to create such centers on the base of the FCSHTs involving a more in-depth integration of science, education and industry. The FCSHTs are replicas of MSTCs only acting in a new legislative environment and on the basis of a new, revised list of priorities in the sphere of science and technology. The status of a federal center means a corporate-type conglomerate of higher educational establishments, research institutes, industrial entities and design bureaus oriented at developing and distributing new technologies in different branches of science. In fact they are corporations engaged in research and industrial production, the foundation of the industrial sector. After a two-year-long discussion of the FCSHT concept, in November 2001 one such center was finally established on the basis of the All-Russian Center for Science and Research on the problems of civil defense and extraordinary situations of the MES of the RF. Though the first FCSHT has come into being, there are still quite a few problems yet unsolved. Thus, there is no definition of the legal term

“federal center”, and the notion is not quite compatible with the provisions of the Civil Code. The FCSHTs have not received any state guarantees for their activity though their status entitles them to receive additional budget financing (similar to the programs of SSCs). Finally, the FCSHTs so far have not been coordinated with state orders in the sphere of science and large-scale development projects in science, technology and industry.

The striving to economize as far as the state funding is concerned has not always been well-grounded which in some cases resulted in curtailing certain studies that are considered to be of primary importance in the rest of the world. Thus, while revising the content and the mechanisms of selecting and financing for the federal targeted programs, cuts were made on a number of important directions for research, including the program “Human Genome”. Besides, from now on there is going to be only one grant recipient on each of the themes (while the themes have been merged to a considerable degree). At the same time it has not yet been specified in detail who and in which manner is going to conduct an expertise and on the basis of which criteria. The new approach in fact encourages monopolism in science and is especially severe toward the regional centers of science. Today only a tiny part of the whole government budget on science (as compared to the base funding level) is being spent on the programs, and economizing could have been done by changing the ratio between basic and competition-based funding. However in practice the structure of funding was still being shifted toward further increase in the relative share of the costs of maintaining the network of research organizations and administrative structures while the share of competition-based funding was being continually reduced and the allocations for the government research funds were being kept at a constant level.

The institutional changes in 2001 were negligible and were primarily concerned with science in the academic and educational spheres. On the whole, the number of organizations in the sphere of science and technology grew 0.7% and, according to preliminary estimates, reached 4176. The growth rate was approximately twice as low as in the preceding year. The highest growth rate was seen as regards research institutes, including those in the system of the RAS. At the same time, the research entities that had been found inefficient continued to operate.

The focus of attention, almost throughout the whole year, was placed on the RAS - and not only because that was the year when its President and Presidium were reelected. The RAS has preserved most of the features characteristic of its predecessor, the Soviet Academy of Sciences and has become poorly adjusted to the framework both of the existing legislation and of the altered economic reality, and this has triggered a discussion on the necessity of its institutional reformation.

During the year 2001 the Academy was trying to demonstrate that its function is to be not only the country's main expert on science matters but also the main coordinator of the development of interaction with branch sciences and the promotion of the innovation activity, the integration of science and education, attracting the young into the sphere of science, and some other initiatives. Some of these measures revealed the crisis of authority within the RAS rather than contributed to its consolidation. Thus, in May 2001 an event took place that which stirred a strong negative response on the part of the academic community and foreign academic and charitable organizations. The Presidium of the RAS approved the Decree (Order) "On the Plan of the Measures to Be Taken by the RAS in Order to Prevent Inflicting Damage on the Russian Federation" which soon was replaced by another document - the resolution of the Presidium of the RAS No 175 of June 19, 2001 "On Improving the Activity of the Research Institutions of the RAS in the Area of International Cooperation in Science and Technology and Protection of Intellectual Property" wherein the original stipulations if the first resolution were to a considerable degree softened and shortened. The essence of the initial action can be boiled down to the following: scientists were to be obliged to submit to the directors of the institutes full information about their international contracts and grants, to provide the information about future applications and submit their copies, to report on all foreigners' visits to laboratories, to submit reports on the results of research-oriented visits abroad, and, finally, to submit to the institutes' administration copies of all articles to be published abroad.

In response to indignant comments the RAS offered some explanations as to the purpose of the resolution in question and also that it was to be applied only to the works involving the development and application of dual-purpose technologies. It is true that this practice as regards the works in question is acceptable all over the globe; however it applies to specialized national laboratories, not to universities which are counterparts of our academic institutions. Besides, the initial document was formulated in such a way that it was difficult to guess that its application is limited only to dual-purpose technologies. Today, after a new resolution has been approved, the question seems to have been settled.

The necessity for institutional transformations has become vital also for the research activity of higher educational establishments, especially after the recent changes in the active legislation. At the present moment, from the legal point of view, the research institutes attached to higher educational establishments has found themselves in a dubious situation: though they are included in the list of research organizations their organizational and legal form as well as the legal

status are not defined. Therefore the research institutes and research divisions at higher educational establishments cannot be accredited as research organizations and thus have no right to enjoy the privileges granted to such organizations. Perhaps one of the natural legislative solutions could be for the state higher educational establishments to create unitary enterprises that are both to finance and to carry out research activity. The situation might also become better regulated after research universities and university complexes are created. However so far many research institutes have joined higher educational establishments as their structural subdivisions thus having discontinued their former status of separate legal entities and pursuing their activity on the basis of a mandate issued by the rector. But this situation is very often inconvenient for both the research institute and the higher educational establishment itself. This collision sets obstacles in the way of research activity at higher educational establishments. At the same time research activity is becoming increasingly important in the system of accrediting higher educational establishments. In the year 2001 the criteria in the system of state accreditation of higher educational establishments shifted toward strengthening the role of research activity. The threshold indices for budgetary and extrabudgetary funding to be provided for research and development per unit (per capita) of the faculty staff and consequently for the establishment in question to be classified within a certain category (university, academy or institute) were increased.

Funding the research activity at higher educational establishments was not among the state's priorities. While the plan of funding provided for the RAS has been overfulfilled, that of funding the research at higher educational establishments through the Ministry of Education, on the contrary, has not been fulfilled as planned. The distribution of budgetary funds by Ministries as envisaged for the year 2002, again, is not favoring the Ministry of Education and the Ministry of Industry, Science and Technologies. And the research activity of Moscow State University whose funding is entered in the budget as a separate item is planned at 76% of the level of the year 2001. On the whole, the year 2001 saw a continuing reduction in the share of the funding on research in the budget expenditures. It was 1.84%, while the budget for the year 2002 is envisaging only 1.5%.

The cuts in budgetary funding have influenced the changes in the structure of the sources of financing in the sphere of science. The share of budgetary funding has been decreasing having reached, according to preliminary estimates, the figure of 48.7%, while the share of the enterprising sector has not changes, and the share of foreign sources has been increasing. Today, according to the results of sociological surveys, the share of foreign funding in the budgets of successful-

ly working is at least 25%. In this respect Russia is a unique country if compared to the developed countries in the West and the former socialist states of East Europe. The growth rate of the foreign funding for Russian science during the past 5 years has been unprecedented, and now Russia has the highest share of foreign participation in the total amount of funding in the sphere of science. Russia, with her 17% of foreign funding in the total spending on science, has left behind the UK – the absolute leader, as far as the share of foreign funding is concerned, among the developed Western countries with her 16.8%, and all the East European countries (Hungary, Czechia, Poland) where this share varies between 1.5% and 5%²³. As for the actual volume of the foreign funding provided for Russian science, it is even higher because due to the peculiarities of statistical reporting this index is underestimated approximately by 20-30%.

The share of industry in financing Russian science today is, according to preliminary estimates, 16.4%, while in the developed countries of the world it varies between 50% (Great Britain, France) and 73% (Japan). At the same time, in 2001 domestic charitable funding emerged which was distributed on the principle of competition-based allocation of grants through specially created foundations. These funds so far have not been large but the tendency itself of such sources to be appearing at all seems important.

The state research funds – the RFFS and the RHRF – represent the most efficient (as of today) mechanism of distributing budgetary financing. Besides, now there exist certain areas where their activity has become indispensable because they are carrying out the functions that used to be performed by other agencies. This has to do primarily with the promotion of publishing, support of electronic libraries and the development of telecommunications. In 2001 the RFFS allocated \$ 4 mn for the creation and maintenance of an electronic library that has provided for scientists a free-of-charge access to full versions of the best foreign and Russian journals and databases on all areas of fundamental science. For RHRF, the support of publishing projects comes second after providing the financing for grants covering individual and collective research. Owing to the activity of both these funds, the scope of certain publications has almost reached the former “Soviet level”. These programs are developing in the situation of dramatically reduced allocations on the part of the RAS for subscriptions to be submitted by

²³ - Sources: Main Science and Technology Indicators 2000-1. OECD, May 2000. Table 16; Science and Technology Main Indicators and Basic Statistics in the Russian Federation 1992-1998. OECD, 2000, Table 3, p.19; Science Indicators - 2000. NSF, 2001. Appendix table 2-65, p.A-115-116.

libraries. However in the year 2002 the situation might become more complicated because in accordance with the new Tax and Customs Codes any purchases of literature on science – both Russian and foreign – are subject to a 20% VAT which in fact would mean a reduction in the volumes of literature to be purchased.

On the whole, because of the scarcity of the funds allocated to these two organizations (both the RFFS and the RHRF are still receiving a total of only 7% of the budgetary financing on civil science on the item “Fundamental research and assistance to the progress of science and technology”) they are unable to support many important directions of research or finance the renovation of the material base of science. Besides, after the approval of their new statutes, the former scheme of distributing financing has become problematic. Now the funds are federal institutions under the government, and they provide competition-based financing of research projects and other activities conducted by research organizations. This in fact means an expansion of the administrative rights of their directors to select the staff needed for carrying out projects and to manage the financial assets allocated by the funds. The notion “research collective” has in fact been replaced by that of “organization”.

In the year 2001 the maximum size of a RFFS grant for a group of researchers under 10 persons was 150,000 roubles, the medium-sized grant – 80,000 roubles. In the RHRF the maximum size of an individual grant was 50,000 roubles, that of a collective grant – 150,000 roubles. And only slight increase has been planned for the year 2002: the size of the RHRF grants is to be 60,000 and 170,000 roubles, respectively.

As for foreign programs and funds, the support provided by the ICST (International Center for Science and Technology) alone for the civil projects of the former MIC scientists in the year 2001 was 335 million dollars which is six times as much as the budgets of both the RFFS and the RHRF put together.

The financing priorities of the foreign organizations are undergoing a change, and the most obvious shift today is toward supporting joint research. According to experts' estimates, nowadays one third of all fundamental studies in Russia is done in the form of joint projects with foreign partners. Besides, those programs where support is provided to certain particular categories of scientists (women, university researchers, researchers from the provinces, young researchers under 35 years of age) have been actively developing.

At the end of the year 2001, a survey was conducted among the foreign research foundations most active in the territory of Russia as an attempt to specify what is the main contribution of these foundations to the support of Russian sci-

ence. It was found that 53% of the respondents believed that their support was most for young researchers who thus were able to stay in the sphere of science. Then, as 47% of the respondents thought, they had helped mainly in the commercialization of Russian products and technologies. Finally, 13% said that they had contributed to the formation of research infrastructure by promoting telecommunications, providing an access to foreign periodicals, replenishing libraries and financing purchases of new equipment needed for research. At the same time there was a question as to how the researchers in the West and Western science in general had benefited from the foundations' activity. Here, the answers are obvious. Three main lines of benefiting for the West are as follows: they had acquired an access to unique and previously unpublished data, they obtained interesting results by participating in joint projects, and, finally, they were granted an access to specific geographical areas (this concerns primarily zoologists, botanists, specialists on the sciences on the Earth).

Among the issues that have been recently discussed by the funds is the possibility and feasibility of implementing the program of "repatriation" of Russian scientists who emigrated from the country by offering them special grants for resettling and working in Russia. Such experience has already been accumulated by some developed countries, for example Great Britain and Canada where the sphere of science has begun to feel the negative effect of an outflow of most talented researchers to the USA. However in those countries the necessary financing is allocated not by funds but by the governments who are well aware of the importance of a "critical mass" of bright scientists for the economic and general cultural development of any country. At the same time there is no single answer to the question as to the efficacy of such initiatives. True, the progress of science depends not only on the presence of "stars" or high salaries of scientists but also by a host of other factors, among them - the availability of well-developed infrastructure of research and innovation activity, incentives for industry to support science, a positive attitude toward science on the part of society.

In the sphere of tax regulation on the whole there have been a number of positive developments. Thus, there are grounds to believe that the lowering from January 1, 2002 onward of the profits tax and the inclusion of the cost of research and development in the total product cost will have a positive effect on the development of innovation activity in the sphere of small-scale high-technology business, as well as will stimulate industry to make larger investments into fundamental and applied research.

Besides, in February 2001 the Decree of the Government of the RF (No 91 of February 2, 2001) "On the Utilization by Research Organizations of a Part of

their Profit Left at their Disposal on Carrying On and developing their Research and Development Work” was approved. This Decree contains a list of the themes for research that are subject to this privilege. Unfortunately they are formulated in such a broad manner that almost any work can be classified as belonging to this list. At the same time the Ministry of Industry, Science and Technologies was to develop the regulations for issuing to research organizations the resolutions as to the consistency of their research and development works to the approved list, but no deadline for the task was specified in the decree. Thus, despite the fact that the idea itself is expressed in the Decree is positive, so far it has remained inactive.

The lack of government financing in the sphere of science was compensated for in the year 2001 mostly by foreign sources and to a certain degree - by the financing provided by industry and the budding private sponsors. As a result, the average salary level in the sphere of science went up and became, according to preliminary estimates, 116.2% of the average wage level in the economy. Thus, in 12 out of 30 main branches of the economy the wage level was lower than in science. This financial stabilization, in its turn, influenced the employment in the sphere of science.

From the point of view of quantity, the situation with employment is no more so acute as it used to be two years ago. Moreover, there has been a further growth in the number of those employed in the sphere of science and technology. According to preliminary calculations, the number of those employed in the sphere of science and technology in the year 2001 grew to 916,200, having increased by 0.6% as compared to the level of the year 2000 and by 5% as compared to the level of the year 1999. The increment in the number of the employed was created mostly by an inflow of the young, including those who had completed their postgraduate studies. The share of postgraduate students who complete their studies with a defended thesis has reached a record of 30% which is the highest figure for the past decade. As for the absolute number of postgraduates who have completed their studies and of new dissertants, it was also by 12.9% and 26% higher than the preceding year's level. Today Russia is the leader by the number of dissertations defended in every 10,000 researchers: for Russia this figure is about 450, for the USA - a little over 200.

Despite the growing interest toward acquiring science degrees, the share of researchers has been gradually decreasing. Today this category amounts to about 48% of the total number of those employed in science, while in the year 1992 this index was 70.5%. This decrease is in part justified because more marketing and

legal services have emerged as well as divisions dealing with commercialization of the results of research and development.

As far as employment is concerned, the problems in today's science relate not so much to an outflow of researchers as to a disrupted reproduction structure and dramatic aging of the research staff. In November at the general assembly of the RAS it was officially admitted that Russian science has become "the most elderly" in the world. True, at the present time the share of researchers under 40 years of age is 12% - a figure the smallest ever.

An outflow of researchers, mostly of young and early middle age (30-40 years) is still continuing though a "pendulum migration" has become dominant when people work abroad for a certain period of time (on the average about 3 months in a year), being engaged mostly in experimental studies with Western equipment, and then process and analyze the results in Russia. Destruction of the experimental base of science has in fact resulted in a situation when Russia can host mostly theoretical studies.

As for a long-term stay abroad, by now a stable scheme of the emigration of young people has been gradually forming. The experience of the previous generations of "the emigrating young" has shown that the most rational is to get a higher and postgraduate education and to defend a dissertation in Russia and then to go abroad at once to occupy a "postdoctorate" position for which there is no analogue in Russian science. As a result, the number of young Russian researchers occupying "postdoctorate" positions is continually growing leaving behind the growth rates of the numbers of students and postgraduates who go abroad to complete their education. It is unlikely that in the next two or three years this outflow will be limited by external factors, such as external market capacity. The USA and Germany - the principal "consumers" of Russian researchers - are planning to considerable increase their quotas which is conditioned both by the development of high-tech industry and by the predicted demographic slump.

The programs of supporting the young were continued in the year 2001, and the number of the initiatives in this sphere is growing. Thus, a presidential decree is being prepared on initiating another new program according to which young scientists will be allocated grants of a total of 40 million roubles. The most active supporters of the young are the Russian Academy of Sciences, the Ministry of Education of the RF and the Russian Fund of Fundamental Studies.

One of the most successful, from the point of view of effectively attracting the young into the sphere of science, current initiatives remains the President's targeted program "Integration" which will be continued in the years 2002-2006 although in a somewhat new edition. It is expected that the brunt of supporting

innovations will be borne by extrabudgetary sources. Besides, such measures as allocating to the young (under 35 years) special grants to cover their participation in academic conferences, including those held abroad, and creating jobs at the laboratories of academic and branch institutes and innovation structures for young students and postgraduates and doctorants from higher educational establishments. The latter seems to be an attempt to apply the "postdoctorate position" mechanism which is popular in the West. So far the pattern of creating such jobs have not been fully elaborated. Thus, jobs are created "for the period of the project", i.e. on the average for one year, and the Program does not specify what will happen to these jobs after it is over. Certain doubts are also associated with the fact that again science as such is identified with academic organizations, and no attempts are made to support the creation of similar jobs at higher educational establishments which would have been more promising in the situation of an institutional reform.

Domestic businesses have also been expanding the forms and scopes of their support for young researchers. One of the most actively operating structures is Vladimir Potanin's Charitable Fund. The purpose of this program is to find young people who are not only studying well but also possess leader's and organizer's traits. In addition to scholarships, grants have been allocated for the development of research and methodology at the departments and chairs with the largest numbers of scholarship-receiving students, so, as result, support is given to the strongest groups engaged in research and education.

However to restore the personnel reproduction structure only to support the young is not enough. A similarly important factor is the ability to conduct research at a state-of-the-art level which can be provided only when adequate equipment and infrastructure are available. However in 2001, just as in the preceding years, no consistent policy aimed at improving the material base of science was conducted. The average age of the equipment applied in research today is 16 years, and less than 12% of equipment are 1 to 5 years old. In 61.8% of organizations in the three past years a certain renovation of their equipment was under way, where budgetary funds comprised only 10% of the total expenditures on this item²⁴. Higher educational establishments in the past 10 years received no budgetary financing for replacing their obsolete equipment applied in education

²⁴ V. Fridlianov, B. Lisin., S. Ostapiuk. Potentsial i problemy innovatsionnogo razvitiia promyshlennykh predpriatii (po materialam sotsiologicheskogo issledovaniia) [The potential and problems of the innovative development of industrial enterprises (on the materials of sociological surveys)] // *Innovatsii*, 2001, No 7.

and research. At the present moment certain hopes are associated with the development of the program "Electronic Russia", as well as with the approval of the proposal not to impose the VAT on imported research equipment and hardware for which there are no domestic analogues. This will make it possible to allocate more funding for purchases, considering the fact that the assortment of Russian research equipment to a large extent is no rival for that produced in the West.

Because of the poor material base of research and the absence of modern infrastructure, the results of research and development work are to a certain extent predictable. According to the "Science Citation Index" (SCI) published by the American Institute of Science Information, the citation index of Russian scientists has gone down. To a certain degree this can be explained by the fact that work has been mostly curbed in a number of promising areas, especially those that involve high costs (molecular biology, nuclear physics). At the same time the number of publications, especially with foreign co-authors, has grown. But this is most probably a reflection of the "pendulum migration" phenomenon and an increased support through funds where the success of an application depends on a largest possible number of foreign publications. By the "gross" index of the number of publications co-authored with foreign colleagues Russian research groups have reached the level of developed countries. Thus, according to SCI, 33.7% of all publications in journals are co-authored with foreign colleagues. By way of comparison, French researchers publish 40% of articles with foreign co-authors, American – 20%.

Another index of good results, as far as applied works are concerned, is commercialization of the results of research and development works. In 2001 the connection between science and the development of technologies remained weak enough, and the demand on the part of industry decreased. As of March 2001, the share of innovation-active enterprises among large and medium-sized ones had been reduced to 3.1% of their total number. In the year 1999 the number of innovation-active enterprises was twice as much (6.2%). Thus, now the innovation activity level is approximately 10-12 times lower than it used to be in the USSR in the 1980s, and 15-20 times lower than in the developed Western countries. The rate of infrastructure development has become slower, now new sources of financing appeared. The most effective sources of support for innovations have remained the state funds - the Fund for encouraging small businesses in the sphere of science and technology ("Fond Sodeistvia") and the Russian Fund for Technological Development (RFTD). However this activity is disastrously small-scale, as, for example, the budget of the "Fond Sodeistvia" is only about 1.5% of the state budget allocated for civil science. The annual volume of the sums dis-

tributed by the RFTD is also moderate and comprises about 20 million dollars - considering that is one of the few funds existing in the country which supplied resources for the development of interdisciplinary innovation projects. Among foreign investors of high-technology businesses the leading role belongs to the EBRD and the USA Administration²⁵. In particular, they are the principal investors for Russia's venture industry, but this can also be regarded as a drawback because at the present time high technology venture business in Russia strongly depends upon foreign sources and is oriented mostly at loans, with a very small part of the assets being invested in the shares of developing technological companies. As for Russian sources, the Venture Fund created last year was to receive from the state 100 million roubles but in reality only a sum of 50 million roubles was allocated, with a considerable delay. This, in its turn, delayed the development of regional venture funds. Only as late as in October 2001 the creation of three regional funds - in Moscow, Dubna and Tomsk - was announced.

The development of Center for Innovation Technologies (CIT) was approaching in the year 2001 a certain landmark: it had already become obvious that among their participant firms not all were efficient, and therefore the problem of attracting small-scale businesses to the CITs had been replaced by that of excluding therefrom ineffective enterprises. One of the possible solutions currently suggested for the CITs set up at higher educational establishments is to transform the former into education/research/innovation complexes according to the international technopark model. The Ministry of Education is planning to allocate targeted funds for establishing 13 such complexes because so far the CITs attached to higher educational establishments have been only modestly successful. One can speak only of singular instances of positive experience achieved by certain higher educational establishments in some regions.

At the present moment the sphere of commercialization of technologies does not possess either the necessary "critical mass" of financing from different sources or the infrastructure which has resulted in a slowdown of innovation activity. Besides, several more factors should be taken into consideration. Firstly, the number of development projects possessing a commercial potential has to a certain extent been exhausted. Secondly, small-scale businesses no more have that easy access to the material and intellectual property previously accumulated by their parent research-and-technology organizations which used to be open to them in early and mid-1990s. At the same time the problem of regulating the

²⁵ - Bridging the Innovation Gap in Russia. The Helsinki Seminar. March 2001. OECD proceedings, p.22.

rights for intellectual property created fully or in part at the expense of budgetary resources has not yet been solved.

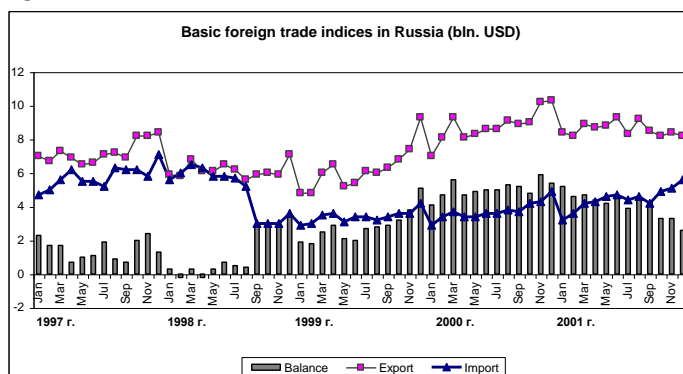
The results of the year 2001 have shown that the sphere of science is still too far from being one of the priorities for the state policy; nevertheless is developing, and some positive trends have appeared. Firstly, at least the situation as regards manpower is no more deteriorating, and the personnel structure is to a greater extent compatible with the market conditions which have become an unavoidable environment for science. "Brain drain" is no more a one-way process and is resembling more and more not an outflow of manpower but rather its mobility. Secondly, a constant process of looking for and creating new institutional forms is under way. Cooperation between sectors in becoming closer, a reform of the RAS has been outlined. Thirdly, the sources for financing science are becoming more diverse. Fourthly, the information support of research has considerably improved, the Internet servicing and a system of electronic libraries are developing. Finally, the legislative base of the sphere of science is gradually developing, as well as its fitting into the common legal space of the country.

2.6. Foreign economic activities

Pursuant to the World Trade Organization's annual report, the quantum of the world trade grew by only 2% in 2001. In 2000, the trade growth accounted for 12%. The slowdown of the world trade operations reflects the general tendency for deceleration in growth, which became even more pronounced after September 11. The WTO experts had revised their original projections downward. In May 2001, the WTO still expected a 7% increase in the world trade operations. It is possible to identify three factors that have triggered off the reduction of the world trade turnover, i.e. the plunging US imports, the declining demand in Western Europe, and the general downturn of the world high technologies market.

According to the Bank of Russia, the volume of Russia's foreign trade in 2001 amounted \$156.5 bln., reaching its peak level in the past 10 years. As compared to 2000, the scope of foreign trade operations had grown by 4.1%. The export balance of trade accounted for \$49.7 bln., being 18% down on the 2000 index. In 2001, Russian exports reached \$103.1 bln. (a 2.3% reduction), and the imports accounted for \$53.4 bln. (an 18.9% increase).

Figure 45



Data source: the Goskomstat of Russia.

Foreign trade relations between Russia and non-CIS states

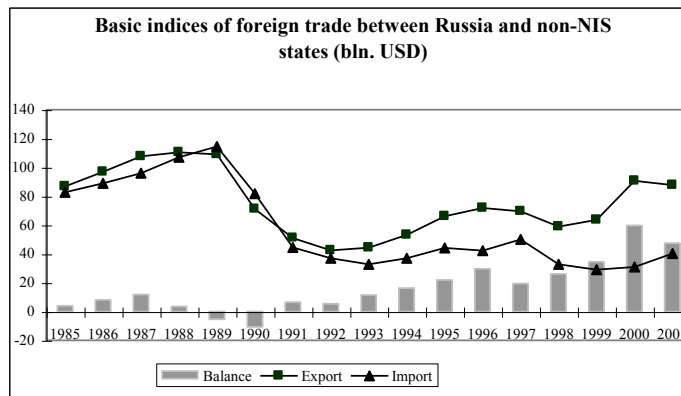
Russia's principal trade partners are those foreign states that do not belong to the coalition of newly independent states. In 2001, the share of non-CIS states in the RF foreign trade turnover accounted for 82%, including 86% of exports and 73% of imports.

The total volume of trade between Russia and non-CIS states in 2001 amounted to \$128 bln., showing a 4.3% growth against 2000. The expansion of trade should be attributed to a significant boost in the imports value, which exceeded the 2000 index by 28.1% and amounted to \$40.3 bln.

Exports continued to grow during the first six months of 2001 and by the period end exceeded by 5.7% the index of the respective period in 2000. However, in July the curve went downward. As a result, in 2001 Russian exports to non-CIS states dropped by 3.9% against 2000 and accounted for \$87.7 bln.

The reduction in exports value was caused by the fall of average contract prices for many of the exported Russian commodities. Most seriously affected by the drop of export prices were nickel (31.9%), iron ore (12.7%), aluminum (10.6%), potash fertilizers (10.5%), and copper (8.4%).

Figure 2



Data source: the Goskomstat of Russia.

Table 35

Average export prices for basic commodities (USD per ton)

	1994	1995	1996	1997	1998	1999	2000	2001
Crude oil	100,6	108,2	133,5	118,6	74,2	100,8	175,0	154,9
Natural gas, thousand m ³	72,8	80,1	84,2	88,6	66,3	53,5	87,5	105,2
Fossil coal	33	36,2	38,8	35,7	27,3	16,6	26,4	29,4
Iron ore	19,6	23,1	26,7	23,9	21,5	15,1	15,8	13,7
Nitrogen fertilizers	80,9	119,8	128	90,3	60,5	38,3	58,3	62,2
Potash fertilizers	69,7	71,9	77,2	79,8	87,4	86,4	87,0	76,9
Lumber, m ³	53	58	59,4	57,5	50,5	43,4	43,5	45,5
Newsprint paper	291,5	591,8	473,7	383,4	398,9	358,3	397,4	425,4
Pig iron	112,8	130,4	136,8	124,3	108,5	68,3	85,4	87,1
Ferroalloys	832,7	1090	1114	818,9	733,8	560,3	631,0	601,4
Copper	2042	2550	2143	2102	1655,0	1429,7	1658,3	1470,8
Nickel	5973	8057	7272	6733	5148,4	5236	8949,4	5652,9
Aluminum	1029	1519	1500	1402	1349,4	1145	1343,2	1175,7

Data source: the Goskomstat of Russia.

In Europe natural gas prices remained very high during the first six months of 2001. Despite a significant reduction of these prices during the second half of 2001, the average annual export prices for Russian natural gas exceeded the 2000 prices by 14.5%. Prices for some other commodities also turned upward (i.e. nitrogen fertilizers, newsprint paper, etc.).

Last year, fuel and energy remained high on the list of most important items of Russian exports to non-CIS states. The reduction, against the previous year, of average export oil and oil product prices was set off by the growing exports of these commodities by 8% and 15% respectively, including the expanding exports of other products of the fuel and energy complex. As a result, the aggregate value of fuel and energy exports remained at the level of 2000, and the share of said commodities in the total exports to non-CIS states went up to 56.2% as compared to 54.0% in 2000.

Table 36

The dynamics of the volume of staple exports to non-CIS states

	1994	1995	1996	1997	1998	1999	2000	2001
Crude oil, mln.t	95,4	96,2	105	110	117,9	115,7	127,6	137,1
Oil products, mln.t	39,1	44	53,4	56,9	51,2	47,8	58,4	68,3
Natural gas, bcm	110	122	128	120	125,0	131,1	133,8	131,9
Fossil coal, mln.t	17,7	21	20,3	18,9	18,6	22,0	37,3	42,1
Iron ore, mln.t	9,8	11,4	7,8	8,2	10,1	7,6	9,1	10,8
Ferrous metals, mln.USD	4371	5646	6208	6018	4464,1	3885,8	4957	5422,8
Aluminum, thou.t	2301	2250	2616	2693	2790,4	3113,5	3173	3070,8
Copper, thou.t	451	467	524	533	550,3	532,9	642,4	592,2
Nickel, thou.t	124	153	166	220	214,1	211,1	196,8	188,0
Plant and equipment, mln.USD	3200	5314,5	5554,2	5598,7	5760,5	5953,6	6825	7405,6
Mineral fertilizers, mln.t	13,1	16,2	15,1	14,4	15,9	18,8	19,9	21,1
Lumber, mcm	13,5	17,9	15,4	17	19,8	27,5	30,6	37,1

Data source: the Goskomstat of Russia.

Metals and metal products rank second in significance among Russian export commodities. Their share in the total exports to non-CIS states continued to decline in 2001 and accounted for 15.3% (in 2000 it made up 18.0%, and in 1999 - 22.2%). The exports value of metals and metal products fell by 18% due to the reduction of both average prices and trade volume. The export volume of ferroalloys dropped by 12%, of rolled stock - by 23%, of copper - by 8%, of nickel - by

5%, and of aluminum - by 4%. Pig iron made the only exception in this group of commodities: its exports grew by 63% due to the increasing volume, and by 8% due to the increasing prices.

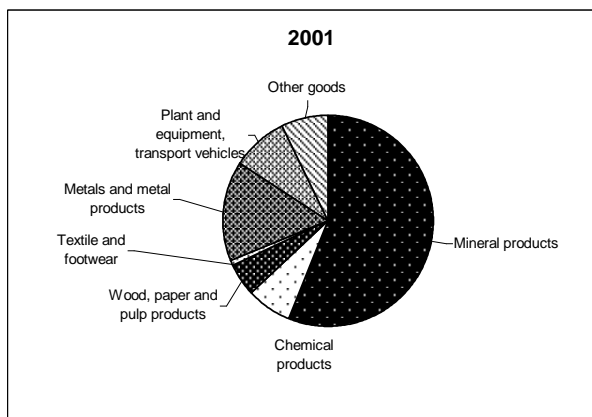
The export of plant and equipment went up by 10%, and the share of these commodities in the total exports to non-CIS states accounted for 8.6% against 7.5% in 2000.

Chemical products made up 6.8% of exports to non-CIS states (in 2000 their share was 6.7%). As compared to the previous year, the value of these exports remained practically unchanged. The actual exports of natural fertilizers grew by 6%, and the exports of synthetic rubber went up by 4%. The exports of ammonia declined by 5%, and of methanol - by 9%.

The upward tendency in the exports of wood and pulp-and-paper products, which crystallized in 2000, remained stable. The exports value grew by 6%, and the share of these commodities in the total exports to non-CIS states made up 5.0% (in 2000 it accounted for 4.5%). The volume of lumber exports rose by 22%, the volume of plywood exports grew by 5%, and pulp exports went up by 4%. The supply of lumber and newsprint paper did not undergo any significant changes.

Figure 47

The commodity composition of Russian exports (%)



Data source: the Goskomstat of Russia.

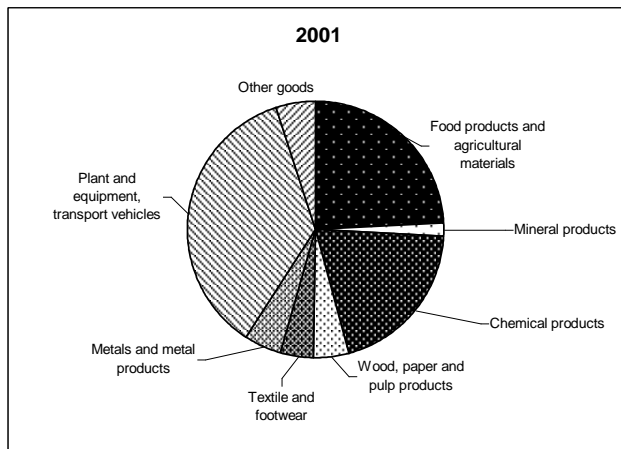
The value indices of Russian exports still remain firmly linked to the primary markets conditions and follow the fluctuations of the fuel prices. Since the fuel market conditions are unlikely to change drastically in 2002 (on the contrary, the average oil and gas prices are expected to go below the 2001 level), the exports may be expected to decline.

Russian imports, by contrast to exports, were demonstrating a steady growth. In 2001, the imports from non-CIS states accounted for \$40.3 bln., or a 28.1% increase as compared to the relevant period in 2000. Following a slight deceleration in the 3rd quarter, the imports escalated in October, reaching the record level since August 1998. The principal driving force behind this process was the growth of the real incomes of individuals, which in October rose by 9.7% as compared to the same period the year before. The growth of imports was impeded by the slackening of the ruble position, whose real value appreciation has recently started to lose momentum.

Russian imports from non-CIS states have grown in almost all of the commodity groups, including the two staple articles - plant and equipment, as well as food products and primary goods for their manufacture, whose share in the total imports made up 61%.

Figure 48

The commodity composition of Russian imports (%)



Data source: the Goskomstat of Russia.

Plant and equipment held the top position in the imports from non-CIS countries in 2001. Their share in the total imports from said countries amounted to 37.2%, as compared to 36.3% in 2000. The imports of food products and agricultural resources grew against 2000 by 34%. The purchases of chemical products in 2001 rose by 30%, and their specific share in the total imports from non-CIS countries insignificantly decreased to 19.9%. Within that commodity group, one should mention the mounting imports of pharmaceutical products, which have risen by 43.1%.

Table 37

The dynamics of the volume of staple imports from non-CIS states

	1994	1995	1996	1997	1998	1999	2000	2001
Piping and tubing, thou.t	631	367	385	239	154,1	366,6	269,8	282,2
Plant and equipment, mln. USD	10696	12804	10172	13511	12789	7881,7	8028,0	11201,8
Pharmaceutical products, mln. USD	1184	969	1083	531	1198	763,0	1089,6	1559,7
Textile and knitwear, mln. USD	861	511	298	313	211,9	89,0	105,7	242,2
Footwear, mln. pairs	41,7	26	45,8	15,4	2,9	1,2	2,8	7,7
Freshly frozen meat, thou.t	358	506	540	694	595,8	806,8	340,4	716,2
Freshly frozen poultry, thou.t	496	824	748	1117	814,1	234,8	677,1	1334,2
Raw sugar, thou.t	1081	1166	1680	2511	3002,9	5774,2	4546,6	537,4
Alcoholic and non-alcoholic beverages, mln. USD	695	1017	379	700	390,4	145,6	170,3	240,0

Data source: the Goskomstat of Russia.

At the end of 2001, the surplus of trade with non-CIS countries accounted for \$47.5 bln., or by 20.8% less than during the same period the year before. The reduction of the trade surplus to the record minimal value over the past two years was caused by a significant deceleration of the exports growth accompanied by the ever-increasing imports.

Foreign trade relations between Russia and CIS states

The year 2001 marked the tenth anniversary of the Commonwealth of Independent States, and that allows for the conclusion that the period of adaptation is over, that the economies of the CIS countries have completed reorientation towards new forms of cooperation basing on market rules and procedures, and that the economies of Russia and the other CIS states cannot develop independently of one another.

The total volume of foreign trade between Russia and CIS states in 2001 accounted for \$28.43 bln., including the total exports of \$15.31 bln. and imports of \$13.12 bln.

Table 38

The dynamics of foreign trade between Russia and CIS states in 2001

	2000 год	2001 год
Commodity turnover (bln. USD)	27,9	28,43
Exports (bln. USD)	14,6	15,31
Imports (bln. USD)	13,3	13,12
Balance of trade	1,3	2,19
Growth rates (%)	24,0	1,9
Share of CIS state sin total commodity turnover (%)	18,6	18,2

Data source: the RF Central Bank

The tendency of the positive reciprocal influence of economic growth in the CIS states and of the intensifying foreign trade activities, which was typical of 2000, slowed down in 2001. For instance, in 2000 the growing Russian economy and the increasing demand from Russian enterprises boosted the imports from the CIS states by almost 30%, while in 2001 the imports dropped by 3%.

Nevertheless, in 2001 the growth of industrial production in the neighbouring states, averaging 9%, was conducive to the expansion of the mutual trade relations. The highest production growth rates were registered in Kazakhstan and Moldova, and the trade turnover between Russia and these countries in 2001 amounted respectively to 8% and 10%. Byelorussia, Ukraine and Kazakhstan still remain Russia's largest commercial partners, although the past year saw a significant escalation of bilateral trade between Russia and Armenia (by 82%) and with Georgia (by 25%).

Exports. Russian exports to the CIS states in 2001 increased by 7.5%. The export of fuel accounted for less than 40% of the total Russian exports, which is indicative of progressive tendencies in the exports structure. This conclusion is confirmed by the expanding export of plant and equipment, which slightly exceeded the last year level and accounted for 17.3 %. The share of chemical products and metals has also risen.

Table 39**Export of specific commodities to the CIS states in January-November 2001**

	January-November 2001	% to January - November 2000
Нефть сырая, млн. тонн	20,5	133,9
Crude oil, mln.t	2318,4	72,5
Oil products, thou.t		
Including:	417,2	54,6
Motor petrol	961,9	97,9
Diesel fuel, thou.t	195,6	34,4
Fuel oil	43,6	80,9
Natural gas, bcm	5188,7	91,4
Fossil coal, thou.t	2660,4	126,9
Plant and equipment, mln. USD	11413,9	122,3
Ore and iron ore concentrates, thou.t	516,0	109,8
Ferrous metals (except for pig iron, ferroalloys and scrap), mln. USD	57,8	120,4
Synthetic rubber, thou.t	66,0	168,3
Wood pulp, thou.t	94,6	92,9
Newsprint paper, thou.t	395,5	97,5

Data source: the Goskomstat of Russia.

As for the fuel exports, the natural gas sales dropped by 19.1%, the exports of oil products went down by 27.5%, including a 45.4% reduction of the motor petrol supply.

The share of CIS states in the total volume of fuel exports in quantitative terms had dropped as compared to the previous year: in 2000 the volume of exported oil products accounted for 6%, as compared to 3.5% in 2001; the volume of exported natural gas respectively accounted for 30% and 27%.

The export of oil, which is Russia's major fuel resource, built up by 33.9%. During 2001 the share of CIS states in the total oil exports grew from 12% to 14%.

Given the world oil market conditions and Russia's commitment to restrict its oil exports, one may expect in 2002 a reorientation of Russian oil exports and an upsurge of oil deliveries to the neighboring states, including a large number of barter transactions.

The exports of iron ore, ferrous metals and synthetic rubber in quantitative terms rose respectively by 22.3%; 9.8%; and 20.4%. The upward tendency in the exports of forestry products remained stable, with an almost 70% increase of wood pulp exports to the adjacent states.

There is no direct correlation between the average actual export prices under contracts with CIS states and the growth of the volume of exports to the neighboring regions. For instance, exports to the neighboring states have grown despite the lower export prices as compared to the similar indices in the trade with Western countries regarding such commodities as iron ore (the export price for CIS states was \$10.2 per ton, against \$13.7 for the third countries) and synthetic rubber (the export prices for CIS states and third countries respectively accounted for \$752.5 and \$923.2 per ton). At the same time, the exports of ferroalloys in quantitative terms have grown by 35%, with the export prices for CIS states being \$622.9 per ton against only \$601.4 per ton for non-CIS states.

Imports. Similarly to the foreign trade operations with non-CIS states, imports from the CIS states during the first six months of 2001 were growing at a faster pace. However, the structure of these foreign trade operations was affected by the newly introduced procedure for collecting VAT from goods originating from the CIS countries. Already in the second half of the year the growth of imports decelerated as compared to the still increasing exports, resulting in the trade surplus, which rose from \$0.43 bln. in the first quarter of 2001 to \$2.19 bln. at the year-end.

The share of plant and equipment imported from the CIS states has grown to 17%. However, food products still rank the highest on the list of goods imported from the CIS states - they account for almost 20% of the total imports. The market of food products demonstrated a multiple increase in the volume of purchases.

The growth of deliveries of particular food products from the CIS states exceeded similar indices in the third countries, i.e. the sunflowerseed oil imports rose by 26.5%, against a 9.0% increase of imports from non-CIS states; the import of chocolate and chocolate products rose respectively 2.5 times and by 20.9%.

Some commodities imported from the CIS states have fully replaced similar items from non-CIS countries. For instance, as compared to the relevant period in 2000, the import of dried and condensed milk from the neighboring states grew 10 times, while the import of same products from the third countries dropped 3.2 times.

Over the year, the average contract prices for goods purchased from the CIS states have risen by 12%. The prices for sunflowerseed oil and butter imported from the CIS states have topped the prices for the relevant products imported from non-CIS states by 67.9% and 8.3% respectively, but the significant increase

in the imports of these goods is indirectly indicative of the growing incomes of the people.

Table 40

The import of specific commodities from the CIS states

	January-November 2001	% to January - November 2000
Plant and equipment, mln. USD	2573,2	112,7
Motor cars, items	9199	72,8
Cereals, thou.t	976,2	36,2
Alcoholic and non-alcoholic beverages, mln. USD	279,3	126,2
Cotton fabrics, mln. USD	56307,2	102,4
Textile and knitwear, mln. USD	119,1	106,9
Ferrous metals (except for pig iron, ferroalloys and scrap), mln. USD.	559,6	107,1
Piping and tubing, thou.t	607,1	85,2
Fossil coal, mln.t	25,6	106,0
Sunflowerseed oil, thou.t	105,9	126,5
Fresh and frozen fish, thou.t	30,2	154,3
Butter, thou.t	76,1	176,1
White sugar, thou.t	108,3	59,2

Data source: the Goskomstat of Russia

Most serious reductions of imports from the neighboring states have been registered with respect to the following commodities: steel pipes and tubes – by 14.8 %; cereals - by 63.8%; and white sugar– by 41.8%.

Annex 2

Foreign trade regulation

During the past year significant changes have emerged in sphere of legal regulation of bilateral and multilateral trade relations of the CIS countries.

At the beginning of April, 2001, submitted for ratification to the State Duma was the Treaty on the Customs Union and Uniform Economic Space, which was signed in February, 1999 by Russia, Byelorussia, Kazakhstan, Kirghizia and Tadjikistan.

The Treaty defined the stage-by-stage principle of formation of a uniform economic space. At the first stage, the Treaty proposes to complete the formation

of the Customs Union on the basis of free trade principles, the establishment of a uniform procedure for the regulation of the foreign trade activities, the creation of the common custom tariff, the simplification and the subsequent cancellation of the customs control on internal customs borders.

The Treaty also provides for the transition of the Customs Union member-states to the collection of indirect taxes basing on "the country of destination" principle instead of the effective "country of origin" principle within the same framework, which is currently applied to the trade relations with non-CIS countries. The RF Government is concerned about the new tax-collection procedure as the positive balance in the trade with the CIS and the Customs Union countries largely depends on the export of power resources.

Therefore, in view of Russia's stand, the Treaty will be ratified after it has been amplified with the exceptional provision for Russia about the inapplicability of the "country of destination" principle to the trade in oil, natural gas and gas condensate, and also about the non-use by the contracting parties of the zero indirect tax rate with respect to the specified fuels. Such agreements have already been signed and ratified with Kazakhstan and Kirghizia.

In sphere of free trade, in 2001 only Armenia, Kirghizstan and Moldova abided by the commitment on the non-use of exemptions and have no tariff restrictions. Russia plans to start the coordination of schedules for the cancellation of exemptions after the completion of the intragovernmental procedures aimed to ensure the entry into force of the Agreement on the creation of a free trade zone, dating April 15, 1994. At present, Russia is applying exemptions to imports from Azerbaijan, Armenia, Georgia, Moldova, Turkmenistan, Uzbekistan, and Ukraine.

Currently Ukraine is not applying tariff exemptions from the free trade arrangement to imports from the CIS states. Byelorussia has not signed bilateral protocols on exemptions with the CIS states and applies exemptions to imports from Azerbaijan, Armenia, Georgia, Moldova, Turkmenistan, Uzbekistan, Ukraine.

Since July 1, Russia's trade relations with the CIS states have involved the collection of indirect taxes in line with the "country of destination" principle: the indirect taxes, i.e. the VAT and excise taxes, are paid into the budget of that country, which is the importer and consumer of the goods.

Russia has long been paying indirect taxes in line with the "the country of destination" principle in its foreign trade relations with non-CIS countries. In its trade with the CIS states, Russia has been collecting VAT on the "country of an origin" basis, i.e. the proceeds remained in the budget of the country where the

goods were manufactured. At the same time, from the beginning of 2001, the bilateral trade relations between Russia and, respectively, Kirghizia and Armenia, have involved the collection of indirect taxes in line with "the country of destination" arrangement. The relevant agreement with Azerbaijan came into force in April same year. The transition of the CIS states to the collection of indirect taxes basing on the "country of destination" principle is progressing rather unevenly. The overwhelming majority of the countries have proclaimed *de jure* the principle of "country of goods' destination". In legal terms, only Turkmenistan has retained the principle of "the country of goods' origin". However, 7 CIS states, i.e. Azerbaijan, Armenia, Georgia, Kirghizstan, Moldova, Uzbekistan and Ukraine, are *de facto* implementing the "country of destination" principle. As a result, the symmetric VAT collection scheme (i.e. according to one or the other principle equally applied by the parties) is used in 60% of the mutual trade operations between the CIS countries under the principle of "the country of destination", and only 10% of such operations follow the principle of "the country of origin". In other instances, the asymmetric scheme applies.

Although the changes have not affected the trade relations between Russia and Byelorussia, the tax collection arrangement creates certain problems within the framework of the Russian and Byelorussian union. The Byelorussian authorities claim significant losses due to the application of the old taxation scheme. They provide statistics to the effect that Russia is the major economic and trading partner of Byelorussia, accounting for up to 60% of the total scope of the Byelorussian foreign trade. Nevertheless, Byelorussia maintains its negative trading balance. The Russian authorities, in turn, assert that the introduction of the new trading arrangement in Byelorussia contradicts the Treaties on the Creation of the Union State and on the Uniform Economic Space. During the past year, Byelorussian and Russian experts several times met in Moscow to develop a coordinated position on the issue, which, however, still remains unresolved. The immediate plans include a complete unification of the custom tariffs, tax benefits, rules and criteria for defining the country of origin and the customs value of goods, and new measures aimed at increasing the efficiency of control over the transit through Byelorussia of foreign-made motor vehicles imported into Russia.

Due to a lack of legal regulation, Russia experiences certain difficulties in its trade relations with the other CIS countries. The reciprocal claims of Russia and Ukraine in sphere of foreign trade moved in May 2001 from the piping market to the oil market. In the near future Russia is planning to impose prohibitive duties at a rate of 40 % on the import of Ukrainian pipes, while Ukraine, in turn, is going to launch an investigation on the dumping of Russian oil products.

In January 2001, the Ukrainian government introduced for Ukrainian oil importers special privileges with a view to increasing the fuel supply for agricultural needs. Besides, starting from July 1, 2001, under the new RF Tax Code, Russian oil product exports will be liable for a zero tax rate, while oil exports will still be liable for VAT and excise duty.

Major oil companies, for instance LUKOIL, own oil refineries in Russia, and under the new conditions it would be more profitable for them to deliver oil products to Ukraine, rather than import and process crude oil in that country. That arrangement would be wittingly placing Ukrainian oil product manufacturers in a losing position before oil product importers. In this connection, the creation of a flexible quota-setting system regarding the oil product imports is becoming a topical issue for the Ukrainian oil market.

Despite the fact that the problem of the Ukrainian debt for Russian gas deliveries has not been resolved, the natural gas exports to Ukraine are expanding. Ukraine has tried to reorientate its trading operations towards the deliveries of Turkmen gas, but lately the scope of these operations have nearly halved - from 80 to 50 million cubic meters per day. The dwindling transit of Turkmen gas through Ukraine is explained by the default by the Ukrainian Ministry of Energy on the obligation to repay the \$50 mil. debt to the ITERA Company, which jointly with its Kazakhstan partners ensures the transportation of oil.

In October, Russia and Ukraine signed new intergovernmental agreements on the re-structuring of Ukraine's gas debts and on the Russian gas transit arrangements. These agreements provide for increasing cash collections for the gas transit and for fixing the amount of cash collections annually by special intergovernmental agreements. Ukraine's debt amounts to \$1.5 bln. and the first settlements are expected only in 2005.

In 2001, Ukraine increased the export of other commodities to Russia almost by 50 %. On the whole, the Ukrainian imports in the eleven months of 2001 have increased by 8 %, and the commodity turnover between Russia and Ukraine has amounted in the same period to \$8.314 bln., exceeding the level of the previous year by 7 %.

Thus, Russia maintains a positive balance of trade with Ukraine within the limits of \$1.26 bln.

Bilateral trade relations between Russia and Kazakhstan are demonstrating some positive tendencies: the commodity turnover is building up, having increased by 8% over the eleven months of 2001 to \$4,34 bln. The Russian exports to this country have grown by 24 %, while the imports have declined by 9 %. In addition, the bilateral trading agreements signed in 2001 in the oil-and-gas and

energy sectors have been put into effect, and a coordinated transport policy is successfully being implemented.

At the end of 2000, the customs tariff reform - the most comprehensive reform in the past seven years - began. Several attempts to revise the customs tariffs have already been undertaken, but none of them has managed to resolve the fundamental problems.

Since January 1, 2001 new import duties have been in effect in Russia, at the rate of 5%, 10%, 15% and 20% of the customs value. The exceptions include motor cars (25%), chicken legs (25%), white sugar (30%) and spirit (30%). The maximum rate of import duty for those categories of goods that are liable for the maximal rate of 30% has been reduced to 20%; and to speed up the modernization of domestic economy import duties on process equipment have also been cut down.

Before 2001, almost 25% of imported goods had been cleared through the customs in violation of applicable rules and procedures, and a significant portion of goods imported to the Russian Federation had been declared in violation of the commodity classification. Some commodity groups provided for too wide a range of custom duties for homogeneous goods - for instance, commodity group 8704 (lorries) provided for five levels of customs duties (5%, 10%, 15%, 25%); commodity group 04 (milk and dairy products) boasted of three levels of customs duties (10%, 15%, 20%). There are many more similar examples.

This diversity of customs rates served to complicate the collection of customs duties, enabled bad-faith importers to import goods under the guise of those liable for minimal duties, depriving the budget of relevant revenues. For example, chicken legs were imported under the guise of turkey meat (which is liable for lower customs duties), and motor cars were imported as spare parts.

Under the circumstances, the unification of the import duties was aimed to improve the customs administration and prevent the evasion of appropriate customs duties.

The new Customs Tariff that came into effect on January 1, 2001, provides for the following changes:

- the actual cancellation of the 30% rate. With respect to 883 out of 888 tariff positions liable for the 30% rate, the rates were lowered to 20% (that mostly concerns consumer goods, chemical products, industrial equipment, and etc.). The 30% rate will only remain regarding 5 positions, including such sensitive for the domestic industry products as white sugar and tobacco products liable for excise taxes (4 positions);

- the reduction (from 624 to 104 tariff positions) of groups of goods liable for 25% import duties. That reduction meant the cancellation of the 25% customs duty for many types of imported food products (i.e. fruits, vegetables, alcoholic beverages and fish products), a number of chemical products, and some others;

- the unification of the import duties within the framework of groups of homogeneous goods with similar consumer properties and technical characteristics. The leveling of the rates was aimed to provide the transparency of custom duties for participants in foreign trade activities and to considerably reduce the instances of improper declaration of imported goods and ensuing violations of the law;

- the increase of import tariffs on the currently duty-free goods up to 5% with respect to 33 commodity positions. The duty-free import regime was preserved only for socially significant goods, i.e. insulin containing medicines; wheelchairs; thoroughbred animals and goods that are liable for duty-free import under the international Agreement (the so-called Florentine Agreement).

As a result, the revision of the customs duties has affected 32% of the Foreign Trade Commodity Classification, including 440 commodity positions, regarding which the rates have been raised, and 3068 commodity items, regarding which the rates have been lowered. The unification and reduction of the customs duties has allowed to lower the average weighted tariff rate to 10.7%, bringing it close to the actual amount of collected customs payments.

On October 1, 2001 new import duties for some 400 commodity positions were imposed for a period of 9 months. In addition, the term of the duties, which were reduced and unified starting from January 1, 2001, was extended in respect of 3.5 thousand commodities. The reduction and unification of the import duties serves to cut down the number of violations of the customs rules and regulations, and promote the transition of the ever increasing number of foreign trade participants into the sphere of legal operations.

In introducing new customs duties in October 1, the RF Government hoped to step up the import of technological equipment, which is a matter of great importance for Russia in view of the high deterioration of the fixed assets of most Russian enterprises. For that reason, the government has reduced the import duties for a number of types of technological equipment. Regarding some types of such equipment, in particular the equipment which is not manufactured in Russia but is necessary for the retrofitting of domestic enterprises, import duties have been reduced from 10-15% to 5-10%. The unification of the customs duties has also affected paper, paints, chemicals, machine engineering products. Previously, various types of these goods were liable for a fairly wide bracket of customs du-

ties, ranging from 5 up to 15%. That provoked bad-faith importers to pass off goods liable for high import duties as goods subject for lower duties.

The unification of customs duties also extended to integrated circuits, transistors, resistors and other unit components. The relevant customs rates used to vary between 5 and 20%, and now a uniform rate of 10% has been imposed. All these decisions were made basing on the monitoring results of the changes in the Russian commodity market since the year beginning; the monitoring showed that the new duties had a positive impact on the imports dynamics and the collection of customs payments. In 2001, the customs authorities collected for the benefit of the federal budget 540 bln. RF Rubles in customs payments. In 2001, the amount of collected customs duties grew against 2000 by \$4 bln. During the year, the amount of collected customs payments continued to build up: starting from May, the monthly payments exceeded \$1.5 bln., and in December they amounted to \$1.8 bln.

The new customs tariff was imposed on January 1, 2002 with a view to promoting further imports legalization. Pursuant to the new customs tariff, the import duties for 140 commodity positions will be revised. With respect to 90% of said commodity positions, the import duties will be cut down. The new custom tariff incorporates all the revisions of the import duties that were introduced in 2000 and 2001 or approved by the Commission of the RF Government on protective measures in foreign trade and on customs tariff policies. The new custom tariff provides for the reduction from 20% to 15% of import duties on audio- and video-equipment, including radio and television parts and components. The imports duties will be reduced from 15% to 10% for Figure tubes; two times, from 20% to 10% - for ships and other floating vessels; from 25% to 20% - for sewing machines; from 15% to 10% - for vitamins; from 10% to 5% - for fruits and berries. At the same time, some goods will be liable for higher import duties: the customs duties will be raised from 5% to 10% for rice, and from 5% to 15% for refrigerators and compressors. These measures are aimed to protect the interests of domestic manufacturers.

As a whole, the average weighted import duties in Russia will be cut down from 10.5% to 9.8%.

Although the customs tariff served as the basic regulating tool of foreign trade operations, a lot of countries are widely applying non-tariff measures to protect the national manufacturer from competition provided by imported goods. Said measures include quantitative restrictions (quotas), licensing, antidumping and countervailing arrangements, and other remedies.

In 2001, the RF Government adopted a number of decisions that considerably expanded the sphere of application of non-tariff measures to ensure support of domestic manufacturers.

For instance, on May 18, 2001 a special customs duty was imposed for a period of 180 days on imported hard candies to the extent of 21% of the customs value, but not less than 0.18 Euro per 1 kg (except for the goods originating from Byelorussia). The Resolution of the RF Government "On provisional measures to protect Russian hard-candy manufacturers" was aimed, first and foremost, to restrict the hard-candy exports from Ukraine because these goods are not liable for import duties or VAT. According to the State Customs Committee, in 1999 the imports of Ukrainian hard-candies to Russia amounted to 62,000 tons, or 96% of the total hard-candy imports and 34% of the annual Russian output.

On July 1, 2001, a 45% seasonal duty was imposed on the sugar imports, which cannot be less than 0.16 Euro per kg (with the base import rate of 30%).

The designed effective period of the protective measures is six months, until the processing of domestic sugar beet has been completed. Similar seasonal duties were imposed in 2000, from June 15 till December 15. At that time imported raw sugar was taxed at a rate of 40%, and white sugar was taxed at a rate of 45%, but not less than 0.15 Euro per kg.

Currently Russia manufactures about 1.5 million tons of beet sugar and another 4.5 million tons from raw sugar, whereas at the beginning of the 1990-ies this ratio was quite the opposite. Before 2001, the raw sugar imports were regulated by seasonal duties, but these measures had not resulted in any significant reduction of the deliveries. In 2001, the government decided to impose tariff quotas on raw sugar to the extent of 3.65 million tons until the year-end. Deliveries within the quota limits were taxed at a rate of 5%, and all excessive amounts were liable for a 30% customs duty.

Starting from January 1, 2002 the customs duty for raw sugar will amount to 40% of the customs value, but not less than 0.12 Euro per kg. The customs duty for white sugar will be set at 40%, but not less than 0.14 Euro per kg. From July 1 until December 31, 2002, raw sugar will again be liable for a seasonal duty to the extent of 50% of its customs value, but not less than 0.15 Euro per kg; white sugar will be liable for a customs duty of 50%, but not less than 0.18 Euro per kg.

Protective import duties were also imposed on starch, ranging from 10% to 30% above the existing rate. Starch imports to Russia have grown several times in the past years. As a result, the RF Government decided to introduce additionally for a three-year period a 30% special duty on potato flour (but not less than 0.11 Euro per kg) and a 10% duty on cornflour (but not less than 0.04 Euro per

kg). Said duties will be collected on top of the effective import duty of 10%. These duties will not apply to starch imported from the Customs Union member-states.

To protect Russian leather manufacturers, an export duty of 500 Euro per ton has been introduced. This decision was provoked by the current situation in Europe, where the leather prices have significantly risen due to the spreading foot and mouth disease. However, the rate of 500 Euro per ton is "an extraordinary protective measure" and cannot be regarded as a strategic arrangement. Before the year-end, the government plans to monitor the market situation and, if the need arises, go back to the subject.

The decision of the Commission of the RF Government on protective measures in foreign trade and on customs tariff policies, dated March 16, 2001, approved the results of investigation of significant damage inflicted on Russian manufacturers by the increased imports of piping and ferrous metals from the Ukraine. The RF Government has imposed for a three-year period a special import duty on Ukrainian pipes manufactured from ferrous metals. Under the document, the customs duty will amount to 40% of the customs value of pipes with an external diameter exceeding 406.4 mm. The duty of 20% of the customs value will apply to pipes with an external diameter of 1420 mm and larger.

In response to the decision of the European Union to cut quotas for the Russian steel exports, the RF Government has introduced a 17% import duty for metal products originating from the EU countries. In addition, retaliatory measures have been adopted against Hungary for permitting market discrimination against Russian products. Said measures include a 15% import duty on frozen vegetables, juices and vegetable oil imported from Hungary.

At present, about 300 commodities are liable for export duties in Russia. Import duties apply, apart from oil and gas, to such actively exported goods as ferrous and non-ferrous metals and alloys, precious metals, chemical products, and products of the wood processing industry.

The worsening situation in the world markets forces the RF Government to lower and cancel exports duties. Thus, on February 5, 2002 the government imposed on imported light and semi-light oil distillates and diesel fuel a duty of 25 Euro per 1000 kg (before February 4 inclusive, the effective import rate had been 39 Euro).

Pursuant to Resolution #17 of the RF Government "On the non-application of import duties to specific commodities", dated January 14, 2002, the customs authorities are instructed to stop from February 19 collecting export duties on some types of birch wood products (until February 18, 2002 inclusive, the effec-

tive rate was 5% of the customs value); paper and coated, soaked or laminated paperboard, except for adhesives (prior to February 18, 2002 the effective rate was 10%); gold (5%); piezoelectric quartz (6.5%). Starting from February 1, 2002, oil and oil products derived from bituminous robbing are liable for an import duty of \$8 per 1000 kg (before January 31, 2002, the effective rate was 23.4 Euro per 1000 kg).

At the same time, some of the effective export duties are performing a regulatory function and are applied to restrict the export of goods. For instance, prohibitive duties have been imposed on hides, sunflower seeds, ferrous and non-ferrous metal scrap. The prohibitive duties will not be lowered.

As it follows from the above mentioned, the legal framework regulating Russia's foreign trade activities has not been finalized yet, and requires further development and improvement. This situation is contingent upon a number of factors, including Russia's impending accession to the World Trade Organization (WTO).

Annex 3

The results of the 2001 negotiations on Russia's accession to the WTO and future prospects

In 1995 the Russian Federation initiated official procedures for its accession to the World Trade Organization (WTO). By now Russia has largely completed the first, so-called information, stage of the accession procedures, which involved multilateral discussions (within the framework of the Working Group for Russia's accession to the WTO) of compliance of the economic mechanisms and foreign trade regime of the Russian Federation with the basic provisions of the Uruguay Round Agreements. At the same time, pursuant to the WTO rules and procedures, this stage, if need arises, will continue until Russia has become a member of said organization.

Since 1998 the Russian delegation has been involved in official bilateral negotiations with the WTO member-states concerned on the future terms and conditions of Russia's membership (rights and obligations) in this influential multilateral economic organization.

Following Russia's submission in 1998 of initial tariff proposals (at maximum rates of export duties as may be allowed from the moment of the country's accession to the WTO) and initial proposals for the agricultural sector (obligations of the Russian Federation relating to the scope of internal support of agricultural production and subsidization of the export of agricultural and food prod-

ucts), and following the submission in October 1999 of proposals concerning the trade in services (a list of specific obligations pertaining to services and a list of exemptions from the most favored nation treatment), Russia has been involved in bilateral negotiations with the interested Working Group member-states on the terms and conditions of access to the markets of goods and services.

Thus, having submitted all of the requisite positional documents, the Russian party has embarked on full-scale bilateral negotiations on access to the markets of goods and services, and on the other WTO Agreements. These negotiations will serve to define a significant portion of the terms and conditions of Russia's membership, i.e. its future rights and duties within the framework of that organization.

At present Russia is in the active stage of accession negotiations, which are covering the following four venues:

- tariffs, including discussions on the maximum permissible rates of import duties applicable in Russia after its accession to the WTO;
- agriculture, including discussions on the scope and types of state support for the Russian agricultural sector;
- services, including discussions on the terms and conditions for the entry of foreign suppliers to the Russian services market;
- conformance of applicable Russian legislation with the standards and rules set forth in the WTO Agreements, as well as the terms and procedures for Russia's commitment to abide thereby.

The economic program adopted by the RF Government in June 2000 sets as a top priority the escalation of the WTO negotiations. In the second half of 2000, the Russian delegation stepped up the negotiations and by now has made considerable progress, which gives hope that the final stage of negotiations may commence in 2002.

On the whole, in 2001 the Russian delegation held in Geneva five rounds of negotiations on access to commodity and services markets; a number of meetings on the specified questions were arranged in the capitals of the countries that are Russia's leading partners, i.e. USA, Canada, EU, Japan, Norway and some others; with several delegations negotiations were conducted in Moscow.

Bilateral tariff negotiations, which entered into a new phase in 2001, represent an important area of these activities. The RF Government approved in January the third version of Russian proposals concerning its entry to the commodities market as a basic document for these negotiations, during which the Russian delegation discussed with the counterparts specific chapters in the Foreign Trade Commodity Classification, including some of the commodity positions adjusted

in line with the Russian tariff proposals. Said discussion also included the topical agricultural issues within the context of the documents provided by the Russian party.

During the past year, the Russian delegation has carried out over a hundred bilateral negotiations and consultations with the delegations of more than 40 countries. By this time, the Russian delegation has coordinated or has come an understanding with the partners on approximately 70% of the tariff positions.

The second major venue of the talks concerns access to the Russian market of services. The RF Government has approved the second edition of proposals on access to the market of services, which was presented to the WTO member-states in February 2001.

In the course of last year, the Russian delegation held meetings with representatives of almost 25 countries and succeeded in getting closer to the position of the trading partners on the matter of regulatory measures applicable to all sectors of services (the so-called horizontal section of obligations), which was instrumental for beginning the discussions on concrete terms and conditions for the entry into those market sectors that are of utmost interest to Russia's principal commercial partners.

Agricultural issues constitute a significant component of negotiations on Russia's accession to the WTO. In addition to the tariff aspect, they include discussions on Russia's state support of its agricultural sector. In the wake of the 1998-1999 negotiations, the Russian position has been adjusted in the part concerning methods used to define the baseline period for computing the aggregate volume of internal support for the agricultural sector. The RF Government has approved the third edition of Russia's proposals on internal support measures and export subsidies, which were submitted to the WTO Secretariat in February 2001.

The multilateral meeting in December 2001 discussed the new Russian document and the future course of negotiations on the agricultural issues.

The fourth subject-matter of these negotiations concerns Russia's potential commitments regarding the format of implementation of the WTO multilateral agreements, which pertain to some or other aspects of the Russian regulatory framework in the sphere of foreign trade and economy. During the past year, a series of multilateral consultations and bilateral negotiations were held on sanitary and phytosanitary measures, technical barriers to trade, industrial subsidies, customs procedures, the trade aspects of intellectual property rights, and etc.

The intermediate results of these negotiations have been summarized multilaterally at the formal sessions of the Working Group, which currently includes

62 WTO member-states. Where necessary (to resolve individual issues), informal sessions of the Working Group were arranged (March, April, December).

The 12th session of the Working Group was held on 26-27 of June, 2001. The agenda included the development of the Russian legal framework, the "Review of the trade and political regime of the Russian Federation" submitted by the Russian party, as well as a block of other official documents.

To ensure the resolution of most topical issues and to define the accession strategy, G.Gref, Minister of Economic Development and Trade of the Russian Federation, regularly met with R.Zelik, US Trade Representative, P.Lami, ECC Commissioner, and other high-ranking representatives of the WTO key member-states.

On 30 of March, 2001, the Governments of the Russian Federation and Sweden jointly with the European Community Commission, organized a summit meeting on the topic of "Russia, world economy and the World Trade Organization", which was attended by WTO Director General M.Moor, Chairman of the Working Group for Russia's accession to the WTO K.Brin, ECC Commissioner P.Lami, Swedish Trade Minister L.Pagrotski, and over 100 heads of Russian business associations, banks and major companies. On March 30, 2001, President of the Russian Federation V.Putin met with M.Moor and K.Brin. President Putin also met with Mike Moor at the G-8 Summit in Genoa in July 20 - 22, 2001.

In November 9 - 14, 2001, the 4th Ministerial WTO Conference was held in Doha (Qatar), which was also attended by the Russian delegation. The Conference adopted the decision to start a new round of multilateral trade negotiations on the following issues: agriculture, services, access to the market of non-agricultural products, some matters pertaining to the trade aspects of intellectual property rights, the WTO rules (the application of the WTO rules in the sphere of antidumping procedures, subsidies, regional trade agreements, and etc), the WTO dispute resolution procedures.

The intensification of the negotiation process does not imply that Russia is ready to join the WTO on any terms and conditions. All of the aspects of the accession conditions (tariffs, obligations in the sphere of agriculture, access to the services market, and etc.) will base on the actual state of affairs in Russian economy, ensure requisite protection of national manufacturers and preservation of the adequate competitive environment.

2.7. Economic problems at the new phase of defense reform in Russia

The year of 2001 became the first at the new phase of transformations in the Russian military organization and defense economy: apart from some one-off accomplishments, the overall goals of the previous phase in the defense reform were never achieved. Moreover, all hopes for an ultimate end to the military operations in Chechnya were dashed.

That explained the reasons for the review of the planned military restructuring, adjusting its goals, concept and content. As before, the key document for the military organization planning was not published. For the purposes of independent analysis or civil supervision, it has to be derived from public statements by the Russian president or various military leaders. For the diagram describing the key areas of the military planning and its stages, see Table 1.

Above all, the stages for the proposed work obviously remain structured around five-year cycles while the actual political life impacting defense reform follows election cycles and primarily that of the election of the Russian President who is the Supreme Commander of the Armed Forces.

In contrast to the previous (failed) phases of the defense reform, the new ones are proposed to accomplish within the limits of the appropriated funds **guaranteed by the RF Government**, which, provided the system of earmarked expenditures is put to order, makes the proposed defense planning more realistic. True, the legal status of the RF Government guarantees is not clear, and no less clear is the degree to which such plans could be implemented.

Another important deficiency in the overall set of the proposed plans is the absence of clear-cut priorities. In the very least, the importance and priorities of such a complex issue as staffing in Russia's military organization are non-apparent, and the measures are scattered among various other planned activities.

In particular, the urgency of the reform in the system of military recruitment of rank and file and junior officers is so obvious for the public that substitution of specific plans and deadlines of the reform in this area for the words "improved recruitment of the army (armed forces)" offered in respect of the Army only, appears extremely unconvincing. The statements to the effect that the set of measures and activities aiming to resolve this issue was to be formulated as a separate federal targeted program were never supported by any real actions in 2001.

We believe the best way would be **to incorporate the reform in the military recruitment in Russia as part of the defense planning in a separate sec-**

tion whose parameters should be coordinated with the relevant parameters of the Social Security Program, with the plans for the streamlined military training and other separately developed action plans and programs.

Table 41

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
RF Government guaranteed appropriations for the defense planning and development of the military organization in the Russian Federation									
Bringing up (R&D + equipment and materiel acquisition) / personnel subsistence ratio from the current 30%:70% to 40%:60 %					Bringing up (R&D + equipment and materiel acquisition) / personnel subsistence ratio from 40%:60 % to 50%:50 %				
Plan of actions to shape the future layout of the Russian military organization as planned for by the RF Security Council on 27 September 2000									
Defense planning for the Russian armed forces, planning for other forces, military units and institutions									
Transition to the three-force structure in the Russian armed forces (the Army, the Air Force and the Navy) + services (airborne troops, strategic missile forces, space troops etc.)									
For the Army:									
- restore the General Headquarters of the Army;									
- retain, in each of the strategic sectors, units and detachments in permanent readiness;									
- improve the recruitment of forces (services);									
- establish the combined Volga-Urals Military Command									
Streamline the system of personnel training and military education									
Formulation and implementation of a single technical policy in the armed forces and government. Establishment of a unified purchasing agency									
Establishment of a unified military R&D complex									
Implementation of a unified system of administrative support in the armed forces, other forces, military units and institutions									
Social security program in defense planning in Russia until 2010									
Increased salaries for active army			Increased salaries for reserve			Increased money allowance for servicemen above the salaries of federal civil servants			

Program for social adaptation of service-
men retiring from the military service, and
their families

Analysis of military expenditure in the Federal Budget of Russia

The data from the 2001 federal budget are presented in the survey structured around recipients of the budget monies, which include, firstly, components of the military organization in the Russian Federation (Ministry of Defense and its subordinate armed forces, and other troops, military units and institutions); secondly, non-military ministries.

The tables below show the structurally aggregated data and assessments of general expenditure, and also (for the Ministry of Defense) some information about the allocation of the appropriated funds. Apart from strictly military expenditures, included are also those relating to the past military activities of the country. Some of those, e.g., pensions to former servicemen and their families, although they may not qualify as military expenditures, are nevertheless handled, when budgeted, by the financial authorities of the military organization.

Table 42

Defense and related expenditure in Russia in 2001

<i>No</i>	Title of expenditure	Amount, in Rbs. mln	% federal budget ex- penditure	% GDP
1	Expenditures of military organization as part of the national defense expenditures			
	Overall national defense expenditures, including:	214 688	18,0	2,77
1.1	Defense planning and maintenance in the armed forces of the Russian Federation	203 061	17,0	2,62
1.2	Support to preparedness activity and military training for civilians	2 278	0,19	0,03
1.3	Preparation for and participation in collective security and peacekeeping	2 716	0,23	0,04
2	Expenditures of the military organization as part of the law enforcement and national security expenditures			
	Overall law enforcement and national security expenditures, including:	131 621	11,0	1,70
2.1	Border services and border guards troops	11 943	1,00	0,15
2.2	Internal security troops subordinate to the RF Ministry of Interior	10157	0,85	0,13
2.3	State security agencies*	21191	1,78	0,27
3	Other expenditures of the military organization			
3.1	Maintenance and equipment of the Emergency Command (Emercom) troops	12455	1,04	0,16
3.2	Federal service of railroad troops	1882	0,16	0,02

Table 42 (cont'd)

<i>No</i>	Title of expenditure	Amount, in Rbs. mln	% federal budget ex- penditure	% GDP
3.3	Federal service of special construction	502	0,04	
4	Additional expenditures on national defense, law enforcement and national security			
4.1	Expenditures under Article 79 of the 2001 Federal Budget allocated to the RF Ministry of Defense and used as financial support to the activities of the Russian armed forces **	unknown		
4.2	Expenditures under Article 78 of the 2001 Federal Budget allocated to the Ministry of Interior and Emercom to be used for the logistical support and social welfare of servicemen ***	unknown		

Notes:

* Tentatively, the amount in line 2.3 may be inclusive of the outlays for the Federal Security Service, Foreign Intelligence Service and some other agencies responsible for the security of the state in Russia.

** These items are funded through the revenues of the institutions subordinate to the Russian Ministry of Defense and financed subject to their budgeting estimate, that are generated under voluntary service contracts, for the sales of arms, military equipment and materiel from the stocks of the RF Ministry of Defense under technical military cooperation, for military personnel training in the interests of foreign states, and through other revenue-generating activities allowed under the Russian legislation.

*** these items are funded through the revenues from the sales of arms and defense equipment, and other movable property under technical military cooperation, military personnel training in the interests of foreign state, and contractual services rendered by the Ministry of Interior and Emergency Command.

Additionally note that earlier, expenditures under item 4 were not mentioned in the budget and were, as a result, classified as extra-budgetary.

Table 43**Military expenditures outside the military organization**

No	Title of expenditure	Amount, in Rbs. mln	% federal budget expenditure	% GDP
From the section "National Defense" (item 1 of Table 2)				
4.1	Defense program of the Ministry of Nuclear Energy	6330	0,53	0,08
4.2	Supporting industries' contribution towards national defense	303	0,03	
4.3	Russian defense and technical sports organization (ROSTO)	33	-	-
From other budgetary sections and subsections				
4.4	Preparedness activities in the economy	500	0,04	-
4.5	Civil defense	22	0,002	-
4.6	Subsidies and subventions to the closed administrative territories	10 149	0,85	0,13

Table 44**Expenditures related to previous military activities**

No	Title of expenditure	Amount, in Rbs. mln	% federal budget expenditure	% GDP
1	Pensions to servicemen	30650	2,56	0,4
2	Recycling and disposal of armaments	6036	0,51	0,08
3	Defense conversion	250	0,02	
4	Military reform	4 337	0,39	0,06
5	Funding to housing certificates construction programs as part of the national capital expenditure outlays	4880	0,40	0,06

It makes sense to discuss some of the aggregated expenditures shown in Table 45.

The overall expenditures of the military organizations comprise more than 22% of the federal budget expenditures suggesting that it may be expedient to get involved with them for those businesses in Russia that look for lucrative contracts, which have also been getting more stable since 2000. The aggregated military spending outside the military organization in Russia is considerably less tangible.

In table 45, item 5 of the national defense, law enforcement and state security spending is significant in the sense that it is indicative of the expenditures level in 2001 (4.47% of the GDP) by comparison with the reference indicator of 5.1% GDP, approved by the RF President in 1998. Note that national defense was sup-

posed to get their “regulatory” 3.5% GDP, i.e. significantly more than 2.77% GDP shown in item 1 of Table 2. Overall, comparing current expenditures with the standards one sees that over the period of the defense reform, that is, by 2005, the level of this spending will hardly be going down.

Table 45

No	Title of expenditure	Amount, in Rbs. mln	% federal budget expenditure	% GDP
1	Overall outlays for the Russian military organization (armed forces, other troops, military units and institutions)	266085	22,29	3,43
2	Overall military expenditures outside the Russian military organization (Ministry of Nuclear Energy, some other industries, ROSTO, etc.)	17337	1,45	0,22
3	Overall military expenditure (military organization and outside)	283422	23,74	3,65
4	Aggregate direct and indirect expenditures related to the current and previous military activities of the Russian Federation	329575	27,61	4,25
5	Overall outlays for national defense, law enforcement and state security	346309	29,02	4,47
6	Amounts of direct and indirect expenditures relating to the current and past military activities, and all federal expenditures in Russia on law enforcement and state security.	417905	35,02	5,39

Note that spending in items 5 and 6 of Table 45 that exceeds 35% of the federal budget expenditures cannot be classified as strictly military. Apart from defense spending, it incorporates a significant amount (88330 million rubles) allocated towards the judiciary, prosecution, police, etc., that hardly any country would classify as belonging to the military organization. The most complete indication of the level of military spending is to be found in item three of Table 45.

We are listing below some analytical data on the distribution of funds allocated to the RF Ministry of Defense for development and maintenance of the armed forces in Russia. The aggregate expenditure for these purposes is to be found in line 1.1 of Table 2, while in Table 46 they are itemized.

Table 46

No	Title of expenditure	Amount, in Rbs. mln	% federal budget expendi- ture	% GDP
1.1	Development and maintenance of armed forces in Russia	203061	17,0	100
1.1.1		70370	5,90	34,7
	Development of the Russian armed forces			
1.1.2	Maintenance of the Russian armed forces, including:	132691	11,10	65,3
1.1.2.1	Central military administration bodies	912	0,07	0,4
1.1.2.2	Sustenance of the armed forces personnel, including:	91064	7,63	44,8
1.1.2.2.1	Money allowance to servicemen and money allowance to civilian personnel	62543	5,24	30,8
1.1.2.2.2	Food supplies	17000	1,43	8,4
1.1.2.2.3	Clothing	3628	0,30	1,8
1.1.2.2.4	Travel sustenance for servicemen and their families leaving for vacations or treatment	2900	0,24	1,4
1.1.2.2.5	Funding of benefits and compensation to servicemen	1409	0,12	0,7
1.1.2.2.6	Other personnel expenses	445	0,04	0,2
1.1.2.2.7	Funding for certain statutory benefits	3138	0,26	1,5
1.1.2.3	Combat training and logistical support to arms (forces), including:	37510	3,14	18,5
1.1.2.3.1	Lodging and maintenance costs	15953	1,34	7,9
1.1.2.3.2	Acquisition and storage of special fuel and petrol	12000	1,01	5,9
1.1.2.3.3	Transportation	5700	0,48	2,8
1.1.2.3.4	Operation, maintenance and repair of property and facilities	1890	0,15	0,9
1.1.2.3.5	Other expenses relating to combat training and logistical support of troops	1967	0,16	1,0
1.1.2.4	Ministerial expenses on education and health care	2155	0,18	1,1
1.1.2.5	Servicemen insurance guarantees	1050	0,08	0,5

Table 47**Tracks changes in military spending over the last three years.**

Budget Sections	1999 (mln. rubles)	2000 (mln. rubles)		2001 (mln. rubles.)	Percent change to 1999 (with- out/ with inflationary effect)		
		Begin- ning of year	End of year		2000 ₀ *	2000 ₂ *	2001
"National Defense"	93702	140852	209445	214688	+50,3 +25,1	/ +123,5 / +86,0	+129,1 / +70,2
"Law enforcement and state security"	51324	79802	111547	131621	+55,5 +29,4	/ +117,3 / +80,8	+156,5 / +90,5
"Preparedness activities in the economy"	450	500	835	500	+11,1 / - 7,6	+85,5 / +54,3	+11,1 / - 17,5

Note: for calculation purposes, the inflation rate in 2000 to 1999 was 20.2%; in 2001 to 2000 it stood at 12%.

* 2000₀ – federal budget early in the year; 2000₂ end of the year, after two adjustments.

The 2001 federal budget was adjusted five times in the course of the year, but only one adjustment made in accordance with Federal Law No 161-FZ of 14.12.2001 impacted military spending. With the actual execution of the 2001 federal budget, military spending increased considerably.

Execution of the 2001 federal budget

We shall start by noting that federal budget administration is not easy to analyze because of the non-performance of Article 272 of the Budget Code whereby the budget execution report "must be drafted under the same structure and budgetary classification as the one used at the time of the budget approval."

The structure of quarterly reports fails to match the structure of the approved 2001 budget. Moreover, quarterly and semiannual reports have different structures. The former report lists expenditures mostly by sections and subsections of the functional classification and only to a very insignificant degree (less than 2 percent), by target items and types of spending. The first semiannual report shows complete breakdown to sections, subsections, target items and types of spending, except those that the Russian Government classified as secret.

For instance, expenditure for the maintenance of the armed forces is fully disclosed in the **non-classified** appendix, while in the first semiannual performance report the expenses are fully classified. Classified were also the expenditures for the personnel of the Russian Emergency Command as were even the

expenses of the Russian defense technical and sports society, fully disclosed in the non-classified appendix to the 2001 budget law.

Performance figures on aggregated expenditure of the federal budget and expenditures relating to the military organization of the Russian Federation are shown in tables 48, 49, and 50. As the tables suggest, expenditures relating to the military organization were executed in full and evenly.

The exception is funding under title "Military Reform" (section code 2500) and two subsections "Internal security troops of the Ministry of Interior" (0502) and "Training and participation in collective security and peacekeeping" (0404).

Under section 2500, in the first six months of 2001 actual expenses stood at 62% (budgeted 75,02%), and under section 0502, 59% actual expenses (69% budgeted).

Accelerated funding under section 2500 might have been due to the intent to reduce expenditures to support retired military and more rational use of current expenses. The increased financing under 0504 must have been caused by additional costs of the military operation in the Republic of Chechnya.

The suspended financing under subsection 0404 was caused by the delayed legal status (no RF Government resolution allowing the payment).

All of the above transgressions from the requirements of Article 272 of the Budget Code, including imposing secrecy on the expenditure data whose level has been made public in the federal budget law, affect the State Duma's ability to fulfill its supervisory functions over the budget performance, thus reducing the efficiency of expenditures in general, and military spending in particular.

Table 48

Military and related spending in Russia in 2001 (mln. rubles)

No	Title of expenditures	Code	Ap- proved 2001 Federal Budget	Jan- ary	Feb- ruary	March	April	May	June
0	Total expenditures under FB-01		1193483 1268006	60615	170415	268772	365169	465029	578789
1	National defense, of which	0400	214688 234582	7551	23400	41470	65318	87566	106729
1.1	Development and maintenance of armed forces in Russia	0401	203061			39571			102106
	- development of the armed forces	0401							

Table 48 (cont'd)

No	Title of expenditures	Code	Approved 2001 Federal Budget	January	February	March	April	May	June
	- maintenance of the armed forces	0401	132691						
1.2	Preparedness activities and military training for civilians	0403	2278			300			879
1.3	Preparation for and participation in collective security and peacekeeping	0404	2716			116			540
2	Aggregated expenditures for law enforcement and state security, of which:	0500	131621 145832	3983	13365	24700	35092	45572	57062
2.1	Border services and border guards troops	0506	11943			1820			4632
2.2	Internal security troops of the RF Ministry of Interior	0502	10157			2249			6037
2.3	State security services	0505	21191			4150			9236
3	Other outlays for the military organization								
3.1	Maintenance and equipment for Emercom troops	1302	12455						
3.2	Federal service of railroad troops, code 029	0403	1851						673
3.3	Federal service of special construction, code 279	0707	483						186

Table 48 (cont'd)

No	Title of expenditure	Code	July	August	September	October	November	December
0	Total expenditures under FB-01		679087	804844	929650	1035836	1135938	1325688
1	National defense, of which	0400	127278	147524	169302	193823	209917	246712
	Development and maintenance of armed forces in Russia	0401						
1.1	- development of the armed forces	0401						
	- maintenance of the armed forces	0401						
	Preparedness activities and military training for civilians	0403						
1.2	Preparation for and participation in collective security and peacekeeping	0404						
1.3	Aggregated expenditures for law enforcement and state security, of which:	0500	68042	79753	90981	104016	118390	140705
	Border services	0506						
2.1	and border guards troops	0506						
	Internal security troops of the RF	0502						
2.2	Ministry of Interior	0502						
2.3	State security services	0505						

Table 48 (cont'd)

No	Title of expenditure	Code	July	August	September	October	November	December
3	Other outlays for the military organization							
3.1	Maintenance and equipment for Emercom troops	1302						
3.2	Federal service of railroad troops, code 029	0403						
3.3	Federal service of special construction, code 279	0707						

Notes: in bold and italics are adjusted expenses corrected for additional amounts allocated under Federal Law No 161-FZ of 14.12.2001. Because of the above deficiencies in the budget performance report, the data in Table 8 are less detailed than the data in the budget.

Table 49**Military spending outside the military organization (mln rubles)**

No	Title of expenditures	Code	Approved 2001 Federal Budget	January	February	March	April	May	June
1.	From the section "National Defense" of the Federal Budget								
1.1	Military program of the Ministry of Nuclear Energy	0402	6330			1432			3070
1.2	Supporting industries' contribution to national defense	0407	303			50			134
1.3	Russian defense technical and sports organizations (ROSTO)	0403	33						
2.	From other sections and subsection of the Federal Budget								

Table 49 (cont'd)

No	Title of expenditures	Code	Ap- proved 2001 Federal Budget	Janu- ary	Febru- ary	Marc h	April	May	June
2.1	Preparedness activities in the economy	2330	500	0	21	72	123	168	227
2.2	Civil defense	1303	22			1			8
2.3	Subsidies and subventions towards the budgets of closed administrative territories, code 485 of Earmarked Expenditure Item, code 350 of Expenditure Type.	2101	8649			2164			4870

Table 9 (continued)

No	Title of expenditure	Code	July	August	September	October	November	December
1.	From the section "National Defense" of the Federal Budget							
1.1	Military program of the Ministry of Nuclear Energy	0402						
1.2	Supporting industries' contribution to national defense	0407						
1.3	Russian defense technical and sports organizations (ROSTO)	0403						
2.	From other sections and subsection of the Federal Budget							
2.1	Preparedness activities in the economy	2330	308	383	432	520	596	941
2.2	Civil defense	1303						
2.3	Subsidies and subventions towards the budgets of closed administrative territories, code 485 of Earmarked Expenditure Item, code 350 of Expenditure Type.	2101						

Note: the absence of certain data from the table is caused by the same deficiencies of the performance reports.

Table 50
Expenditures relating to past military activities

No	Title of expenditures	Code	Ap- proved 2001 Federal Budget	January	February	March	April	May	June
1.1	Pensions to servicemen	1804	30651			7383			15029
1.2	Recycling and disposal of armaments	2200	6036	29	395	728	1654	2242	2719
1.3	Defense conversion	0704	250			41			125
1.4	Military reform	2500	4237	127	509	984	1720	2177	2632
			5937						
1.5	Funding under the housing certificates programs as part of the state capital expenditure	0707	4880						2406

Table 50 (cont'd)

No	Title of expenditure	Code	July	August	September	October	November	December
1.1	Pensions to servicemen	1804						
1.2	Recycling and disposal of armaments	2200	3251	3772	4429	5188	5589	6554
1.3	Defense conversion	0704						
1.4	Military reform	2500	2896	3007	3111	3247	3599	5533
1.5	Funding under the housing certificates construction programs as part of the state capital expenditure	0707						

Notes: in bold and italics are adjusted expenses corrected for additional amounts allocated under Federal Law No 161-FZ of 14.12.2001.

Status, trends and prospects for the solution of social problems of servicemen

The biggest obstacle to higher combat readiness of the Russian military organization is the social status of servicemen which depends largely on two factors: money allowance and housing.

Money allowance to servicemen. The current money allowance paid to Russian servicemen throughout 2001 remained unchanged at the dramatically low level. Noteworthy is the regular payment pattern of the allowances, with the exception of the so-called "wartime allowance." There was no lack of comment on the extent of abuse with respect to this category of allowance.

In April 2001 the State Duma approved a federal law providing for a substantial increase in the money allowance of servicemen, but the bill was never signed by the RF President because of the deficiencies and discrepancy between the intent to raise the allowance and finances available to the government. The reasons for which the pay rise was refused must have been related to the difference between the number of personnel in the military organization as declared by the end of 2000, and its actual strength. It was believed that the overall strength of the armed forces in the Russian Federation stood at 1,200,000, but certain publications in the mid-2001 asserted that the number must have been near 1,350,000. Naturally, a considerable amount of funds was spent to support the surplus 150,000 servicemen.

The issue of money allowance was discussed on 11 May 2001 at the meeting of the RF Security Council, attended by both chairmen of the two chambers of the Federal Assembly.

As the meeting recommended, on 31 May 2001 the RF President submitted to the State Duma a draft federal law No 98384-3 "On amending certain legislative acts of the Russian Federation on money allowance to servicemen and their benefits."

Under the draft law, the amount of the basic salary depending on the category of the military office and the basic salary depending on the military rank of the servicemen contracted for active duty, and any additional payments shall be granted subject to uniform allowance rates applicable to all federal agencies that comprise the military organization in Russia.

The official salary and military rank salary should be **no less** than the amount of official salary and monthly bonus to it depending on the qualifications rating for the relevant categories of federal civil servants in the federal executive authorities.

The correspondence between the standard office positions and military ranks of servicemen and public service positions and qualifications ratings of the relevant categories of civil servants shall be approved by the RF President.

The amount of money allowance of servicemen should be indexed or increased in the same way and period as provided for federal civil servants.

Note that there are cases when the correspondence of the army allowance with the salaries of civil servants in the federal government is not feasible. For instance, the allowance paid to soldiers and junior command officers contracted for active duty would be feasible to relate to the average actual salaries in the country, since it is exactly the difference between the money paid to the servicemen and the average salaried across the country that could make the contract with the army attractive to soldiers and junior command officers. In a market economy where the service is a voluntary contract, **the military organization of Russia should be a competitive employer** on the labor market, offering proper consideration for the hardship and specific circumstances of the military duty.

The official salary to servicemen is expected to be increased starting 1 July 2002, and the allowance for the military rank, starting 1 January 2004. As the money allowance to servicemen is raised to the level of the salaries paid to federal civil servants, the monthly allowance to junior command officers will be doubled, and that of senior command and higher command officer will increase 1.7 and 1.4 times, respectively.

Note also that apart from the significant increase in the money allowance the servicemen will be asked to bear some additional expenses as a result of the annulment of housing and utilities benefits. Such additional expenses will not be large. For instance, a lieutenant and platoon commander, starting 1 January 2004, will be paid on average a monthly amount of Rbs 4,797 (which is 2.03 times more than currently), but a significant portion of this amount could be spent to pay for the cancelled benefits.

Providing servicemen with housing. Throughout all the after-war decades, neither the Soviet nor, later, the Russian government proved capable of resolving the issue of housing to servicemen and civilians retired from military duty.

Initially, they tried to address the issue by allotting military institutions a certain quota (10 %) of all homes built anew by any other ministry. This option, apparently, did not suit all. Then, they continued with the government program called "Housing." This scenario failed to resolve the problem since the main incentive to the performers was not measured by the amount of apartments built but rather by the costs sunk in the construction. Abandoned construction projects everywhere became a telltale monument to the period.

In 1997 this housing policy was recognized as inefficient, to be replaced by the presidential program of state housing certificates. Under the program, it was planned to meet all the requirements of active servicemen and retired servicemen in housing, provided they were entitled to it, within 5 years (1997 – 2002). All in all, over the 5 year period, 210,000 apartments must have been commissioned.

The 1998 default and certain other reasons disrupted this program too. Currently, the president's housing certificates program continues, but at a very modest pace. The 2001 budget, for instance, allocated a meager Rbs 4.8 billion for the purpose. This amount is hardly good for 20,000 certificates whereas homes are still needed for about 200,000 households. Given such a pace, it will take more than one decade to satisfy all those active and retired servicemen who need housing.

These uncertainties about housing at the end of long service undermine the attractiveness of the military profession and cannot but affect the operational efficiency of the armed forces.

What is required is the development of a new comprehensive program "Housing for servicemen" as commissioned by the President, and having the RF Security Council strictly monitor its drafting and implementation. Such program must provide for:

- faster rates of construction of service lodgings for servicemen;
- increased funding and faster implementation of the President's housing certificates program;
- additional resources allocated to residential construction out of proceeds of the real property disposed of in the course of the military reform;
- saving accounts opened up to young officers, warrant officers, soldiers and non-commissioned officers which, given a prospect of long service, would allow them to acquire apartments.

Current issues in military-industrial complex

The current state and prospects for the military-industrial complex in Russia remain a concern for virtually all government authorities, many leaders of the federation subjects, and employees at the key industrial and research institutions. The reason for concern is to be found in the effect that preservation and consolidation of the military-industrial complex has on the defense security as well as on the economy, foreign policy, social stability, on the pace of technical and scientific progress, and the promise it holds for many key national interests of the country.

Among the more important problems that have to be addressed as a matter of priority, is the need for advanced and efficient management and control mechanisms; domestic consolidation of the military-industrial complex stripping it of excessive structures; and more economically efficient state holdings.

The above and some other problems must be addressed through a well-substantiated program integrating the military-industrial complex in the market

infrastructure and making it more economically competitive. The complex can be made more efficient and competitive only through implementation of modern market instruments.

That was the aim of the new version of the government policy formulated in the “Basic policies of Russia in its defense-industrial complex for the period to 2010 and in a longer term” and in the government’s federal targeted program of reform and development of the military-industrial complex in 2002 - 2006.

In accordance with the approved documents, the first target for the reform in the domestic defense industry should be consolidation of the 1,700 current defense projects into up to 50 holdings producing military equipment and armaments. The consolidation of production operations could be structured round technological compatibility or historical schemes of cooperation or regional factors. In other cases, integration will be mechanical merging similar product operations. At the second stage, those entities would be consolidated further in even larger civilian-military associations. The consolidation will come together with the reduction in the number of enterprises charged with defense contracts, leaving approximately half of the more efficient businesses.

The issue of the efficient owner is still pending. Back in 1996 a presidential decree established the Sukhoi aviation military industrial complex. Despite the strong administrative support, its operations were heavily criticized, so a more recent decision was about setting up, on the basis of the complex, a publicly held joint-stock company Sukhoi aviation holding. As a result, they would incorporate state-held Novosibirsk and Komsomolsk aircraft operations and contribute the controlling stakes in those enterprises to the Sukhoi holding. Such a decision is believed to help invigorate and make for more efficient management of the businesses related to the production of Sukhoi planes.

At the same time, low operability of the military-industrial complex may be unrelated to the variety of forms of ownership across its businesses.

The operation and legal protection of intellectual property rights held by the state should be discussed separately. The plans are to license the right to develop and produce research-intensive and high-tech products to the parent entity in the holding, which would grant such rights to the plants and thus help consolidate cash flows. This is the proposed solution to R&D funding.

However, the state does not have any proper experience in the utilization of intellectual property in a market environment. There should be a more transparent procedure for the statutory licensing commercial businesses to develop and produce military equipment. In addition, intellectual property is a unique property difficult to sell for profit. Part of the problem is the valuation of such intellec-

tual property and identification of its true owner. The legislation needs to be improved.

The government is to resolve the issue of mobilization of capital for the military-industrial complex, including foreign capital. Instances of international cooperation under joint defense-related projects are no longer isolated. The Russian-Indian BraMos is ready to offer to the international markets a unique multi-purpose rocket developed by Russia's Research and Production Machine-building Institute and India's DRDO. There is an ongoing joint project of Irkutsk aircraft factory and Indian HAL. Mutually beneficial Russian-Chinese defense projects are in the pipeline.

Going back to the restructuring of the military-industrial complex, note that it has been already exposed to seven major reorganizations. It would be appropriate to analyze the effects of the changes and all the consequences of the previous stages of restructuring in the industry.

It all started in 1992 when the scope of defense orders for armaments and equipment plummeted a whole 400 percent. Then, the list of operations banned for privatization started to shrink. By 1997, about half of the enterprises belonging to the military-industrial complex were incorporated to become part of the private sector.

Let us consider the economics of those events. In 1992, the public was promised that a smaller defense industry and a more efficient owner replacing less efficient (government) would spawn growth in the civilian production. The indicators suggest that throughout the period of intense reforms in the military-industrial complex up to 1998, resulted in the declining production both at the defense and civilian projects (Table 51).

All these years, except the last two, owing to the destructive attitude of the government to defense enterprises, and moreover, regular underfunding, their debts kept accumulating. Many were edging to the brink of bankruptcy, others walked over the edge.

After the 1998 financial and economic crisis, not only there was no further slump in the output, but on the contrary, there was a certain growth in the output of both military and civilian products. It must have been a combination of two factors: firstly, active import substitution as a result of ruble devaluation which made many domestic products competitive and stimulated output growth at civilian and defense enterprises (increased output of civilian products); secondly, increased world oil prices and, as a consequence, bigger revenues for the Russian budget and a possibility to finance defense orders (increased output of defense products).

Table 51
Production dynamics in the military-industrial complex

Indicators	Years									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001*
Changes in the aggregate output of marketable products, in % to the previous period	78,7	80,8	61,4	80,3	73,6	86,9	101,9	132,7	125,3	107,6
Changes in the output of military products, in % to the previous period	62,6	73,8	60,8	83,4	75,7	73,8	109,5	136,7	129,5	101
Changes in the output of civilian products, in % to the previous period	96,4	86,0	61,5	78,2	72,4	98,6	99,3	128,6	120,3	116,5
Integral change in the output of all marketable products, in % to 1991	78,7	63,6	39,1	31,4	23,1	20,1	21,7	28,8	36,1	38,8
Integral change in the output of military products, in % to 1991	62,6	49,3	30,3	25,1	18,8	13,9	16,6	22,7	29,4	29,7
Integral change in the output of civilian products, in percent to 1991	96,4	82,9	51,0	39,9	28,9	28,5	28,3	36,4	43,8	51,0

* Forecasts of the Russian Ministry of industry, science and technologies, and estimates of the Institute of Transition Economies.

Proper structural changes must have been prompted by a competitive selection of the more important projects and their efficient performers, and not by bureaucratic inventions. In fact, over the last 2 – 3 years defense projects have been consolidating with the resulting voluntary restructuring, instead of the one imposed from the top. The merged businesses managed to locate additional sources of financing, established additional contacts, some outside the military-industrial complex, and thus raised both civilian and military output, and in such way are saving high-technology industries in Russia.

Reform is costly. It is difficult to expect that the restructuring of the defense industries to help them grow would concern private investors as well as the government. But state investment in the defense industries could help set up production, to be followed by leasing, of aircraft needed by our airlines. Another example – the funds assigned to defense industries reform could be invested to set up a

mass serial production of Russian cruise missiles, similar to U.S. Tomahawk, which are required domestically and could be offered to the world market of armaments (see our surveys for the previous years). There could be other options. Such projects promising good returns and long-term partnership of private capital and the state could easily find an investor.

Later, a tender could help select the most preferable contractors. This would be the natural way to segregate the core defense industries which would not be imposed from above but instead based on specific models of armaments, their key elements and technologies, specific goals of defense planning, and specific circumstances in the area of technical military cooperation.

If, despite the budding economic growth, the government that has a major stake in the defense operations is still uncertain about the efficiency of the industry, a comprehensive analysis of the cause is needed. This prompts the need to make public the following:

- a list of businesses and institutions of the military-industrial complex, and a complete list of their owners;
- costs (borne by the government and other owners) to operate and help develop defense projects;
- revenues generated by defense projects and their distribution among owners;
- non-financial results from the operations of the military-industrial complex;
- a valuation by independent experts of the economic and functional efficiency of all owners;
- reasons for which the industry needs the reform.

With this analysis done, a tender should be opened up for the best project of the industry's reform. The best project would then serve as a basis for the reforms in the industry.

The most favorable effect on the military-industrial complex could be had from proper funding of the state defense order. According to the commentary by the Russian Deputy Defense Minister for armaments, published in *Rossiiskaya Gazeta*, the 2001 state defense order was fully funded. A State Armaments Program was approved, complete with resources and funding, allowing defense projects to embark on a long-term planning for their operations. Another good impact could come from the repayment of the debt that government owed to the military-industrial complex over the past years. Note that under RF Government Resolution No 1020 of 29.12.2000, full repayment of the outstanding debt should be completed by 1 January 2003. The repayment is currently on time. Those positive changes bode well for the defense economy.

Part 3. Social sector

3.1 Residents finances.

Residents' revenues. Mostly favorable tendencies manifested by the Russian economy in 2001 had a positive impact upon living standards and residents' revenue variables. By GOSKOMSTAT's estimates, real disposable cash revenues grew by 5.9% in 2001 as compared to 2000, while real wages rose by 19.8%, and real pension revenues grew by 21.4% (the average for annual variables).

The advanced payroll growth relative to revenue growth rates revealed a positive tendency of the last two years. In December 2001, real wages rose by 19.7% relative to the respective period in 2000, while the growth of real revenues accounted for 108.8%. The real wages in December 2001 thus almost reached the pre-recession level (98.5% relative to December 1997), and real cash revenues were still much lower than those of the pre-crisis period (by almost 12%) (Table 1).

Table 1

The dynamics of nominal / real payroll and cash revenue variables, 1997-2001. *

	1997	1998	1999	2000	2001
Average wages applied, rbl.	1215	1468	2283	3025	4294
Real wages (1997 = 100%)	100	65,7	74,7	82,3	98,5
Average per capita revenues, rbl.	1270	1679	2524	3118	4025
Real cash revenues, rbl.	100	71,8	79	81,2	88,3
Consumer Price Index (1997 = 100%)	100	184	251,7	302,5	358,8
Consumer Price Index (% relative to the previous year)	100	184,4	136,5	120,2	118,6

* by the end of the year

Source: estimated by data provided by GOSCOMSTAT of the Russian Federation.

The December pensions indexation and the rise in public employees' wages facilitated an increase in real revenues in 2001, which allowed for the forecast

that the average annual growth of real cash revenues would reach 12%.¹ But the predicted level was not attained, albeit the growth rates of real cash revenues in 2001 (108.8%) were much higher than those in 2000 accounting for 102.3% only.

Throughout I to III quarter of 2001, there was a strong tendency towards the advanced growth of the consumer price index relative to cash revenues and wage rates. Official statistical data displayed the increase in prices for consumer goods and services by 13.9% throughout I to III quarter, 2001, whereas nominal wages rose only by 12% (September 2001 relative to December 2000). By official statistic estimates, nominal cash revenues didn't grow at all but fell by 4.2% during III Quarter 2001, if compared to December 2000. The rise in nominal cash revenues and wage rates occurred only at the end of IV quarter 2001, and in December per capita monthly revenues accounted for 4,025rbl versus 3118rbl in December 2000, while monthly wages accounted for 4,294rbl versus 3025rbl in December, 2000.

The fact that total arrears of wages kept growing from 31,7mld rbl (on January 1, 2001) up to 34,7mld rbl (on December 1, 2001) should also attract attention. But paying the liabilities in December 2001 resulted in reducing the latter to 29,9mld rbl, which is by 5.6% lower than those at the end of 2000. As before, manufacturers and enterprises had the largest share (87.9%) in total arrears of wages, which accounted for 26,3mld rbl on January 1, 2001. Last year budget arrears decreased to 3,6mld rbl (or by 12.1% relative to total for arrears on January 1, 2001).

In 2001, the interindustry differentiation of the average wages applied kept growing over 8.8 times according to the data of November 2001, whereas in May 2000, there was a 8.4 times difference in average wages over different industries. The highest monthly wages were recorded in fuel industry in November 2001 and were 3.6 times higher than the average wages in Russia (in 2000 – 3.2 times, in 1999 – 2.95 times) including gas industry wages, which exceeded the average wages rates in Russia by 4.3 times. The poorest performance of wages rates was observed in agriculture, where average wages in November 2001 accounted for 41% of total average wages in Russia, as well as in education (53%), public health service, culture and arts (57%).

The high level of differentiation of per capita revenues proves to be an evidence of current misbalance in wages earned by employees of different profes-

¹ Social Indices of Revenues and Living Standards. The Ministry of Labor and Social Development of the RF, Issue 7(93), Moscow, 2001, p.5.

sions. Table 2 displays the data on cash revenue share of 20-% groups in total per capita revenues, revenue concentration indexes (Jinny's Index) as well as decile ratios of revenues differentiation in 1991-2001.

Table 2

Total per capita cash revenue distribution in the RF, revenues differentiation and concentration rate, 1991-2001, %

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Cash revenues, total	100	100	100	100	100	100	100	100	100	100	100
20% Group 1 (the lowest revenues)	11,9	6,0	5,8	5,3	5,5	6,2	6,0	6,1	6,1	6,1	5,9
Group 2	15,8	11,6	11,1	10,2	10,2	10,7	10,2	10,4	10,5	10,6	10,4
Group 3	18,8	17,6	16,7	15,2	15,0	15,2	14,8	14,8	14,8	14,9	15,0
Group 4	22,8	26,5	24,8	23,0	22,4	21,5	21,6	21,1	20,8	21,2	21,7

The data in Table 2 show that the most well-off part of the population in Russia (20-% group 5) shared almost half of the total cash revenues (47% versus 30.7 % in 1991). Thus, despite the positive performance displayed by microeconomic living standard variables in 2000-2001, their distribution reflects the same negative tendencies as before: the major part of revenues fell upon well-to-do groups of the population.

Jinny's Index and the decile revenue differentiation ratio rose in 2001, as compared to 2000 (Jinny's Index increased from 0.394 up to 0.396, revenue ratio rose from 13.7 up to 13.8), which reflected the ongoing process of stratification of population on the basis of revenue rates started up in 1992.

According to the official statistical data, the gap between per capita revenues on interindustry level kept growing in 2001. In August 2001, the average per capita cash revenues in Moscow were 5-11 times higher than the relevant rates in the other regions of the Central Okrug, whereas they had been but 4-10 times higher a year before.

The share of those for total population, whose average per capita cash revenues were below the living standard, was gradually decreasing in 2001, in IV quarter it accounted for 24% (34,8mln people) versus 26.9% in the respective period of 2000. In III quarter, 39.4mln people (27.2%) had the cash revenues below living standard, in II quarter there were 45,2mln people of this kind (31.3%) and in I quarter they accounted for 52,9mln (36.6%). Alongside with

that, in IV quarter 2001, the living standard grew by 3%, if compared to III quarter, and accounted for 1574rbl.

According to the I-III quarters 2001 totals, the correlation between average pension rate and pensioners' living standard considerably improved. If in 2000, the average pension was 26% below the living standard, then by September 2001 it had reached 94% of the living standard. The correlation between the average wages and living standard also improved and became 2.1 times higher than the living standard, whereas in 2000 they were only 1.7 times higher.

Household spending. Throughout 2001, rather sustainable growth rates of real per capita consumer spending were observed. In 2001, real expenditures grew by almost 8.7% (9.3 % in 2000). Nominal cash per capita spending accounted for 3944,4mld rbl in 2001.

The share of expenditures for purchasing goods and services remains very large within aggregate spending (it grew from 77.8 % in 2000 up to 78.4% in 2001). The share of savings dropped down to 4% in 2001 versus 5% in 2000, and the share of compulsory payments and fees increased up to 9.3% (in 2000 it equaled 8.1%). The per capita spending on purchasing foreign currency rose, it accounted for 7.4% of aggregate per capita spending (in 2000, it was 6.7%).

In 2001, the retail turnover accounted for 3005mld rbl, which was 10.8% more than that in 2000, and practically equaled the level of early 1998. The retail turnover increased mostly owing to the rise in non-foods retail rates, which accounted for 13.7%. Foodstuffs retailing grew by 7.4%, if compared to 2000. In 2001, the foodstuffs share in retail turnover accounted for 46.1%, the nonfoods share was 53.9% (respectively, 46.5% and 53.5% in 2000).

3.2 Branches of social and cultural sector

The past year was marked by a more pronounced increase in financing provided by the government for social and cultural sector, which started in 2000. The consolidated budget allocations for public health service, education, culture, and mass media grew in real terms by 9% in 2001 relative to the previous year, which considerably exceeded the corresponding ratio of 2000 (5%) and GDP growth rates (5%), the latter being for the first time in many years. Besides, unlike 2000, when the rise in federal financing was achieved mostly at the expense of the 30% increase in federal budget allocations, while regional budget allocations grew only by 1%, in 2001, regional expenditures increased by 8% and federal expenditures grew by 17%. Last year the most solid funding was provided for education (13%) and culture (9%). Allocations for public health services and mass media increased relatively by 5% and 3%.

Public health services

For the last years public health service structure has been characterized by a number of problems, which necessitate reforms within the current system of management and finance. The crux of the problems might be summarized as follows:

- Misbalance between medicare guarantees provided for citizens by the government and the level of federal funding for such guarantees;
- Unsatisfactory control over the operations of different agents within the system of public health management and finance;
- Incompleteness of the compulsory medical insurance implementation and promiscuity of budget and insurance system elements within public health service finance;
- Inefficient allocation of federal funds for out-patient and hospital medical services, purchasing of medical products, medical facilities, construction and reconstruction of health service establishments;
- Reproduction of hang-the-expense type of management in public health service establishments.

In «Major Objectives of Social and Economic Policy of the Government of the Russian Federation within Long-term Prospects» approved and adopted by the Government in June 2000, the primary targets of health service reforms in the period of 2000-2001 were fixed as follows: the formation of the integrated medical insurance system, management independence and the diversity of structural and legal forms of medical establishments, the development of federal program on medicare guarantees. But in practice there were no conspicuous results in respect of meeting the given targets either in 2000 or in 2001.

The reformation of the health service finance system implemented in the first half of 1990-s created a peculiar institutional trap for the system itself. Actual refuse to reconsider the government's medicare guarantees in conjunction with the decline in federal budgeting resulted in the large-scale substitution for government financing made by private businesses mostly in the form of shadow or quasiformal payments, which lead to inefficient spending of both government and private funds. With all this going on, the changes undergone by the current combination of formal and informal payments for health service had both considerable political negative effects and high economic costs.

Another institutional trap resulted from compulsory medical insurance fees introduced in 1993 and meant for employed citizens, which accounted for 3,6% of labor remuneration fund, it being absolutely insufficient to fully finance the medical care as should be provided for such insured. Besides, it was aggravated by the lack of strict rules for insurance compensations offered by local and re-

gional budgets for unemployed citizens and limited authorities of federal government to impose such compensations on regional and local governments. All this lead to numerous eclectic and inefficient regional budgets' insurance models for funding medical care, which, however, can be hardly changed without any serious political effects.

The terms of insurance companies' participation in compulsory medical insurance system proved to be another institutional trap. The current legislation fails to foster the competition among insurance companies and does not facilitate the efficient usage of insurance funds and health care service potency. As a result, a lot of insurance companies turned into passive and, therefore, superfluous mediators in capital flow from compulsory medical insurance funds to medical institutions. Formal terms of contracts entered into by an insurer, an insured, and a medical institution are, to a great extent, supplemented with informal terms and agreements, which impede effective employment of insurance funds. Under the current conditions, administrative flaws in the development of legal competition among insurance companies and in turning the latter into active participants in compulsory medical insurance system appeared to be excessively harmful.

As a result, the current system of federal financing provided for public health service maintains rather sustainable but, at the same time, ineffective equilibrium. The system needs reforming but this can hardly be attained without strong external pressure. The legislation in respect of health care service in the past year became a good example to prove the foregoing assumption.

The legislation was a little more active than in the previous year, but the introduced institutional innovations hardly facilitated handling key problems within structure and economy of the given industry. The major goals of such innovations were to empower the Ministry of Health to exert better control over the health care service system.

«Tuberculosis Preventive Measures Act of the Russian Federation» #77-FZ was enacted on June 18, 2001. The provisions of this new act were supplementary to the current «Health Protection Standard Act of the Russian Federation» # 5487-1 adopted on July 22, 1993. At the same time, it should be noted that the act provides the federal government with additional powers to carry out a system of measures against tuberculosis. In particular, the act empowers the federal authorities to work out a system of measures against tuberculosis, as well as to provide governmental control over production, storage and transportation of tuberculosis vaccine and immunobiological medical products. As for the «Health Protection Standard Act of the Russian Federation» # 5487-1 enacted on July 22, 1993, it gave the federal government the right to establish basic norms of health

protection policy, work out and implement federal programs, provide public epidemiological services, adopt federal standards in respect of pharmaceutical and medical industry and exert control over the latter. But this did not include the right to provide specific medical services on the territory of the whole country and the right to exercise control over production, storage, and transportation of medical products. Such rights are not provided by «The Medical Products Federal Act» #86-FZ enacted on June 22, 1998, either. The differences in the provisions of the new act and the old ones are not regarded as conflicting each other but clearly display the policy aimed at strengthening the federal government powers in respect of health care management.

In the past year the regulations in relation to medicine circulation were renewed. Pursuant to the current legislation, medicine sales on the territory of the Russian Federation are allowed provided that the uniform conformance certificate valid for 1 year is submitted. The RF Subjects shall establish the certification authorities. The resolution #2 enacted by GOSSTANDART of the Russian Federation on January 3, 2001 adopted «Medicine Certification Regulations» instead of the regulations valid since 1998. The main peculiarity of the new regulations consisted in considerable reinforcement of the certification authorities delegated to the RF Ministry of Health. The certification conformance control over domestic and foreign medicine shall be exerted solely pursuant to the standard acts adopted by the RF Ministry of Health. Formerly, the regulations read that the certification shall be carried out pursuant to the «Products and Services Certification Federal Act». CEOs of the certification boards and quality control laboratories shall be accountable to the RF Ministry of Health. Quality control laboratories shall carry on their activity in accordance with the regulations enacted by the RF Ministry of Health.

In November, the government introduced some changes into the pricing policy in pharmaceutical products market (The resolution of the RF Government # 782 «On Medicine Pricing Federal Control» adopted on November 9, 2001). Since 1999 the mechanism of public recording of the prices set by domestic and foreign manufacturers for medicine listed among vitally important medical products has been implemented. The medical product list includes over 750 unlicensed items, which correspond to over 6,000 trade names out of 14,000 trade names of licensed medical products. The innovations apply to the price recording procedure. The cost price declared by the manufacturer or the importer shall be submitted for the consideration of the RF Ministry of Economic Development and Trade and the Ministry of Industry, Science and Technologies. However, under the new resolution the RF Ministry of Health plays the key role in the price

recording procedure. Formerly, it had to perform technical functions, i.e. record the prices approved by the ministries mentioned above. Now, the applicant submits all the documents necessary to record a product not to the Ministry of Economic Development but to the Ministry of Health, which files an application with the given ministries. In the event that the MEDT and the MIST have different opinions on pricing decisions, the Ministry of Health performs mediating functions in reaching a consensus. Then, it is the Ministry of Health that makes the final decision on the adoption of the marginal cost price.

Like the previous standard governmental act, the given resolution has no clearly defined criteria to be applied to pricing decisions, which provides a wide scope of opportunities for shadow deals between officials and applicants. The former procedure provided that the application shall be rejected, in case the applicant submitted inadequate information or in the event that the price for the medical product either in European Union or in the country of origin proves to be much lower, transportation and storage fees being adequate. Any provisions in relation to turning down an application for price adoption were excluded from the new resolution.

Some amendments were introduced in the procedure established by the RF Subjects in respect of marginal markups (wholesale and retail) to the adopted price. Before 1999, markups had been set to the «first wholesaler» cost prices, i.e. the prices established by the companies, which had purchased the medicine directly from domestic manufacturers or foreign suppliers. At that, the volume of the markups set by the first wholesaler had not been controlled. This is a very condition that was the reason for the price differentiation (price gap) not only at the interregional level but also inside the Subjects of the Russian Federation. Since 1999, marginal markup procedure applied solely to the adopted prices of domestic or imported medical products. It resulted in overpricing and application of shadow schemes to the revenues distribution among manufacturers and wholesalers. The new resolution reads that markups may be set both to cost prices and the first wholesalers' prices at the discretion of the RF Subjects.

The analysis of changes in medicine pricing policy allows us to make a definite conclusion that all those changes serve the interest of the RF Ministry of Health officials who control pharmaceutical business activity, as well as of those major firms that are engaged in medicine wholesale.

The foregoing standard acts provided, to some extent, that the problem of unsatisfactory administration of the operations performed by different health care authorities was resolved by (through) strengthening the RF Ministry of Health powers. The other health care management problems were discussed, some de-

claratory statements were made but no practical measures were taken in the past year.

In July, the Government adopted a new redaction of the *Program on Federal Medicare Guarantees provided for the Citizens of the Russian Federation* (the resolution of the Government # 550 enacted on July 24, 2001). The amendments introduced were of technical character, but the qualitative parameters under the program (the volume of hospital, off patient, and emergency rescue aid per 1,000 people) remained unchanged. The list of medical aid types guaranteed was enlarged. Thus, dispensary medical observation of healthy children was added to the list of preventive measures and medical aid provided for the citizens by family planning and reproduction centers was listed among free health care services. Meanwhile, the problem of poor financing provided for such guarantees still proves to be urgent.

Since the fall 2000, the Government has been drafting the *Compulsory Medical and Social Insurance Federal Act*. The conception of the given draft was subject to analysis made in previous IET's editions, the results of the letter being up to date. The uniform medical and social insurance system proves to be a solution to the problems inherent to the current systems of medical and social insurance inclusive of the problems of their interrelations and problems of spendings on treatment and rehabilitation, preventive measures against a disease, as well as on compensation for the wages lost. The key impediment to drafting out the act consisted in defining insurance sources to compensate for the unemployed. At present, the insurance payments compensating for the unemployed within compulsory medical insurance system are provided at the expense of local and regional budgets. The federal legislation makes no provisions in relation to such payments, which proves to be a major reason for incomplete implementation of the compulsory insurance and its poor performance within the old system of budget financing. In preparing the draft, the government considered different possible sources of the payments under consideration, i.e. personal income tax revenues, alcohol and tobacco tax revenues, etc. But no final choice in favor of this or that variant was made, which appeared to be the main reason for the delay in the given act enactment.

The transition from standard-cost budgeting to assignments observing the resultant performance is a major tool to surmount cost-based management. As early as 2000, The RF Ministry of Health made an order, which provided for the transition to a new financing mechanism applied to the federal medical institu-

tions under the ministry's jurisdiction in 2000-2001². It was assumed that the government would budget for clinical services on the basis of the tariffs paid for the cured patients after the course of medical treatment was completed. The tariffs shall be differentiated in accordance with nosological forms (kinds of diseases) and medical reports used in federal clinics. In 2001, the RF Ministry of Health started approbation of the new mechanism. It was decided to limit the innovations to the changes in budgeting for high-tech medical services, i.e. to change the funding model for one item (1701/430/315) within functional classification of the budget expenditures. The new mechanism caused negative reaction of the Chief Medical Officers of most federal clinics having no wish to introduce any changes in the current convenient financing model, which imposed no accountability for the funds consumption. As a result, in 2001, the new mechanism was implemented only in one pilot federal medical institution, the Research Center of Obstetrics, Gynecology, and Perinatology of the RAMS (Moscow)³. And it was the Research Center on Obstetrics, Gynecology, and Perinatology rather than the Ministry of Health that displayed more activity in implementation of the new mechanism.

The high-tech medical services budgeting provided for all the other federal clinics in 2001 was established regardless corresponding tariffs and fund allocation criteria. The federal clinics were under the old financing model per se. Actual violation of the order made by the Ministry of Health proved to be evidence that the relations between the Ministry officials and the Chief Medical Officers of the clinics are far from direct administrative subordination. The Ministry Administration preferred not to impose the order upon the subordinates but to persuade those discordant of the need to transfer to the new financing model. Such an approach was probably based upon two key assumptions. First, the Chief Medical Officers of the clinics have a considerable impact upon federal officials including their former patients of high rank. Second, The Chief Medical Officers of federal clinics hold, at the same time, the positions (posts) of the Russian Academy of Medical Science (RAMS) members. Academy membership is rated among prestigious occupations in medical community. Probably, in the view of this fact, the Ministry officials do not want to run a risk of provoking a conflict with the opponents of the given innovations. The foregoing makes it possible to characterize

² Russian Economy in 2000. Tendencies and Prospects, Moscow, IET, 2001; S.V. Shishkin Health Care Financing Reforms in Russia, Moscow, IET, Teis, 2000.

³ For more detail, see: Russian Economy in 2000. Tendencies and Prospects, Moscow, IET, 2001.

the relations between the Ministry of Health and major federal clinics as mutually dependent. Consequently, any future innovations aimed at higher efficiency of budget funds allocation may be implemented provided that both the Ministry and federal clinics are exposed to strong pressure of the Ministry of Finance and the Government or when the clinics regard such innovations as being in conformance with their interests.

In accordance with the RF Government Plan, some drafts were prepared in the past year to extend the scope of social institution types, in general, and medical institutions, in particular. The institutional development is especially important for public and municipal establishments. The Budget Code requires that cash budget should reflect all kinds of revenues received by an institution. Under current economic conditions, the institutions rendering medical aid feel an inevitable need to reallocate expenditures under the adopted budget. But for this purpose, the institution has to win over the funds administrator and the Board of Treasury in order to confirm the changes introduced into the cash budget. The budget-focused model considerably limits the economic activity of the institutions receiving significant revenues from non-budget sources and necessitates their devising shadow schemes to attract capital and spend funds. The very status of a public institution, which entails budgeting, fails to provide economic independence for health care service producers to the extent necessary to facilitate rational economic activities of theirs.

In order to achieve gradual transition to specific-purpose financing provided for federal and municipal health care institutions and guarantee the latter certain independence in making economic decisions, it is necessary to change the current legal status of the given institutions. It is reasonable that existing medical institutions should be re-organized to acquire a new legal status of a federal (municipal) non-profit establishment⁴. The key characteristics of the target status, if viewed from the standpoint of civil and budget laws, are the following:

- The founder provides the institution with property entitling the right to run the business to it, but not operative management, therefore, the status of a budget institution defined in the Budget Code does not extend to the institution under consideration, and provisions of the Budget Code entailing cash budget-based model do not apply to it either;

⁴ E.V. Kushtanina, B.L. Rudnik, S.V. Shishkin, L.I. Jacobson The Modifications in the Legal Status of Medical Institutions, a report under Boston University project on Legislation Incentives in Health Care Sector, Moscow, 2000.

- A joint board, namely a Trustee Board, which shall be formed by the founder, is entitled to control financial and economic activities of the institution under consideration;
- The organ of public authority (either a federal organ or an organ of the Subject of the Russian Federation) or a local self-government organ, which extends its jurisdiction to the non-profit institution under consideration, shall be entitled to allot a task to the given institution to provide public (municipal) health care services provided that such services are financed from the corresponding budget in such amount as is necessary to cover the health care service expenditures entailed by the task;
- The financing provided for a specific federal (municipal) non-profit institution by the federal budget, the budgets of the RF Subjects, local budgets or public non-budget funds may be received as payments for the goods, jobs, and services produced by such institutions under public (municipal) order or as certain types of compulsory social insurance payments.

The introduction of the new legal status will allow for effective functioning of most public and municipal medical institutions. At the same time, it seems reasonable that the old status be preserved for some institutions, such as military hospitals, epidemiological stations, etc., since it is essential for the authorities in question not to lose control over such institutions.

In the past year, an inter-ministry working group formed by the RF Ministry of Economic Development and Trade was working at the draft of «Special Federal (Municipal) Non-profit Organizations Act», which embraced the foregoing principles. But up to early 2002, no agreement on the draft was reached by the parties involved.

Investment Policy in Health Care Sector.

The poor performance of investment resources in public health sector has hardly undergone any changes as a problem to be solved.

8. We will now consider the investment spending of the federal budget during 2001.⁴ Government investments in healthcare institutions are allocated among a number of federal customers and programs. The federal customers of those healthcare institutions invested by the federal budget embrace 10 federal ministries and authorities and also include the administration of Stavropol territory.

⁴ The present analysis was performed by the authors as part of "Efficiency Analysis of Federal Budget Spending on Healthcare", TESIS.

The RF Ministry of Finance was the biggest public investor in healthcare institutions, allotting 416mln. rubles that accounted for 43,1% of total for investments. The Ministry of Finance invests those healthcare institutions that are not to be found under federal specific-purpose programs (are locked out of the program bulk segment) and are property of the RF Subjects or municipalities. Notably, the above institutions were not listed among investment objectives at the outset, but were on the list only after a set of amendments had been introduced into the draft federal budget by the State Duma. Such cases evidently exemplify a bargain struck by the federal government and deputies.

The RF Healthcare Ministry with its 314,1mln rubles sharing 32,5% of total for investments is just in the second place as a public investor. Capital investments amounting to 134,5mln. rubles are budgeted within the framework of specific-purpose programs, while 179,6mln. rubles constitute the non-program part. In the sense of the latter, the RF Healthcare Ministry provides for investments in government healthcare institutions.

The third place in the chart is the Ministry of Emergency Situations with 101,2mln. rubles accounting for 10,5% of total for investments in healthcare institutions. This whole amount is managed under «Chernobyl Children» specific-purpose federal program.

The biggest share of total for government investments in healthcare institutions is allocated beyond federal specific-purpose programs (as locked out of the program segment). In 2000, this was 59,7% of total for all provisions versus 70,4% during 2001. The non-program segment public investors are the RF Ministry of Finance, Ministry of Healthcare, the Russian Academy of Medical Sciences, ФУ «Medbioextrem», the Administration of the RF President.

The federal requesters for specific-purpose programs are the RF Ministry of Health, the Ministry of Economic Development, the Ministry of Justice, the Ministry of Sports, the State Ecology Committee and also the administration of Stavropol Territory. Among specific-purpose programs, the largest volume of investments is earmarked for «Tuberculosis prevention measures» (218,5mln. rubles) and «Chernobyl Children» (101,2mln. rubles) as the respective 44,9% and 35,4% shares of total for the investments volume budgeted as part of the program segment.

The volumes of investments in healthcare institutions are considerably smaller under other specific-purpose programs. Their aggregate investments account for 56,5mln. rubles (19,7%). The investment objectives for such specific-purpose programs (except for «Safe Motherhood» and «Catastrophes Medicine) would be ambulance stations, children's hospitals and polyclinics, the rehabilitation hospital under the program of developing «The Caucasus Mineral Waters as Russia's health and ecology

resort under special conservancy», the oncological center under the «Social and ecological rehabilitation of the Samara region territory and protection of its residents' health» program, the construction of a health resort under the program of «Economic and Social Development of the Komi Republic», the state epidemic control center under the program of «Social and Economic development of Stavropol Territory». Notably, no investments in public health were assigned in the draft budget for 2001 under the programs listed above, but they were enrolled on the federal budget later on, as resulting from the amendments inserted by the State Duma.

The present system of investment hampers the coordination of investment flows and makes their performance difficult to evaluate. The below examples reveal discord in investment decisions:

- Rebuilding and construction of maternity hospitals and obstetrical centers carried on under Chernobyl Children program (MЧC being the program requester with 25mln. rubles investments for year 2001) and also beyond the program segment (the Ministry of Finance as a requester appropriating 54,4mln. rubles for 2001), all above the specific-purpose «Safe Motherhood» program (requested by the Public Health Ministry).

- the construction of a perinatal maternity center in the Ingush Republic is funded as part of the non-program segment, while creating such centers is the objective of «Safe Motherhood» program.

- renovation of the state epidemic control center in Krasnogvardeisk region of Stavropol Territory (the Ministry of Economic Development as a requestor), while that institution appears under the jurisdiction of the RF Ministry of Public Health.

- The AIDS prevention measures in Irkutsk region are invested beyond the program segment framework, while Russia's Ministry of Public Health is piloting a specific-purpose AIDS-prevention program.

In order to analyze investing policy on the regional level, the regions had to be grouped according to overall assessment made by the Ministry of Economic Development basing on their social and economic performance during 1999⁵. Table 1 reflects the allocation of the investments planned for 2001 among regional and municipal public health institutions over the RF Subjects. Moscow region (47mln. rubles), Leningrad region (34,8mln rubles) and Orenburg region (32,1mln. rubles) are rated among the three most heavily invested ones. It should be noted that Orenburg region is ranked with a number of regions, the economic performance of which is better than average. At the same time, five out of the ten least heavily invested regions of 2001 are

⁵ See the refined data on Russia's social and economic development forecasts till 2003.- The Ministry of Economic Development, the year ended December 2000, Moscow.

those of poor and extremely poor economic performance. An analysis reveals the lack of interrelation between a region's level of economy and the volume of federal budget investments in the respective public health systems. Thus, during 2001, the regions performing better than average (9 in number) received 81,7mln. rubles as investments in public health institutions from the federal budget, others performing their average (14 in number) received 113,9mln. rubles, while the regions performing below average (16 in number) received 133,7mln. rubles, the respective figure for those having extremely low-leveled economies (12, all in all) being 87,2mln. rubles.

Table 3

Federal budget investments in the institutions under regional and local jurisdiction planned for 2001*.

Subjects of the Russian Federation**	The volume of federal budget investments in the institutions under regional and local jurisdiction
Regions displaying high and above-average economic performance	
Orenburg Region	32100
Saint-Petersburg	16500
Khabarovsk Territory	11500
Yaroslavl Region	7000
Samara Region	4000
Moscow	4000
The Republic of Tatarstan	3000
<i>Lipetsk Region</i>	2600
<i>Yamalo-Nenets AO</i>	1000
Regions displaying average economic performance	
Belgorod Region	16900
Saratov Region	13500
Kursk Region	12000
Irkutsk Region	11500
Nizhniy Novgorod Region	9500
Tula Region	9000
Krasnodar Region	8500
Krasnoyarsk Region	8000
Smolensk Region	7500
Rostov Region	5000
Astrakhan Region	4500
Tumen Region	4000
<i>Novgorod Region</i>	2500
<i>Kaliningrad Region</i>	1000
<i>Perm Region</i>	500
Regions displaying poor economic performance	
Moscow Region	47000
Leningrad Region	34800
Stavropol Region	25500
Sverdlovsk Region	20000

Table 3 (cont'd)

Subjects of the Russian Federation**	The volume of federal budget investments in the institutions under regional and local jurisdiction
Voronezh Region	17000
Primorski Territory	11500
Orel Region	8600
Kemerovo Region	7000
Volgograd Region	7000
Nenets AO	5900
Vologda Region	5000
Kaluga Region	5000
Arkhangelsk Region	4500
Tambov Region	4400
Novosibirsk Region	4000
Regions displaying poor economic performance	
Bryansk Region	20900
The Mordvian Republic	16700
Tver Region	13500
Ryazan Region	13100
The Chuvash Republic	13000
Vladimir Region	11000
The Republic of Northern Ossetia-Alania	9500
Kabardino-Balakarian Republic	8000
The Kalmyk Republic	6500
The Buryat Republic	5000
Kostroma Region	4000
The Adigei Republic	4000
Kirov Region	4000
Pskov Region	3500
Ivanovo Region	1000
Regions displaying very poor economic performance	
The Dagestan Republic	23500
Chita Region	18000
Tuva Region	11000
Penza Region	8700
The Mari El Republic	5500
Kurgansk Region	5500
The Ingush Republic	5000
Jewish AO	5000
Komi-Perm AO	3000
Ust-Ordinsk Buryat AO	1000
Aginsk Buryat AO	500
The Altay Republic	500
Total	623700

*The 10 regions in bold type were invested most heavily, whereas the 10 italicized ones received the lowest investments.

**The regions are grouped basing on the overall evaluation of their social and economic performance during 1999, submitted by the RF Ministry of Economic Development (For refined data on Russia's social and economic development forecasts till 2003, see the Ministry of Economic Development, the year ended December 2000, Moscow).

The situation was much the same in 2002. The figures dated that year entail an analysis of interrelations between the volume of federal funding invested in regional and municipal public health institutions and the sick rate combined with PPE (tangible assets) performance within the respective public health systems. Throughout 2000, children's health care institutions received more than a quarter (24%) of total for moneys invested in the institutions under the jurisdiction of regional and municipal public health systems. Table 4 shows the investments volumes and children's sick rates for the recipient regions. Children's sick rate happened to exceed the average for Russia just in 10 regions out of 24.

Table 4

The allocation of federal budget investments in children health care institutions among the RF Subjects, 2000

The RF Subjects*	The volume of federal budget investments in children health care institutions (thousand rbl.)	Children's sick rate per 100,000 children in 2000	Children's sick rate relative to Russia's average
The Russian Federation		182985	1
Regions displaying relatively high and above-average economic performance			
Lipetsk Region	5700**	172504	0.94
Khabarovsk Territory	2500	187132	1.02
Moscow	1500	260996	1.43
Regions displaying average economic performance			
Tula Region	11000**	170560	0.93
Kursk Region	7000**	166902	0.91
Belgorod Region	4000**	186872	1.02
Saratov Region	3500	184681	1.01
Smolensk Region	1200	196913	1.08
Tomsk Region	500	209452	1.14
Regions displaying below-average economic performance			
Orel Region	12600**	188597	1.03
Tambov Region	6700**	187658	1.03
Kaluga Region	6500**	210494	1.15
Moscow Region	6240**	188769	1.03
Voronezh Region	5400**	137744	0.75
Leningrad Region	3800**	161154	0.88
Sverdlovsk Region	1500	171833	0.94

Table 4 (cont'd)

The RF Subjects*	The volume of federal budget investments in children health care institutions (thousand rbl.)	Children's sick rate per 100,000 children in 2000	Children's sick rate relative to Russia's average
Regions displaying poor economic performance			
Bryansk Region	18970**	175605	0.95
Ryazan Region	7400**	174344	0.95
The Republic of Northern Ossetia-Alania	4000	107267	0.58
The Adegei Republic	2900	116448	0.63
The Kamyk Republic	1000	143257	0.78
Regions displaying very poor economic performance			
Penza Region	10800**	170066	0.93
Chita Region	3000	126539	0.69
The Ingush Republic	1400	115006	0.63
TOTAL	129110		

* The regions are grouped basing on overall assessment of their social and economic performance in 1999, submitted by the RF Ministry of economic development (for refined Russia's social and economic development forecasts up to 2003, see the Ministry of Economic Development, the year ended December 2000, Moscow).

** All the investments were allocated through the federal «Chernobyl Children» program.

In 2002, oncological institutions became another significant investment objective on the regional level, collecting 7,6% of total for investments in institutions of regional and municipal public health systems. Table 5 contains data on investments volumes versus the cancer-rate in the recipient regions. Two regions out of 9 (Irkutsk region and the Udmurt Republic) showed a 16% by 17% lower cancer-rate as compared to the average for Russia. It is also noteworthy that Irkutsk region is rated among other regional economies performing on the mid-level.

Table 5**The allocation of federal budget investments in oncological institutions among the Subjects of the Russian Federation in 2000.**

N	The RF Subject*	The volume of federal budget investments in oncological institutions (thousand rbl)	Oncological sick rate per 100,000 people, 2000
	The Russian Federation		309,3
	Regions displaying relatively high and above-average economic performance		
1	Samara Region	3000	357,3
2	Orenburg Region	2000	315,3
	Regions displaying average economic performance		
3	Irkutsk Region	10000	260,3
4	Novgorod Region	10000	366,8
5	Saratov Region	3000	356,7
	Regions displaying below-average economic performance		
6	The Udmurt Republic	1500	256,1
7	Moscow Region	200	341,5
	Regions displaying poor economic performance		
8	Kostroma Region	3500	339,4
9	Altai Territory	1500	354,8
	TOTAL	34700	

* The regions are grouped basing on overall assessment of their social and economic performance in 1999, submitted by the RF Ministry of economic development (for refined Russia's social and economic development forecasts up to 2003, see the Ministry of Economic Development, the year ended December 2000, Moscow).

The analysis of government investments in the institutions of regional and municipal public health systems has revealed no determination between the volumes of capital spending on investments, the level of social and economic performance, resources available to the local public health systems and sick rates. The key factors of investments allocation to particular regional public health institutions are thus political factors.

In order to provide for a well-coordinated and savvy investment policy (from the standpoint of administrating a public health system), it would be advisable to incorporate investments in public health under a unified federal investment program (or subprogram) within public health domain, the requestor of which would be the RF Ministry of Public Health. The number of public health institutions financed beyond the framework of program segment should be substantially reduced. This will create favorable institutional conditions to secure for

sufficient ground and systematic nature of investment projects as well as for their conformance to strategic priorities as are set for the development of public health system by the RF government. Such strategic priorities are listed by the Concept of Public Health and Medical Science Development in the Russian Federation dated November 5, 1997 (No. 1387). Incorporating all investment objectives under one specific-purpose program (or subprogram) would set forth conditions to perform an in-depth analysis of Russia's integral public health system as made of the federal and regional subsystems and also allowing for comprehensive investments planning within the uniformity of national public health. The assumed uniformity would ensure applying up-to-date methods to evaluate social and economic efficiency of investment projects in public health sphere, impart transparency to decision-making process, extricating it from under political factors and lobbying pressures that lead to inefficient resource management.

Federal investments are expedient to finance only federal, interregional and regional level institutions that render tertiary medical aid (i.e. basing on pioneered technologies that have not hitherto gained all-round adoption). Capital expenditures on financing municipal public health institutions, especially those of generic type rendering primary and secondary level aid (such as central hospitals, regional hospitals, and out-patients' clinics) should be assigned by local budgets and those of the RF subjects. The dearth of such moneys should be replenished by the RF Subjects Support Fund.

It's necessary that validity be increased for planning all-level capital expenditures on public health. The volume of investments in regional public health systems should be strictly bound to the regions' social and economic performance, sick rate, resource provision and management within a public health system. For these purposes, it appears compulsory to have investment decisions on projects budgeted by either the RF Subjects or municipalities (such as creating new public health institutions or obtaining costly equipment) approved of by higher executive authorities. This corresponds to worldwide experience: many countries adhere to promissive precious equipment purchasing and new public health institutions building.

Education

In 2001, education was one of the key government policy issues on both federal and regional level. President Putin's Address to the Federal Assembly (dated April 3, 2001) outlines major goals faced by the Russian education today, and namely:

- altering the very approach to education under ongoing globalization and development of new technologies; its transformation from the «social sphere» of sheer spending into a sphere of investment, which ensures investing in Russia's future as a joint effort of the State, corporations and social organisations, as well as all the residents whose interest is high-quality education of succeeding generations;

- a need for the transition to permanent education, since the rapid development of economy, sciences and IT-technologies require ongoing education throughout the whole life.

- the introduction of new economic mechanisms into education sphere, which will ensure the development and legalisation of non-budgetary funding sources for educational institutions, apart from stabilisation and perfection for the current budget financing.

- a vivid borderline to distinguish between the free education sphere, the access to which should be provided and fair, and pay education which is to acquire a steady legislative ground; paying for one's education has recently become common, however, this market has remained far from transparent; the official *costlessness* of education, as opposed to its covert but, actually, for-profit nature corrupts both teachers and pupils.

- developing a system of governmental education guidelines which would lay the basis for further per capita education financing.

- greater accessibility of education to children of poor families, attainable through budgeting and allotting personal social scholarships.

The key priorities listed on the President's Address pushed federal authorities to work out documents that appear strategic, on the one hand, but come to determine the reformation tactics within education as a sphere, on the other. To solidify the approaches to education reforming (such were announced in «The national Doctrine Of Education Development», «Russia's Up-Grading Strategy» strategic documents), a working group was established in May 2001 within the State Council to control the issues of education upgrading. It embraced Regional Governors, CEOs of regional and municipal education-ruling authorities, major university rectors, State Duma Deputies, trade union members and qualified educators. In the course of the workshop held on August 29, the RF State Council heard the report on «The Current Education Policy of the Russian Federation», prepared by the working group.

The most radical idea, which gained recognition with the State Council and was rated among top-priority measures for the period throughout 2001 to 2003 consists in assigning a governmental status to municipal institutions providing

general education through passing them over to the jurisdiction of the RF Subjects. It is for the first time, that this proposal, actually implemented in Samara region, gained so much support of the federal level.

A opportunity was provided for big donor-cities to «delegate state authorities to municipal level within the field of education». Notably, the above proposal is no novice. The Education Act adopted in 1992, public schools were passed over to the jurisdiction of local self-government authorities, which measure disabled the direct administrative oppression that regional authorities used to exert upon schools. However, financially disadvantageous municipal budgets failed to provide steady school funding; this resulted in increased liabilities for wages payable to teachers in the late 1990-ies. As early as at that time, trade unions pointed at the violation of Article 43 of the RF Constitution, which provides for state warranties in respect of school education, and claimed that the authority to finance schools be transformed from municipalities to the federal level.

The proposal to yield schools to the jurisdiction of the RF Subjects necessitates co-founding and co-financing on the part of regional and municipal authorities. However, no particular mechanisms of authority delegation have been set forward up to now, which provokes criticism for the part of economically autonomous municipal institutions. The most valid argument for schools' withdrawal from under municipal control consists in the opportunity obtained thereby to prevent inappropriate municipal usage of moneys assigned by other budgets and to ensure teachers timely wages. The disadvantages stemming out from here are as follows: first, municipalities thus escape the responsibility for schools operation, and second, building up co-financing schemes would entail a profound normative, administrative and procedure study of capital flows, which fact would bring about overcoming numerous beurocratic hindrances instead of financial stability at schools.

A section in the report that describes measures to modernize education and develop economical mechanisms dwells on much the same concepts of strategic up-dating as are contained in «The Key Directions of Social and Economic Policy and in Economy Modernization for the period throughout 2001 to 2010» (dated April, 2000). Namely, they are standard-cost-based budgeting, all-budget-levelled allocation of moneys for up-grading education purposes, transformation of federal transfers to recipient regions into specific-purpose subventions, remitted through treasuries; remodelling the rural school; imposing strict regulations upon the inflow of non-bedgetary capital to school; creating a federal education-crediting system; conducting the experimental State Unifom Test (SUT); independant supervision over the quality of education.

The report also presents a bunch of measures to reinforce social protection of pupils and staff, which was set forward by the trade-unions, and namely: bringing teachers' payroll to the average for industry wages by the year 2004, abandoning uniform tariff scales, providing housing on favorable terms, an introduction of a flexible system of bonuses and social allowances, bringing scholarships to the average of living standard; rendering personal support to pupils in low-income families, recruiting deferments granted to students who have never been enrolled in general and professional training classes before and also to the staff of specified educational institutions etc. Such proposals are far from new and have been recurring since the 1992 adoption of Education Act, however, remaining just claims due to the lack of funding and political will. Moreover, some of the reported proposals (such as departmental privileges, pensions, medical and social insurance) contradict President Putin's budget Address.

The transition to a 12-year-long education program has not won much support. Therefore, the report allotted a very vague task for the long run, namely, to work out standard acts to outline a new structure and essence for general education. In the course of the State Council workshop, it was suggested that a National Education Council should be incorporated under the Administration of the RF President.

Thus, the major political effect of the State Council decisions was the recognition of a national (not departmental) value that education represents in light of developing the Russian economy, and also the acknowledgement of the need to take more responsibilities for the present and future state of education sector. In the meantime, the recommendations on introducing new economic mechanisms into education comprised next to all the liberal issues of the strategic education development.

On October 25, the RF Government approved of the Education Development Concept in Russia till the year 2010. It should be noted that despite the heated controversy over some proposals and recommendations of the State Council concerning future educational policy, it's right these materials that laid the foundation for the government's Concept. Considering education as a priority in view of the future Russian economy and assuming that Russia can not remain unaffected by worldwide progressive tendencies, the Concept sets forth quite harsh assessments of the Russian education in its present state. Firstly, the current public school is recognised as failing to provide high-quality education standards in the field of computer science, foreign languages, economics and law. Secondly, the current financial provision for schools accounts for 25% to 40% of total for their estimated standard, real underbudgeting making 50% to 60%, which

leads to uneven accessibility of high-quality education subject to disposable family income.

The Concept defines the major administrative and economic mechanisms of modernization within the field of education as follows:

- an introduction of standard-cost budgeting;
- passing municipal public schools to the jurisdiction of the RF Subjects and assigning a status of state educational institutions to them;
- establishing personal specific-purpose transfers for the low-incomed above federal standards;
- creating a state credit system for education purposes to allow for professional education;
- a transition from common interbudgetary transfers to specific-purpose educational subventions;
- standard-act provisions for economic independence and implementation of the economic independence concept in educational institutions.
- generating opportunities to attract extra capital and render extra pay educational services on the basis of educational institutions.
- creating culture and field-study centers on the basis of educational institutions, especially, in rural schools.

The past year was marked not only by the debate over basic strategies in education, but also by education-reforming measures embarked on by executive authorities. On February 16, 2001, the RF Government enacted a resolution No. 119 «On Performing a State Uniform Test Experiment». The experiment consisted in performing a test that would combine state final certification procedures for school-leavers in their 10th and 11th grades with high-school and university entrance examinations. The spendings inflicted by running the experiment were financed with the moneys earmarked for the Federal Education Development Program and through shared contribution of the RF Subjects involved in the experiment. The first stage of SUT Experiment engaged The Chuvash Republik, The Mari El republic, the Sakha Republic (Yakutiya), Samara region and Rostov region. The exams were taken at two sessions: the first session was meant for the school-leavers of the year 2001, while the second session was meant for school-leavers of the past years, non-resident applicants and college- and technical school-leavers. It is only the Chivash Republic and the Mari El Republic that showed the highest validity of the experiment, while the examination in mathematics engaged all students there. In the other three regions, only volunteers took the SUT test.

The first results of the experiment were discussed at an interregional meeting that took place in the capital of Chuvashiya in the fall of 2001. The overall conclusion was confined to the fact that 'double-testing' (as taken at school-leaving stage and high-school/university entry stage) has become obsolete, however, administration of SUT will require a good deal of effort from professionals. The sceptical forecasts that most school-leavers would not cope with the test have not come true. As compared to the common final certification held previously, the SUT results proved certainly lower in many cases.

For instance, in the Chuvash Republic, the major pilot region under the experiment, the excellent grade share in mathematics accounted for 6%, whereas in the previous years it reached 23-25%, and poor grades in experimental tests accounted for 6% versus 0,1% of the previous years. Respectively, good grades accounted for 35% versus 41-42%, and satisfactory grades rate grew almost by 20%. Albeit the transition of a 100-score system into a 5-grade one needs thorough reconsidering, educators regard SUT results as quite objective and veracious. To support the idea they cite the following facts: in the Chuvash Republic, the Mari El Republic, and the Jakutsk Republic the final year pupils of special physical and mathematical schools demonstrated a better performance at the examination in mathematics.

The comparative analysis of the two SUT-experiment sessions displays rather peculiar results. In all pilot regions school leavers had, in general, higher results than technical college graduates, professional school leavers and school leavers of the previous years. Educators explain this phenomenon by more advanced education programs at secondary schools as compared to professional schools and technical colleges. At the same time, a more detailed analysis of the data collected in the Jakutsk Republic showed that school leavers had better performance within the middle range of the scale. Thus, 67% participants of the first experiment session got 40-90 scores versus 56% of those who took part in the second session. However, there were more examinees with the maximum score of 90-99 among the participants of the second session, while only 1.6% of them displayed poor performance versus 7.7% of the examinees in the first session. The data prove to be an evidence of a more sound professional orientation of those who took part in the second session. 55 examinees got 100 scores out of 100 scores possible in mathematical test inclusive of 10 participants from the Jakutsk Republic and 31 applicants from the Chuvash Republic.

In general, according to the SUT results, poor grades rate in Physics (the first session) did not exceed 8%, in Russian it accounted for 7%, and in Chemistry it was 6%. However, it should be noted that the scores appear to be a little over-

stated since they were counted according to the statistical analysis of examinees' performance in each subject but not according to the fixed score scale.

It is vitally important that there were no considerable gap between urban and rural schools test results. On the contrary, school leavers from remote rural areas got a better chance to enter federal or regional universities due to participation in the SUT. Thus, Mari Classical University enrolled 4% more rural applicants this year relative to the previous year. The number of students from rural areas in Mari Technology University grew by 6%.

The SUT made the majors under the experiment much more competitive as compared to the competition inherent to the traditional entrance examinations. The point was that the examinees were entitled to apply for several university departments simultaneously.

At the same time, the analysis of the first SUT stage revealed a number of serious drawbacks and faults listed as follows:

1) educators considered poor performance of Test Center computer programs for data processing to be one of the major faults. Control and measurement facilities were also subject to severe criticism;

2) the tests in Russian, Physics, Biology, Chemistry and other subjects had some shortcomings, misprints and incorrect questions;

3) the test variants offered in the first and the second experiment sessions proved to be of different complexity;

4) the preparation period was limited, which caused a lot of problems;

5) the Ministry of Education failed to provide test manuals and sample tests to conduct rehearsal sessions for the regions on time;

6) the federal budget failed to finance the purchase of scanners for the Yakutsk Republic on time in order to process the test results, which imperilled the experiment in the given region.

On acknowledging the timeliness and urgency of the SUT implementation, we should state that testing shall not be a one-time action at the end of secondary school program but it shall be conducted several times throughout the school period. It is only in this case that teachers and parents would see the dynamics of pupils' success. It is not by chance that in England, the English education being rated among the best in Europe, there are three tests conducted at different stages at school.

According to the 2001 SUT first stage results, in November 2001, the Ministry of Education enacted Order 537 setting forward the targets of the second experimental stage for 2002-2003 and providing a new list of pilot regions, namely, the Bashkir Republic, the Mari El Republic, the Mordovian Republic,

the Yakutsk Republic, the Udmurt Republic, the Chuvash Republic, Krasnoyarsk Territory, Kaliningrad, Lipetsk, Novgorod, Orenburg, Pskov, Rostov, Samara, Tomsk, and Chelyabinsk regions.

For the purpose of improving paid education services administration, the Government of the Russian Federation adopted Resolution 505 «Paid Education Service Regulations within Pre-school and Secondary Education Sectors» on July 5, 2001. The education services referred to paid services provided by public and municipal educational institutions are the following: optional education programs, special courses and subjects, tutoring, classes for advanced learners and other services. Public and municipal educational services that are not subject to paid education and shall be free of charge were defined as follows: 1) basic secondary school programs, 2) advanced programs provided for special schools, gymnasiums, lyceums, pre-school institutions according to their status, 3) individual and group optional courses conducted under basic programs for general education. Besides, any extra charge for a small number of students enrolled in a class (a group), which appears to be below some fixed standard, or for the division into sub-groups under basic educational programs shall not be allowed. The regulations of public, non-public and municipal educational institutions shall provide for a list of paid educational services and their procedure.

For the purpose of improving the education quality and using the potency of educational organizations and institution, the RF Ministry of Education introduced some amendments into «The High Education Institutions Standard Act» of the Russian Federation. On September 17, 2001, the RF Government enacted Resolution #676 «On University Complexes». It provided that university complexes, which unite education institutions of different levels, non-educational institutions, non-profit organizations and their subsidiaries, may be formed on the basis of universities. Analogous complexes may be formed on the basis of academies. The federal budget shall provide financing for education and scientific activities carried out by federal university complexes in accordance with the order placed by the government for professional training and retraining. It should be noted that, besides university complexes, the intergration of education institutions, scientific, construction and other self-reliant non-profit organizations into associations (unions) proves to be another possible way to improve the quality of the education and exploit intellectual, material, and production resources to the best advantage.

Low absolute and relative payroll of educators is considered to be one of the most urgent problems of education development. On December 1, 2001, federal Act #139-FZ «On Rising First-Class Payroll Rates under Tariff Scale for Public

Employees» came into effect. But insufficient differentiation between tariff ratios still remains a vital problem. Pursuant to Article 1 of the given Act, the first-class tariff rate was set at 450 rbl. on December 1, 2001. At that, the correlation between 1-class and 18-class tariff ratios equaled 1:4.5. Consequently, the largest 18-class wages accounted for 2,025 rbl.

The tariff scale expenditures were shared by regional and federal governments at a ratio of 1:4. The federal budget provided for 50mld rbl. for this purpose, whereas regional and municipal governments had to allocate 150mld. rbl. Evidently, the target can hardly be met but at the expense of other items in the budget. Therefore, higher payrolls will cause inevitable problems. Most regional authorities will have to cancel their allowances for public employees. Almost half of the regions might declare a rise in payrolls but fail to provide financial support for it.

Part 4. Institutional and microeconomic problems

4.1 Privatization

According to the RF Property Ministry's plans, in 2001, minimal receipts from the sales of public property, which since 1999 have not been included in the revenue part of the federal budget, should have accounted roughly for Rb. 18 bln. In compliance with Art. 24 of federal law No. 150-FZ "On the federal budget for 2001", revenues from the property owned by the government or from respective operations should make up Rb. 26.8 bln. particularly dividends on shares – 2 bln., rental payments – 5.6 bln., payments (incomes) from public enterprises – 9.4 bln. The latter relates primarily to the Russian-Vietnamese joint-stock company "Vietsovet" rather than to profits generated by public unitary enterprises.

Apart from annual conflicts with regard to the government's powers and concrete objects considered for privatization, the problem of formation of the list of enterprises subject to privatization in 2001 appeared complicated due to Art. 100 of the federal budget law for 2001. According to the latter, in 2001 the shares of those AOs whose capital assets' value as per balance sheet (considering a consolidated budget with assets of daughter and subsidiary companies) exceeded 50 mln. minimal wage rates, as of January 1, 2000, were not subject to sales in 2001 until the enforcement of a federal law on state privatization program.

Overall, it was intended to put up for sale about 700 stakes in year 2001. In the first quarter of 2001 the government failed to abolish Article 100¹, therefore the Property Ministry has prepared a list of 19 enterprises to be privatized in the first half-year, which complied with the law in formal terms (the list comprised Rosgosstrakh, Yuzhuralnickel, Kuzbassugol, Kuznetskugol, Khakasugol, Orenburggeologiya, Slavneft Mezhrionneftegazogeologiya, two Nizhni Vartovsk oil companies, three integrated mining enterprises. The government longer-term program included the elaboration of a

¹ The government had planned to use the revenues from the sales of shares in 20 enterprises, which were blocked by Article 100, for the settlement with the Paris Club.

new law on privatization (see below). Therefore, the privatization process at the federal level was started only in the spring of 2001. In May, the Property Ministry presented the list of 81 enterprises (including Lukoil and about 40 federal state-owned unitary enterprises - FSUE) to be privatized in the second half of 2001 for the approval of the government. 2001 The Russian Fund for Federal Property (RFFI) planned to sell blocks of shares in 7 joint stock companies in the first half of 2001 and in 32 joint stock companies in the second half of the year.

As it was noted over the past years, the traditional budget orientation of the privatization process determined seasonality of main receipts from privatization deals in 2001. In the 1st quarter, the overall receipts amounted to Rb. 5.11 bln. (at 1/3 more than envisaged), however, receipts from sales accounted just for 1/7 of the noted amount. The aggregate receipts over 10 months of 2001 made up Rb. 28.5 bln., including those from sales of assets and stakes- 8.4bln. (though with account of sales held in the Subjects of RF), 3.9 bln.- rental payments, and another 12 bln. – in income on Russia's share in "Vietsovetpetro"².

By mid-December 2001 revenues from privatization accounted just for Rb. 9.3 bln., or a half of the amount planned for 2001 (see Table 1), while the crucial privatization deals, as usual, fell on the fall of the year. It is still unclear if the Property Ministry have met all its privatization targets for year 2001.

After a few years of inert debates, in 2001 the government launched privatization of the oldest insurance giant – OAO "Rosgosstrakh". It was yet in 1996 when the plan to sell control block of the OAO to the company's top management raised a broad criticism. At present, the OAO has 80 daughter insurance companies and 2,500 subsidiary branches. The company also is licensed to carry out 69 kinds of insurance operations and, As Of April 1, 2001, its assets stood at Rb. 850 mln. The privatization strategy underwent several changes, thus, along with the company's informational closeness and problems of manageability of its regional network, forming a negative factor for investors. However, in 2001 50 per cent minus 1 share was put up for sale in 2001, provided the sale would be carried out in 3 stages.

² According to preliminary data for year 2002, the total revenues derived from sales of properties made about Rb. 10 bln.

Table 1
Privatization in 1995 through 2001

	1995	1996	1997	1998	1999	2000	2001 (fact, 10 months)	2002 (plan, RF Property Ministry)
Actual number of privatized enterprises	6000	5000	3000	2583	595	320	No data	500
Approved budget, Rb. trillion ^a	4,991	12,3	6,525	8,125 billion ^c _d	15 billion ^{cf}	18 billion ^{cf} (total 18,5)	18 billion ^c (total 44,8 billion)	35 billion (total 64 billion)
Actual revenues, Rb. trillion	7,319	1,532	18, 654 trillion ^b	14,005 billion ^e	8,33 billion ^c (total 17,3)	31,4 billion ^c (total 50,6)	8,4 billion (total 28,5 billion)	-
Actual dividends on blocks of shares in federal ownership, Rb. billion	92,8	118	407	574,6 mil. (200 JSC)	6,15 billion (600 JSC)	5,6 billion (1050 JSC)	4,1 billion	10 billion
Actual lease revenues, Rb. billion	116,7		305	540 mil.	2,165 billion	3,4 billion	3,9 billion	6 billion
Actual payments (revenues) from state owned enterprises, Rb.	-	5 billion	26 billion	660 mil.	-	9,8 billion – « Vi-etsovpetro »	12 billion – « Vi-etsovpetro »	12,4 billion – « Vietsovpetro » 1,23 billion – revenues from SUE

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 assets 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

As a result, in September 2001 “Troyka-Dialogue”, which most likely represented interests of a consortium of investors, acquired a 9 per cent stake of OAO at an auction for Rb. 201 mln. with the starting price of Rb. 153 mln. Consequently, on December 22, Troyka - Dialogue acquired another 39 per cent of shares worth a total of Rb. 1.03 bln. with the starting price being 1 bln., and on December 25 – 1 per cent of shares (25.003 mln. with the starting price of 25 mln.) The fall in budget revenues against the starting price with every new auction is evident. To acquire the noted shares, “Troyka - Dialogue” was granted with a technical credit against the OAO’s shares as a collateral. It is intended in the future to increase the stock package owned by the consortium up to the con-

trol one and to get the OAO's shares to the "blue chip" level. However, the lack of clarity about the consortium members so far does not allow an unambiguous identification of the purpose of the acquisition – whether it was a strategic investment or portfolio investment for the purpose of its further sale once capitalization is increased.

The majority of the privatization deals, both those accomplished in 2001 and deferred to 2002, highlighted corporate control and governance problems as their crucial component.

Privatization practically is over in the aluminum sector. In August 2001, The Russian Fund for Federal Property (RFFI) sold the 14 per cent stake of Novokuznetsk Aluminum Plant to Russky Aluminum for USD 6.02 mln. As any analogue deal with a residual package, the deal became possible only after RA acquired 66 per cent shares of the Plant. The qualified control RA gained over the plant allowed the company to ignore the remaining minority stockholders (especially after the Supreme Arbitration Court's decision made in October 2001 – see the Section on corporate governance), however problems with "alien" creditors (in control of up to 50 per cent of the plant's debts) and the former owners (seeking a USD 3 bln. compensation in the court for false bankruptcy of NAP by structures of Russky Aluminum).

It was the sale of shares of "Kuzbassugol" holding (the 3rd biggest national coal producer, 17 coal mines, 3 concentrating mills, 62 back-up facilities) that appeared the largest deal in 2001. The shares (a 79.73 per cent stake) were offered in two lots (39.73 and 40 per cent) at special auctions, thus complicating the possibility of a non-recurrent consolidation of control. At the same time, one had to submit his application for participation in the second auction prior to the conclusion of results of the first one. In this particular case the RF Ministry of State Property proved to be a successful gambler playing on competitors' interests, which ensured unquestionably positive results for the budget.

The struggle for the holding's shares started yet at the stage of discussion of conditions. In early 2001 the Kemerovo oblast authorities had a stock package directly sold to "Belon" coal trader, which allowed an early forecast of the outcome of the deal in favor of members of "Russian steel" ("Evrazholding" and Novolipetsk Metallurgical Plant, or NMP). Nonetheless, by summer the alliance formed by Magnitogorsk Metallurgical Plant and Severstal managed to convince the authorities to introduce competition-based procedures that suggested a victory through offering the highest price. After approval of conditions of the deal in June 2001 there were also some attempts to strip the holding off assets through bankruptcy procedures. At the same time both the auction procedures and the fi-

nal balance of forces just intensified the corporate struggle and, most likely, ensured its continuation over time. With account of earlier acquired shares, the stock package of the holding in possession MMK and Severstal accounted for 52 per cent, while another 44 per cent was held by NMK and Belon (apparently affiliated with NMK). The controlling alliance that put maximal efforts to ensure its autonomy and security by buying the holding plans to establish a joint managing company. At the same time its competitors, apart from 44 per cent of the holding's shares also have control and blocking stakes in a number of holding's daughter companies. Each alliance holds 5 seats in the holding's Board of Directors, while the 11th one is fixed for the RF Ministry of Energy as the government representative managing the "Golden Share". The Director General (as of December 2001) granted key posts in the company to representatives of the former alliance, while the Kemerovo oblast authorities supporting the latter one appealed to the RF Ministry of State Property with a request to delegate them the rights for the "Golden Share". The immediate effect of the confrontation became series of failures to hold stockholders meetings and the problem with regard to holding a meeting of the Board of Directors and electing Director General.

The privatization of the national coal sector should be over in 2002 after the possible sale of a 38.41 per cent stake of "Vorkutaugol" holding. It is Severstal, the biggest consumer of the holding's products and owner of a 15 per cent stake of that that may become a main pretender for that, however, the repetition of the noted scenario with Kuzbassugol may become possible.

It has been noted for several years that stock packages of Slavneft (19.68 per cent), Vostoschanaya neftyanaya Compania (VNK) - (36.817 per cent), and Svyazinvest (25 per cent minus 2 shares) have been in the list of potential objects for privatization, with respective deals deferred for the next years. Further privatization of Svyazinvest may become possible only after the holding restructuring and its presale preparation.

According to the privatization program for 2002 approved by the RF government on August 2, 2001, the sales of Slavneft's shares was deferred to 2002 (with the control block to remain in the government property). The struggle for this stock package has been already underway since 2001. First, pursuant to the claim brought by Ost-West Handelsbank AG, yet in August 2001 Slavneft's assets worth a total of USD 2.6 mln. were arrested. The claim is related to Slavneft's refusal to repay to the bank a credit extended to its daughter company against Slavneft's guarantees. Interestingly, the control block in the German bank belongs to the Bank of Russia. This case can result either in a lower starting price, or in postponement of the term of privatization. Secondly, the governmen-

tal ruling on the sale of the holding's stock package automatically eliminates the problem of transition of the holding towards single share which could have ended up not earlier than in 2003 and, according to some estimates, lead to 3-4 fold rise in its capitalization. Apparently, this appears profitable both to the government (acceleration of the sale in the conditions of uncertain prospects for oil prices) and to the holding's management, as the latter struggles for control over the company with TNK. The transition towards single share would allow TNK (with account of its 12.5 per cent share in Slavneft plus blocking stakes in its two daughter companies) to get 33 per cent of shares of the united company and then, in the course of privatization, to buy other shares to ensure a control block, which would obviously imply lowering the government share in that.

RFFI has prolonged the auction on selling shares of VNK (with the starting price of USD 225 mln.) announced in December 2001 until February 14, 2002. It is YUKOS, whose general strategy is a maximal consolidation of its assets that appears a real pretender for the shares. However, the fact that YUKOS is in possession of another 54 per cent of shares of VNK allows questioning whether the sale of the stake is profitable for the government. As well, TNK has also declared its intention to take part in the auction yet in December 2001,- however, from the perspective of corporate struggle, its decision notably discredits unofficial statement issued by the Accounting Chamber of RF regarding YUKOS stripping off VNK's assets (Achinsky Oil Refinery and Tomskneft). According to the data as of January 2002, the deal will not be accomplished until the clarification of the issue.

Although there have been no plans to privatize "Transneft" as yet, it is worth mentioning that it was, in fact, forced to pay dividends (Rb. 1.6 billion) for year 2002 to minority shareholders owning 25 per cent of preferred stocks (75 per cent of ordinary stocks are owned by the state). It allowed to preserve the present structure of corporate control favoring the state and the company's management.

As noted above, the privatization program for 2002 (a mandatory component of the passing of the budget) was approved by the government yet on August 2, 2001. The quantitative side of that is given in Table 2. It is the sales of 19.68 per cent of Slavneft's shares, 17.77 per cent of shares of Magnitogorsky metallurgical Plant and 85 per cent of NORSI-Oil that may become the biggest deals. The government also approved the RFFI proposition to sell blocks of shares in the Murmansk, Taganrog, and Tuapse sea ports in 2002. The actual initiators of this proposition and most likely pretenders for the purchase may be largest groups involved in coal, metal, and oil exports, which have already become owners of a number of ports. Roughly as many as 40 per cent of enterprises planned

for privatization in 2002 fall within the fuel and energy sector that formed the favorite source for fulfillment the annual privatization plan.

For the first time in the course of Russian privatization there was introduced a law setting the legal framework for the return of actually sold assets. According to Federal law No. 194 FZ of December 31, 2001 "On the Federal Budget for Year 2002" (Article 79), the RF government aiming to release shares in JSC "Novoship" and "Severo Zapadnoye Parokhodstvo," which were put up as collateral under certain credit agreements concluded in accordance with the RF President's decree No. 889 of August 31, 1995, "On the Procedure Governing the Transfer of Federally Owned Shares as Collateral in 1995," assumed the obligations set by these agreements. The agreements were amended to the effect that the credits would be repaid at the expense of the federal budget in year 2002. At the same time, the agreements under which these shares were put up as collateral were cancelled.

The original forecast of revenues from property sales with account of necessary organizational measures and favorable state of affairs envisaged some Rb. 18 bln., but then it was increased up to Rb. 35 bln. According to 2002 budget law No. 194-FZ of December 31, 2001, the budget task on revenues from the use of public property (dividends and rental payments) and enterprises' operations (joint ventures' incomes, contributions from the federal state owned unitary enterprises - FSUE) for 2002 made up Rb. 29 bln., upon adjustment introduced by the RF Ministry of State Property in December 2001 - 36 bln., including: rental payments 4 (once adjusted -6), dividends 7.6 (10), rental payments for land - 4.4 (6), deductions from profits of federal unitary enterprises - 0.5 (1.2), joint venture Vietsovetpetro - 12.4 (12.4).

It is the prevailing focus on delegating government representatives to boards of directors of joint - stock companies rather than managing state unitary enterprises that constitutes a relatively new approach practiced by the RF Ministry of State Property. Accordingly as long as the medium-term period is concerned, it is envisaged to proceed with incorporation and gradual sales of shares of an absolute majority of FSUEs, with not more than 1-2 thousand of them retain in government ownership. As usual, there are discussions as to whether the government should "get rid of the burden" of owning an absolute majority of minority stakes that do not allow the authorities to exercise management functions but require certain costs.

In addition to privatization of incorporated FSUEs and traditional sales of minority stakes, it is likely that 2002 would witness a sharp contraction in the list of strategic enterprises whose privatization was prohibited. As a result, the RF

government should own shares of not more than 1-2 per cent of the most significant JSCs.

Table 2

The RF Property, as of 2001

	The RF gov- ernment prop- erty, total	As % of the total number of registered in RF	Due for privatiza- tion in 2002, as units
State unitary enterprises	9718	12	152
Joint-stock companies whose stock packages are owned by the RF government	3949	0,91	365
Including the respective govern- ment share in their authorized capital accounting for:			
- 100 %	88		
- over 50 %	625	-	4
- 25-50 %	1393	-	26
- under 25 %	1843	-	118
- Golden share	542	-	217

Source: data from the draft privatization program for 2002 submitted to the RF Government by the RF Ministry of Property in August 2001. According to the data from the register of the Ministry, as of Sept. 1, 2001, the figures are slightly different: 9,855 FUEs, 34,868 public institutions, 4,308 stock packages in AOs, 3,317 incomplete construction objects. According to some other estimates, the AOs with the government share outnumber 6,000, while the register of FUEs is far from completion. In 1999, the Ministry argued there were roughly 14,000 FUEs, which, considering the current reorganization and privatization rates, does not allow trustworthiness of the official data for 2001 as well.

In addition to a considerable number of statutes passed between 2000 to 2001 pursuant to the 1999 Concept for management of public property, the government envisages crucial innovations for 2002. First, to raise budget revenues through profits of FSUEs, the government needs a strict formulation of principles of deduction of their profits to the federal budget. There are several approaches to this problem in existence by January 2002. Specifically, the Accounting Chamber of RF suggests a uniform 95 per cent deduction rate for all such enterprises, while the RF Ministry for Economic Development and Trade suggests computation of individual rates for each enterprise. Finally, according to government Resolution of February 3, 2000, No. 104 (amended on February 16, 2001) "On Strengthening Control over Operations of the State Owned Unitary Enterprises and Shares of Open-End Joint Stock Companies in Federal Ownership" it is necessary to carry out a sectoral computation of indicators of FSUEs'

economic efficiency and amount (share) of profits due to be transferred to the federal budget. The respective executive body of RF is responsible for ensuring such a computation in coordination with the RF Ministry for Economic Development.

Another important innovation may become adoption of the “Regulation of Protection of Rights of the Russian Federation as an Owner” which provides the transfer of the institution of government representatives to the professional grounds. There are two obvious components of such a transfer: tightening requirements to pretenders for such a position in Board of Directors of JSCs and identification of sources of financing of their operations. The third component that has not been tackled as yet is development of a system of responsibility measures. Such a system should particularly include the possibility of introduction of amendments to the Criminal Code of RF concerning protection of the state interests, should the noted professional representative exercise their duties in an “unduly” fashion.

As it can be seen from notes to table 2, it is a trivial examination of state assets that remains a necessary condition for furthering the reform. In addition to a quantitative account, it is necessary to ensure a clear distinction between levels of power with regard to their enjoying certain rights for state property. According to the Department for the Account of State Property of the RF Ministry of State Property, in 2001 there were over 300 JSCs whose shares are owned by the federal government, however their stockholders’ rights are exercised, on behalf of the Russian Federation, regional agencies managing state assets or other entities not granted with the respective legal powers.

Adoption of a new law on privatization forms a separate issue³. The final adoption of the law was scheduled for 2001 (with the 1st reading held on June 21, 2nd- November 29, 3rd – November 30, and the reading in the Federation Council – on December 5, 2001). However, President Putin postponed the signing of the bill for 2002. Apart from the procedural collision (the bill has not been signed, however, it has not been returned over the term due). There is another problem: according to some sources, the Presidential Administration is not satisfied with the list of objects transferred under President’s competence.

At the same time, to a significant extent the privatization program for 2002 is based on innovations provided by the law.

In order to increase the budget effect from privatization, it is envisaged to proceed with the individual strategy of sales, analysis of the market (effective

³ See the draft law at : <http://www.akdi.ru/gd/proekt/gd03.htm>.

demand), and application of new privatization methods. Although the focus on “unique” large deals on liquid stock packages by means of auctions is retained, should they prove to be ineffective, it will be possible to employ such new methods as sales through public offer, with no competition in place or by results of trust. There also are two in principle new matters: sales of land sites as an integral part of the privatized property (as dictated by the Land Code of RF) and increase in capital assets at the expense of intellectual property rights (which is important specifically in the case of privatization of MIC enterprises).

On the whole, there are ten possible privatization methods depending on the size of an enterprise, its liquidity, or results of initial sales:

- shares in enterprises evaluated over 5 million of minimum wages shall be sold via “auctions,” “special auctions,” or “outside the territory of the Russian Federation”;

- all other enterprises shall be sold at open auctions, special auctions, or “tenders”;

- in case there are no purchasers, the assets shall be sold via “public offer” (i.e. via Dutch auction, where the price may be reduced to the original value);

- in case the sale via public offer for small and medium-sized businesses fails, there shall be employed the “sale of property without the price announcement”;

- there may be organized tenders for trust management (blocks of shares from 51 to 100 per cent) giving winners the right to purchase later the shares at the value registered at the time the contract was signed.

The privatization methods also include “the transformation of unitary enterprises into JSCs,” “sales of JSC shares via the organizer of trade on the stock market,” and “transfer of property as a contribution to JSCs’ charter capitals.”⁴

The successful passing of this bill became possible thanks to a compromise multi-level system of decision making with regard to privatization of objects. While it is President whose competencies embrace strategic enterprises (nuclear plants, MIC, etc.) and particularly the list of objects whose privatization is prohibited, the federal natural monopolies (the Ministry of Railway Transportation, RAO UES, and RAO Gazprom fall within the powers of the State Duma, while

⁴ The latter method, although it is strange, is indicated also in the general definition of privatization (p. 2, Art. 2 of the draft law): “State owned and municipal property may be transferred to individuals and (or) legal entities only on the paid basis (for money or by transfer of shares in open joint stock companies receiving state or municipal property as a contribution in their charter capital in the state or municipal ownership.”)

the other federal enterprises are subject to the RF government's rulings. As concerns privatization of regional and municipal property, the framework of a uniform approach suggested by the federal law provides that it is an authorized local agency that deals with this process. In light of this, the bill lacks traditional prohibitive lists, which implies the possibility of privatization of practically any object. Accordingly, there will be no conflicts between the Duma and the government with respect to annual approval of the list of objects to be privatized and the annual (over 1998- 2001) failure to pass the privatization program bills. It is envisaged that annually in August the government should submit to the Duma the draft budget with the program of privatization of federal objects for the next year.

An important moment is the abolition of the registration principle of privatization. While earlier an application from an individual or an organization (alongside with the government's initiative) was enough to start the privatization procedure, now, according to the draft law, this initiative is not necessary to implement. It is also of principal importance that the stipulations of the law are mandatory for each authority level in the RF.

Despite the noted positive innovations, the bill raises ambiguous attitude. According to some analysts, first, the bill extends possibility for bureaucrats' arbitrary actions (specifically, the possibility to amend conditions of a tender and the winner's obligations upon signing the respective contract) and intensifies inequality between potential participants, regardless the principle of participants' equality stipulated in p.1 of Art. 2 (especially with respect to procedures of implementation of privatization methods); second, the bill sets more sophisticated and labor-intensive procedures of privatization of the enterprises whose privatization is not prohibited. In other words, essentially, this concerns a considerable volume of stock packages remained in the government ownership and not sold yet, due to various reasons. If such restrictions appear justified, as long as 700 strategic objects are concerned, their effect with regard to non-blocking minority stakes that should be sold by any means can be questioned.

Finally, a permanent absence of a clear privatization strategy (apart from budget tasks) appears a clearly negative factor. Once being designed, it should be based on the clear awareness of which enterprises and sectors should be retained in the government ownership under any circumstances. Once this strategy completed, one could then start discussing the list of sales for a short-, medium and longer-term perspective. Such a list should obviously comprise both the sub-list of actually salable and attractive objects and the sub-list of non-liquid objects (due both to financial and economic indicators and already formed property structure). As well the Russian privatization suffers from traditional defects, spe-

cifically, transparency of deals and actual equality between participants in the conditions of systemic corruption, and in this case, sales procedures appear a secondary matter.

A special problem is the duration of the period of limitation for privatization transactions. The RF Civil Code and RF law No. 123 FZ of July 21, 1997, "On Privatization of State Owned Property and on Principles of Privatization of Municipal Property in the Russian Federation" currently in force do not stipulate a special limitation period with regard to consequences of invalidity of privatization transactions. Accordingly, the general period of limitation as set by Article 181 of the RF Civil Code is applied to privatization transactions (10 years for the implementation of consequences arising from the invalidity of null and void transactions).

This period of limitation apparently creates an opportunity to carry out mass or "contracted" deprivatization of practically any privatized enterprise in Russia, depending on the political and (or) economic circumstances, since apparent or inadvertent offences, formal small mistakes, or farfetched pretexts may be found without much effort. It is also an ideal way to influence a company in terms of operative administrative pressure both at the federal and regional levels. For instance, the apparent risk that a company may be deprivatized in case there are found any violation of the privatization law is one of the most serious obstacles to investment in Russia's companies from the view point of practically all investment institutions active in Russia.

However, in technical terms, it is difficult to launch this process as a massive action. The two-sided restitution presupposes the necessity of compensation, what requires that a whole complex of problems must be settled: the stand with regard to bona fide purchasers (after a number of resales); the necessity to find funds to finance the compensation (it will require a special budget item with targets for the respective year); a special method to evaluate shares; a special method for the evaluation of privatization coupons ("vouchers"); a special method to evaluate property complexes (of enterprises). There are also in place protection designs feasible only for larger firms because of their cost intensity. An example is presented as the Norilsk Nickel restructuring carried out after the General Prosecutor Office had demanded to return to the state the money allegedly not paid in the course of privatization of the company.

On the whole, the necessity to reduce the period of limitation with regard to privatization transactions is justified. The respective amendment to the RF Civil Code to reduce the period of limitation from 10 to 3 years was presented to the State Duma on November 30, 2001 (the amendment was rejected). However, it

would be enough to settle this legal problem. For instance, the RF Criminal Code sets a 10 year period of limitation for a number of crimes against the state. Apparently, in terms of policy the reduction of the period of limitation with regard to privatization transactions is equal to a decision on tax amnesty. It may be maintained that the opposition to such an innovation will be exceptionally strong.

4.2. The State and Corporations

Consolidation of ownership, reorganization of groups (holdings), intra- and inter-industry expansion remained the major trends of the institutional development of the corporate sector in year 2001. This characteristic may be applied not only to largest private corporations and groups, but also to a considerable degree to the policy of the state as represented by its executive branch with regard to the assets remaining in the state ownership.

It is a known fact that the mass privatization in Russia resulted in the transfer of legal property rights for large Russia's companies to the hands of, first, small shareholders, predominantly employees of enterprises. Second, foreign investors as the only participants of privatization having sufficient funds to buy shares at privatization auctions became the owners of medium-sized blocks of shares. The state, which retained controlling interest in companies in a number of strategic sectors of the economy, first of all, in the oil, natural gas, and metallurgy industries, remained the third owner of shares in privatized enterprises.

After large blocks of shares or controlling interest in strategic enterprises were transferred to private investors in 1996 through 1997 in the course of loans-for-shares auctions and investment tenders, there were formed prerequisites for the emergence of the market, or, more precisely, non-state transfer of ownership rights among economic agents. At the same time, there were formed major financial and industrial entities (partnerships or "personal interests"), which play such an increasingly important role in the modern Russia's economy.

Having obtained partial control over one or a few large enterprises, groups faced the following problems arising as a consequence of the mass privatization or presented by tax and forex constraints:

- initially, a group had a relatively small percentage of assets of enterprises it controlled (as a result of multi-stage privatization model the present owners of, for instance, of 49 per cent of TNK shares initially had only slightly over 12 per cent of shares in extracting enterprises, which were the actual owners of all fixed assets and licensees for oil extraction);

- at that time, the tax system allowed the individuals owning companies to transfer about 10 per cent of profits generated by the enterprises they controlled

(not taking into account the share due to minority stakeholders) to their personal accounts in case they would run their businesses absolutely honestly selling products at real market prices and withdraw profits from their companies as dividends. After an “honest” split of profits with minority shareholders the controlling shareholders would receive from 2 to 5 per cent of profits depending on company.

- there were required considerable financial resources to reorganize the system of management of controlled enterprises, “stimulate” local and federal officials, to fight criminal groups in regions, or cooperate with such groups. Naturally, there were also required considerable investment in production and funds to purchase technologically related enterprises, which became independent companies as a result of mass privatization.

- in a number of cases the controlling groups also required resources to repay credits they used to purchase control over enterprises.

An apparent way to meet these goals used by groups controlling enterprises were:

- concentration of profits abroad by the way of transfer price setting with subsequent conversion of Rubles and illegal or “gray” export of foreign currency (large foreign banks and offshore financial structures, schemes where Russian residents purchase “securities” from non-residents), and also by the way of withdrawing profits via external and internal tolling and setting too low export prices;

- after the funds obtained by the methods mentioned above were transferred to controlled offshore companies, they were split up depending on priorities set by respective groups. In some cases money was withdrawn to personal accounts of group bosses; however, more often large groups pursuing the aforementioned goals allocated the money for “productional” purposes (that is why these groups became large in stead of disappearing form the Russian economy together with their owners).

The “productional” spending, alongside with aforementioned “necessary” investment, also included the investment aimed to strengthen the juridical control and the parallel increase in the share in controlled enterprises. In 1997 through 2001, large groups spend billions of dollars to purchase shares belonging to minority and even controlling shareholders. It shall be noted that the majority of these funds left Russia for good: the entrepreneurs of the “first wave,” who received them, have retired and their investments, if any, are made as far from Russia as possible. The controlling groups also had to purchase blocks of shares belonging to foreign investors, who received them at the first stage of privatization and actively defending their rights in courts, mass media, etc.

Apart from purchase of shares, the controlling groups reduced minority interests in companies in other ways, for instance, by eroding minority shares in the course of additional issues of shares, premeditated bankruptcy of enterprises they controlled (upon obtaining control over the bulk of creditor indebtedness of these enterprises), and exchanging shares in their own favor.

A comparative easiness of this process of concentration of their economic interests was caused by extremely low value of minor blocks of shares, since the controlling groups concentrated practically all companies' profits in offshores, ephemeral companies, foreign traders and tollingers. Capitalization of the majority of Russia's companies was extremely low, partly due to this "robbing" of companies, and partly due to the full collapse of the market after the crisis of 1998 and withdrawal of practically all foreign investors from Russia.

Year 2001 was in certain sense the final year of the epoch described above⁵. What are the current and medium-term institutional trends?

Intra- and intersectoral **expansion** of large groups basing in extracting industries seems to be close to its threshold. The factors behind these developments are, first, a comparatively small number of "free" attractive objects remaining available for purchase from private agents (including the "first wave" privatizers) or the state and being outside the spheres of influence of competing groups. As the privatization statistics demonstrate, the state has sold practically all its assets in oil, coal, aluminum industries, and ferrous metallurgy. Certain prospects arise in connection to a comparatively limited number of non-privatized objects (for instance, in the area of nuclear power, generating capacities in the electric power industry, objects belonging to the Transport Ministry) and foreign expansion on the part of largest companies. Second, in one to two next years the financial resources appeared as a consequence of the crisis of 1998 will probably be exhausted (first of all, in the oil and metallurgy sectors, which were the base for the property expansion in 1998 through 2001)⁶.

⁵ See for a detailed report on trends of consolidation and integration in 1998 through 2000 in: Russian Economy in 2000. Trends and Perspectives. M. IET, 2001.

⁶ However, according to a number of estimates, the "purchase potential" of "Surgutneftegaz is at about US \$ 4 billion, "YUKOS" – US \$ 2.5 to 3 billion, "LUKoil" – US \$ 1.5 billion.

The process of mergers and takeovers, initiated by largest oil companies, was most typical in metallurgy, chemistry, coal industry, mechanical engineering, food industry, and forestry⁷.

The process of vertical consolidation (oil, natural gas, chemistry, metallurgy) caused the concentration of extracting and processing industries. It was most typical in industries involving a considerable number of technological processing stages and allowed to maximize the group's aggregate income along the whole chain producing added value (also taking into account the specifics of "optimization" of taxes and financial flows within the group).

At the same time, it is observed that groups having their bases in extracting industries expand to, first, technologically linked sectors, and, second, to profitable industrial sectors and, since recently, to the agrarian and industrial complex (AIC). The most illustrative examples of this process are the takeovers metallurgy companies carried out with regard to mechanical engineering, aircraft construction, and motor vehicle enterprises, the expansion of oil and natural gas holdings to the sector of chemistry products, the growing interest of a number of largest groups (Lukoil, Interros) to the agrarian sector and (Yukos, MDM, BIN) to retail trade.

An apparent advantage of the vertical integration in Russia is also related to the process of property redistribution. In case the control over a supplier or a consumer is intercepted, it means the stop of the whole vertically integrated chain (if the task is to exert pressure). The examples of "raw material" pressure on competitors or a shareholder who refuses to surrender control are numerous and well known. The "coal war" between largest metallurgy companies in ferrous and non-ferrous metallurgy in 2000 through 2001 was directly related to their striving to regulate the volumes of output, supply, and prices, as well as to exert effective pressure on electric power companies.

The horizontal consolidation (integration) is the market expansion of a group, first of all, at the expense of taking over similar regional enterprises ("Krasny Oktyabr," and "Babayevski" holdings, "Sladko" group in the food industry, "Baltika" brewery, etc.). Among the advantages arising due to amalgamation are the reduction of production and sales costs, and reduced tax payments.

Within the framework of large groups, there continues the construction of vertically and horizontally integrated "sub-holdings." For instance, MDM group,

⁷ Here and below are used the data: "Ekspert 2000: yezhegodny reiting krupneishikh kompaniy Rossii (Annual Ranking of Russia's Largest Companies) (Ekspert, 2001, No. 35).

which has only comparatively recently started its active expansion in the industry, by 2002 owned three large branch sub-holdings – Mineralno-Khimicheskaya (Mineral and Chemical) company, Ugolnaya Energeticheskaya (Coal and Energy) company, Trubnaya Metallurgicheskaya (Pipe Metallurgical) company. The process of formation of holding structures in mechanical engineering underway in 2000 through 2001 was both initiated by largest multi-branch groups (from “outside”), and on the base of independent large mechanical engineering structures (TVEL, Benukidze group, “Silovye Mashiny (Power Machines),” “Novye Programmy i Kontseptsii (New Programs and Concepts),” “Sibirski Aluminum,” etc.

However, the giant conglomerates and multi-tier holdings with parity management of the business based on multiple economic and personal interests and political connections will hardly become a real perspective in the framework of the institutional and structural transformation of Russia’s industry.

It is well known that in 2000 and 2001 the experts paid considerable attention to the large-scale process of formation of the conglomerate linked to R. Abramovich, I. Makhmudov, M. Cherny, O. Deripaska, “Evrazholding,” “MDM Group,” etc. Its structure was vague, seemingly due to the continuing expansion and its managerial principles. Sub-holdings managed by partners, trusted managers, or previous managers who kept their shares in chartered capitals and became “junior” partners controlled considerable segments of copper, ferrous, coal, aluminum, and motor vehicle industries. Although there are no (and can not be) convincing data basing on changes in property and financial interests of partners, the collapse of this conglomerate in 2001 may be considered as a logical development.

Apart from the break of political connections and the new wave of compromising materials being distributed in the country and abroad, the collapse of such an externally amorphous structure may be related to more serious contradictions caused by the very “system of partnership.” The system of partnership presupposes the focus on current short term revenues, and, accordingly, there arise problems of coordination and implementation of long term investment strategy.

In 2001, there were registered numerous examples of aggressive strategies some groups implemented to take over companies. These strategies were based on the discrediting of previous management and the use of “administrative resource.”⁸

⁸ The authors understand that many information sources describing corporate events are often subjective and express interests of only one party in this way becoming independent instruments of corporate pressure. Selecting the facts, the authors strove to use only

For instance, the logic behind FIG “Sibal” taking over motor vehicle industry is described as follows: 1) a massive PR campaign aimed to discredit the enterprise and its managers in order to diminish the price of the future deal; 2) negotiations with local authorities about “strategic cooperation and investment,” which involved top federal officials; in the course of negotiations “Sibal” promised to settle local debt problems, support election campaign, etc.; 3) purchase of the controlling interest with subsequent replacement of managers and changes in the composition of the Board of Directors; 4) “cleaning up” of debts and withdrawal of liquid assets to a new company in the framework of the holding structure.

MDM group also used Russia-specific standard methods in the course of taking over JSC “Nevinomyssky Azot” (Stavropol krai)⁹. The general plan of the takeover envisaged: 1) purchase of about 30 per cent of shares at the secondary market; 2) replacement of the general manager; 3) purchase of 21.8 per cent of shares still owned by the state at a tender. The implementation of this design included additional measures: discrediting of the general manager¹⁰ and his arrest by the tax police, an extraordinary meeting of shareholders taken place on the group’s “territory” in the Murmansk oblast, militia was used to prevent “outside” shareholders (both individual shareholders and state representatives) from participation on the grounds of “violation of passport control regulations.”

An illustrative example is the conflict between “Alpha Group” and the Taganrog Metallurgical Works in the Rostov oblast. Although the factory’s management and affiliated structures owned the controlling interest (51 per cent of shares), “Alpha Eco” employed well-tested takeover methods, which included the

indisputable facts or several sources, which would make a whole picture. Apart from the data the authors obtained on their own, there were also used data from issuers’ web sites and other Internet resources, periodicals published by “Kommersant,” “Finansovaya Rossiya,” “Vedomosti,” “Ekspert,” “Finansovye Izvestiya,” “Kompaniya,” “Zhurnal Dlya Aktsionerov,” “Rynok Tsennykh Bumag,” and a number of other sources.

⁹ The group’s mineral and chemical company also includes the Kondorsky Iron Ore Dressing Works (Russ. abbr. GOK) (Murmansk oblast) and JSC “Fosforit” (Leningrad oblast).

¹⁰ This plot is interesting enough to analyze it separately. In July of 1999, the enterprise’s management founded a not-for-profit “Sodruzhestvo” association in order to “represent the interests of the association’s members in the managerial bodies.” The employees were eligible to become members, however, they were to lose it in case of dismissal. In 1999 through 2000 the enterprise granted the partnership two interest-free loans (about Rb. 160 mil.), which were used to purchase 10 to 16 per cent of shares in the enterprise.

purchase of a minor block of shares (to be gradually increased) and the use of infamous “administrative resource” at the federal level (initiation of court procedures using any pretext, inspections carried out by the prosecutor office, the Accounting Chamber, the Interior Ministry, the Federal Security Service, the Federal Commission for Securities, tax and anti-monopoly agencies). The regional authorities preferred not to interfere on the verge of the local election campaign. As a result, the enterprise had to put two representatives of “Alpha Eco” on the Board of Directors (it shall be taken into account that any Board’s decision is considered legitimate only if 10 out of total 11 members approve it) and to transfer a larger share of profits to dividends¹¹.

In spite of the positive shifts in legislation (see the section on corporate governance), law enforcement (settlement of corporate conflicts, including those related to takeovers and “shared control” situations) often involves the use of armed units (private security structures, bailiffs, etc.). Usually, the final decision (in case a conflict is of local character) is taken in favor of the party, which managed to obtain the support of the regional administration and mobilize the employees. In 2000, the most publicized examples were Moscow-based JSC “Kristall” and SUP “Moskhimfarmpreparaty,” “Babayevsky” (a confectionery producer), Kachkanarski Iron Ore Dressing Works (*Russ. abbr.* GOK), JSC “Uralkhmmash,” Kamyshlovski construction materials factory (Sverdlovsk oblast), etc. Among the examples registered in 2001 there were Saldinski Metallurgical Works (the monopolist of rail production, Sverdlovsk oblast), Ust Ilim LPK (1/3 of Russia’s pulp production, Irkutsk oblast), Stupinski Metallurgical Works (non-ferrous metals and heat resistant steel production, Moscow oblast)¹², “Alstom – Sverdlovski Electromechanical Factory (energy equipment, Sverdlovsk oblast), Pskovski Heavy Electric Arc Welding Equipment Plant, JSC “Karabashski Copper Smelting Integrated Works – JSC “Karabashmed” (blister copper, Chelyabinsk oblast), etc.

At the same time, certain stabilization observed in the area of property interests (in a certain sense it is the post-crisis fixation of the spheres of property interests) creates prerequisites for a *new stage of hostile takeovers*. Both the deficit of “free” objects for takeovers, and the gradual depletion of idle financial re-

¹¹ *Finansovaya Rossiya*, 2001, No. 29, p. 6, No. 41, p. 4

¹² Some observers tend to review this conflict in a broader context: it is possible that on the base of companies controlled by “Gazprom” there will be formed a holding involved in production of special alloys and / or an attempt to obtain indirect control over JSC “Permskiye Motory.”

sources allows to assume that the “administrative” methods of takeovers involving debt schemes, court decisions ruling earlier transactions to be null and void, etc., will prevail at that stage.

In this connection, the example of Zavolzhski Motor Plant (*Russ. abbr. ZMZ*) is of certain interest. ZMZ is the major supplier of automobile motors for GAZ (Gorkovski Automobile Factory). According to some estimates, 65 per cent of ZMZ shares belong to affiliated structures of “Severstal.” GAZ, a member of “Sibal” group has a chance to purchase about 9.4 per cent of shares. Both “Sibal” and “Severstal” (the latter, it seems, already is the real owner) were given MAP (Anti-Monopoly Ministry) permission to purchase the controlling interest in the enterprise. “Sibal,” which is in the process of establishing of an automobile holding, is apparently interested to get rid of the necessity to coordinate prices of motors with competitors. At the same time, “Severstal” has certain interests in the automobile industry (the Ulianovski automobile factory) and does not intend to sell its assets. There is no sufficient number of shares on the market, and the only legal way of consolidation for GAZ is to claim a number of previous transactions null and void¹³.

The only automobile factory still not taken over by largest holdings is JSC “AvtoVAZ.” After the problem of debts to the federal budget was settled in year 2001, the block of shares, which was given as collateral to the state, must be either nullified, or sold. Over 2001, the value of ordinary shares in “AvtoVAZ” increased tenfold, while the value of preferred shares increased fifteen times, what is an evidence of active buying up in anticipation of the takeover.

Consolidation and reorganization of assets to a considerable degree will remain the dominant institutional processes over next few years.

Consolidation of property in the framework of groups is related to the striving of real owners to build a maximally controlled corporate structure (in terms of corporate governance) free of unpredictable influence of “outside” shareholders, including corporate blackmail. At the same time, reorganization is merely a consequence of expansion and consolidation of groups and the formation of multi-tiered holding structures. The spontaneous process of expansion of groups’ spheres of influence and the achievement of practically absolute corporate control in affiliated companies (sub-holdings) requires, at a certain moment, the le-

¹³ It is also probable that the roots of the conflict are in the price policy pursued by the parties (ZMZ supplies GAZ with motors, while GAZ supplies ZMZ with completing parts for motors).

galization of the whole structure acceptable for concrete beneficiaries and the term is used below exactly in this context.

At present, there are at least four major types of legalization of existing groups:

- formally transparent ownership structure within holdings (Lukoil and other oil holdings after transition to the single share, "TNK-International");

- the central structure of a holding is the managing company established by nominal owners of the parent holding company (or of a group's assets, which real owners transferred to various offshore companies) and having a warrant of attorney to manage the assets ("group of shareholders" of "Sibneft" after the 2001 reorganization, confectionery holding "Sladko");

- "shell" holding, in fact operating as a single structure with real management authority, where neither the controlling shareholder in the central company, nor the central company itself own subsidiaries. The latter are transferred to other, not legally related to the holding, structures (oil and chemistry holding "Sibur");

- a group where participants are involved in different degrees. For instance, in the framework of "Sladko" confectionery group there is a not-for-profit partnership "Sladko" embracing a number of enterprises. At the same time, there is established a single company JSC "KO Sladko," to which, upon taking a respective decision, affiliate other enterprises (their shareholders).

Additional aspects are related to the registration of the head company as an open or closed JSC, or its registration abroad. In spite of such clear differences in the transparency of the whole structure of a holding (group), the general feature of practically all groups (even those structurally transparent and those who got an approval of their structures from the Anti-Monopoly Ministry) is the beneficiary ownership, or juridical identification of actual poles of control (in Russia's conditions these terms are practically synonyms).

In terms of the problems of corporate governance, the importance of this issue depends on the degree to which the activities of actual controlling owners (and their managers) negatively affect other groups of shareholders (dividends, transfer price formation, too low export prices, withdrawal of assets, etc. It is apparent that 100 per cent consolidation of group's assets by the controlling owner settles the issue as concerns private minor shareholders and the management of shares owned by the state; however, the range of problems concerning the relations between the group and the state remains (taxes, export of capital, etc.).

As in the case of expansion, processes of consolidation and reorganization more often take place in extracting industries. An illustrative example is the consolidation of 100 per cent of shares in extracting enterprises of TNK completed by January of 2002. Before the process of consolidation has started the holding owned 51 to 71 of voting shares in the subsidiaries. Originally, there was envisaged the classic design – an additional issue of shares in the holding and their exchange for shares in the subsidiaries. Later it was modified to be implemented in several stages: shareholders of subsidiaries could exchange their shares for TNK stocks before December 1, 2001, in December they could sell fractional shares originated due to the consolidation of the company's shares (this mechanism was prohibited since January 1, 2002). According to some estimates, the conditions were favorable for minor shareholders, and their share in TNK increased from 0.1 to 3 per cent (13000 shareholders). In 2002, there is planned to consolidate two oil processing and 6 marketing companies of the holding, where the share of the holding is above 75 per cent.

At the same time, there was completed the juridical reorganization of the holding (according to the available information it was approved by the RF Anti-Monopoly Ministry). “TNK International,” which was established (in London) on parity basis by partners / owners of “Alfa Group” and “Renova” at end-2001, owns 97 per cent of TNK shares¹⁴.

The negative attitude taken by TNK towards the entry to the domestic market after the completion of consolidation is also illustrative in the context of consolidation as a general trend and respective prospects of the Russia's stock market. The factors behind the company's unwillingness to sell its stocks, especially on the open market, may include the minimal number of minor shareholders, scandals and corporate blackmail threatening the company's reputation, the unwillingness to orient towards “cheaper” domestic quotations.

While TNK and Lukoil (which, in fact, was the first to carry out consolidation via the exchange of its shares for shares in its subsidiaries and the transformation of the latter in limited liability companies) managed to carry out consolidation virtually without conflicts with minor shareholders, “Sibneft,” “YUKOS,” and “ONAKO” were involved in a number of trials. First of all, they were related to claims about abuses on the part of the controlling shareholder (the holding) filed by minor shareholders, which refused to participate in the exchange. Alt-

¹⁴ Earlier the partners / owners of “Alfa Group” and “Renova” controlled TNK via three affiliated closed JSCs also established on parity basis: “Novye Priority” (49.86 per cent), “Novy Holding” (40 per cent), “New Petroleum Finance” (10.1 per cent).

though the mechanism of buying up fractional shares is often viewed as unconstitutional (forced withdrawal of property without trial, what contradicts Art. 5 of the Russia's Constitution), conflicts with minor shareholders are most often arise due to financial conditions of purchases or trivial corporate blackmail.

In the autumn of 2001, there was completed the reorganization of the "group of "Sibneft" shareholders" (Abramovich group). The right to manage all group's assets (88 per cent of shares in "Sibneft," 50 per cent of shares in "Russky Aluminum," 26 per cent of shares in "Aeroflot," etc.) was transferred to the largest London company Millhouse Capital. It is planned that the company will have the power of attorney to manage blocks of shares as the representative of the owner, however, it will have no right to directly manage the companies (i.e. it is a type of property trust).

Therefore, first, the formal juridical reorganization and the legalization of group ownership are underway. However, a certain improvement in terms of transparency of the structure of assets of the group has absolutely nothing to do with the formal identification of beneficiaries as physical persons.

Second, the new three-tier system of the "partner" organization of the business becomes more clear. Millhouse Capital directly manages all blocks of shares of the "Abramovich group," at the same time, it manages on parity basis with the investment and industrial group "Sibal" only the jointly purchased assets (Ust Ilimsk LPK, "Irkutskenergo," etc.), and manages "Avtobank" group ("Avtobank," "Ingosstrakh," "Nosta") together with GNK "Nafta Moskva" and "Sibal."

The formation of such a group, whose economic and financial power is equal to the capacity of "Alfa" or "Interros," probably is an alternative for the aforementioned collapse of the system of partner interests in the framework of informal conglomerate, which in 2000 through 2001 comprised R. Abramovich, I. Makhmudov, M. Cherny, O. Deripaska, and others. However, there is no convincing evidence (as in the case of the aforementioned conglomerate) that this structure is stable (there is certain information about plans to resell financial assets).

At the same time, the interests of former partners somewhat diverge. For instance, it seems probable that "Deripaska's group" was deprived of direct management of assets not directly related to the present sphere of interests of "Sibal," including "Rusal."

At the same time, the reorganization of "Sibal" group is underway. Since year 2000, "Sibal" has been registered as an investment and industrial group (after its aluminum-related assets had been transferred to "Russky Aluminum"). It focuses on takeovers in the automobile industry, mechanical engineering, and

coal industry. The sub-holding JSC "Ruspromavto" controls GAZ and four bus factories. In 2001, the group obtained control over JSC "Bryanski Arsenal" (60 per cent of the autograders market, 30 per cent of asphalt pavers and semi-trailers market), and purchased the controlling interest in JSC "UralAZ," thus indicating its interest in the production of heavy freight trucks¹⁵. In 2002, there may be completed the consolidation of diesel manufacturing enterprises in the Yaroslavl oblast. Coal companies belong to another subsidiary of holding JSC "Soyuzmetallresurs." It is planned to increase the number of sub-holdings specializing in a certain industry (aircraft construction, timber industry, power engineering, mining industry).

The reorganization of "Russky Aluminum" holding (it was established in March of 2000 as a limited liability company), which is owned by groups of Abramovich and Deripaska on "parity" basis, has also been completed. Due to a number of factors, the holding started to operate in April of 2001 upon obtaining the permission on the part of the RF Anti-Monopoly Ministry together with instruction to complete the consolidation of industrial assets by December of 2001. Although the holding controls over 70 per cent of Russian and about 10 per cent of world production of aluminum, the form, in which this structure was established, allowed the RF Anti-Monopoly Ministry not to regard the involved enterprises as a single company. According to the RF Anti-Monopoly Ministry's instruction, the aluminum-related assets (assets of ten enterprises), which previously had been registered with offshore companies, were transferred to the holding's authorized capital by end-2001.

In year 2001, there was started the reorganization of "Interros" group assets. Alongside with restructuring of JSC "Norilsk Nickel," strategic direct and portfolio assets were more clearly delimited in the framework of the group. The direct assets comprise GMK "Norilsk Nickel," holdings "Silovye Mashiny" (buying up of shares in electric power machine building enterprises in year 2002) and "Profmedia," agro-industrial holding "Agros," financial institutions ("Rosbank," pension and insurance structures); portfolio assets include group's shares in "Mastkom" consortium (it was established in 1997 in relation to the purchase of shares in "Svyazinvest"), "Russia Petroleum" and a number of other enterprises.

¹⁵ It is an interesting fact that in May of 2001 "Sibal" signed an agreement with P. Sumin, the Chelyabinsk oblast governor. According to the agreement, "Sibal" has the most favorable treatment for takeovers in the Chelyabinsk oblast. Besides UralAZ, the "Sibal" sphere of interests includes Chelyabinsk factory of road machines and Chelyabinsk forging and pressing plant.

It is probable that the group plans to gradually concentrate its strategic assets, what presupposes both the sale of its portfolio investments (or those the group does not consider as strategic assets) and the subsequent investment of returns to the group's assets. According to the available data, only in the North-West region the group has sold its shares in JSC "Fosforit," JSC "Krasny Vyborschets," LOMO (JSC "Leningrad Optical and Mechanical Association"), the holding limited liability company "Novye Programmy I Tekhnologii" (which, in its turn, controls open JSC "Sudostroitelny Zavod Severnaya Verf" and open JSC "Severo Zapadnoye Parokhodstvo"). The latter of the aforementioned sales may be related not only to the general reorganization of the group, but to the state policy of consolidation and strengthening control over enterprises and military and industrial complex (MIC) programs.

Similar process take place in the Benukidze group (open JSC "Obyedinennye Mashinostroitelnye Zavody" – OMZ, metallurgical, drilling, and mining equipment, special steels, equipment of nuclear plants, torpedo launchers, ship building, numerous "auxiliary" assets). The group plans to focus on heavy engineering in the process of reorganization. Yet in year 2000, the group made public its plans to sell "auxiliary" assets explaining the fact by too close integration and inefficiency of "self-sufficiency." In the winter of 2001, the managers purchased a motorcycle factory (open JSC "IMZ – Ural") owned by the group.

It is probable that this trend will become more clear and massive over a few next years. The first wave of disposal of various assets the groups (FIGs) had purchased before the crisis of 1998 was spontaneous and caused by the collapse and financial problems many formal and real FIGs experienced in the post-crisis situation of 1998 and 1999. At the present stage, the groups pursue more rational and conscious policy. As a result, it is probable that amorphous conglomerates spontaneously created in the environment where financial resources were abundant (at two stages: "banking" – before the crisis of 1998, and "industrial" – after the devaluation) will be transformed into clear structures presupposing highly consolidated ownership and exploitation of integration effects.

However, there arises another issue, which requires a special study: to what degree the current reorganization of large Russia's business will meet the goal of their international competitiveness. Yet another potential problem is more immediate – the exhaustion of post-crisis (devaluation) resources, which at the moment are needed not for expansion, but for the development of investment potential of reorganized groups. In this connection the sale of auxiliary assets, currently occurring in the "planned" manner and bearing indirect testimony of the exhaustion of "easy money" may acquire even more chaotic character.

On the whole, the process of structural changes in Russia's companies (different types of reorganization in juridical terms) develops rather intensively. According to the data provided by the RF Anti-Monopoly Ministry, the number of various operations related to structural transformations made 5000 in 1997, about 9000 in 1998, about 11000 in 1999, about 16000 in 2000, and estimably over 20000 in 2001.

As concerns the perspectives of corporate governance in Russia, these trends will exert profound and often contradictory influence on the situation:

- in the course of consolidation the formal transparency of companies will improve and, accordingly, will make possible the "safe" transition to international rules of corporate governance;

- the completion of ownership consolidation processes creates the objective basis for real delimitation of property and management in the framework of groups having completed reorganization;

- reorganization processes (both the juridical fixation of groups (holdings), and restructuring of assets) will boost the demand for efficient corporate governance – primarily for the purposes of free of conflict settlement of relations between different types of shareholders;

- a certain post-crisis fixation of spheres of property interests creates prerequisites for a new wave of hostile takeovers.

The state policy of keeping large capitals at the "equal distance" from power (even in case of its external, most demonstrative layer) directly affects the processes described above.

First, at present there are no reasons to believe that the declared principle of "equidistance" will be abandoned after the completion of consolidation (return) of assets and re-orientation of financial flows on the part of largest natural monopolies and state-owned holdings, while their managers appointed by the present president will, probably, be given carte blanche for expansion in the private sector and building of their own groups. The probability of such a scenario (in fact, "state capitalism" favorable for a narrow circle of personally loyal individuals) requires certain protective measures on the part of private groups.

At the same time, there arise certain doubts about the set of instruments rather widely used in 2000 and 2001 to influence corporations. Measures taken by state agencies (tax police against "Lukoil," the RF Accounting Chamber against TNK, the Attorney General office against "Sibneft" and "Norilsk Nickel," etc.) failed in spite of numerous searches and initiation of criminal cases – there were found no "constituent elements of crime."

In this connection there arise an obvious question about the juridical justification of the “use of force” and reliability of evidence used to initiate criminal cases. In other words, it is the question about who and why initiated criminal cases (probably justified but doomed to fail nevertheless), especially taking into account the systematic nature of this process.

The principle of “property in exchange for freedom,” which has already proved its effectiveness, is still widely used. The case of arrest of “Sibur” managers in the winter of 2002 is suitable only in form, because in terms of substance the withdrawal of assets in favor of a “group of persons” is rather obvious. It seems that there arises a different problem: a contradiction between the legal environment (i.e. practically legal possibilities to withdraw assets) and the methods employed to return them (the necessity to resort to force and use various articles of the RF Penal Code because of impossibility to settle the problem in court). Similar methods (initiation of a criminal case) proved necessary to carry out to replace a number of officials in the Ministry of Railroads.

In more general terms, the problem is related to the vagueness of final goals: either it is the real start of fight against corruption and an attempt to effectively stop the withdrawal of assets in any form, or it is the trivial continuation of the redistribution of property and putting pressure on competitors (in favor of state-owned groups and / or in the framework of elementary use of the “administrative resource” by all subjects having such a possibility).

Second, there arises an apparent counter trend on the part of private capital – to become maximally “equidistant” for safety reasons. The means to achieve that also include the legal registration of ownership rights for their consolidated assets abroad. The fact that groups “Alfa” and “Renova” established company “TNK International,” while the “Abramovich group” registered “Mullhouse Capital” as the managing company is, obviously, the first indication of their attempts to achieve “safe transparency.”

Yet another “defense line” of large groups is the achievement of absolute access to the resources of regional administrations (A. Khlopynin in the Taimyr Autonomous Okrug, R. Abramovich in Chukotka, V. Shtyrov in Yakutia, V. Lisin in the Lipetsk Oblast (potentially), A. Vavilov in Gorny Altai (failed), etc.).

Third, only few large businesses have started the transition from clear and direct policy of privatization of the “administrative resource” to emphasized loyalty to the federal authorities and demonstration of “social responsibility.” Some companies (for instance, SUAL holding, second largest in the Russia’s aluminum industry) make agreements on social partnership with regional authorities, other initiate increases in the state-owned shares or surrender control over certain as-

sets to the state (for instance, group “Interros” transferred some assets to state-controlled “Permski Tsentrv Dvigatelistroyeniya” in the process of reorganization of “Permskiye Motory”).

A number of large companies found themselves involved in court proceedings, which, although formally classified as economic disputes, had clear political significance directly damaging reputations of plaintiff companies (“Gazprom” – “NTV,” “Lukoil” – “TV 6”).

In its turn, the **state** itself (as represented by its executive branch) intensifies its expansion into economy more and more whatever the motive. This process is developing along six key interrelated avenues:

- changes in the management of largest natural monopolies and strategic companies partially owned by the state (“Gazprom,” Railroad Ministry, MIC, Atomic Energy Ministry, subsidiaries of “Rosspirtrom,” the State Investment Corporation, etc.);

- reorganization (primarily mergers) of existing and creation of new holding companies in strategic sectors (consolidation of regional communication monopolists in seven interregional companies of “Svyazinvest” holding (for seven federal okrugs), five integrated structures in aircraft industry, open JSC “Promyshlennaya Kompaniya Kontsern Antei,” etc.);

- return of previously withdrawn (privatized, pledged) assets (former assets of “Gazprom” – enterprises of “SIBUR,” “Itera” group, etc., pledged blocks of shares in open JSC “Novorossiyskoye Morskoye Parokhodstvo” and “Severo Zapadnoye Parokhodstvo,” etc.);

- transfer of certain segments of state-owned property in jurisdiction of the President’s administration (creation of a FSUE to manage Russia’s property abroad, etc.);

- attempts to change the rules governing the delimitation of ownership levels and RF shares in capital established yet in 1992 (ALROSA);

- setting of control over major financial flows and concentration of financial flows in state banks. As a substitute for de-privatization of industrial assets there is used nationalization of financial flows. RF Sberbank and Vneshtorgbank, which have exclusive access to the largest and cheapest financial resources – household savings and resources of the Bank of Russia respectively, issue credits to largest Russia’s companies¹⁶. An illustrative evidence of this is the discussion on the privatization of Vneshtorgbank, which took place in 2001 and 2002.

¹⁶ See: Grigoryev A. Dvenadtsat s plovinoi (Twelve and a half), Kompaniya, 2002, January 14, No. 1, p. 21. There is an interesting indirect analogy (although inverse and

The tough political struggle in 2000 and 2001 related to reorganization of largest natural monopolies (RAO "Gazprom," RAO "UES of Russia," Railroad Ministry) brought comparatively modest results:

- the problems of further privatization of federal natural monopolies were transferred (in a draft new law on privatization) to the State Duma;
- there were approved concepts of privatization for RAO "UES of Russia" and Railroad Ministry;
- there were carried out changes in the management of RAO "Gazprom" (resignation of R. Vyakhirev in May of 2001, replacement of financial managers, initiation of criminal cases concerning the excess of power in January of 2002, etc.) and Railroad Ministry (initiation of a criminal case against ex-minister N. Aksenenko, who was accused of excess of power, and his resignation in January of 2002).

The latter result seems to be quite sufficient in the framework of "restructuring" of both sectors. There is still no real plans for restructuring of "Gazprom," although such plans similar in ideological terms to the design applied to restructure RAO "UES of Russia" have been discussed more than two years. According to the latest statements by A. Miller (January of 2002) the restructuring is not needed at all. In August of 2001, there was discussed only the issue of liberalization of stock market. It seems, that the issue of restructuring as the process of creation of several competing natural gas companies (not merely sale of auxiliary assets) is closed. A certain argument supporting such a decision may be the immediate necessity to return assets to RAO and to settle the problem of financial flows (regardless of non-economic tasks of the new management).

The restructuring program for Railroad Ministry, as approved by the government in the summer of 2001, envisages the creation of open JSC "Rossiyskiye Zheleznye Dorogi (Russia's Railroads)" (this project existed yet in 1993) and transfer of economic functions from the Ministry. JSC "Russia's Railroads" shall comprise major railroad capacities, including the infrastructure (electric power distribution lines, railroad network, embankments, etc., i.e. 90 per cent of the sector's assets). At the same time, in January of 2002 FSS objected the plan insisting that the railroad infrastructure was a strategic object and should be reorganized as an independent FSUE. In January of 2002, the draft law on privatization of railroad sector was recalled from the State Duma.

taking place under new conditions) with the actively applied since the early 1990s privatization of financial flows without privatizing enterprises themselves.

The practical implementation of the plans to reorganize RAO “UES of Russia” started only in year 2002. According to the approved program, the major goal of reorganization is the attraction of investment resources to the industry. In institutional terms, the system shall be split in the “monopoly” part (power grids, dispatching services) and “competitive” part (generation of electric power, marketing, servicing) before 2010. It is also envisaged to create the wholesale market of electric power and implement market mechanism of tariffing of heat and electric power¹⁷. By end-2001 (currently as an experiment) there was established the Administrator of trade system (electric power exchange for sales at market prices), through which generating companies shall sell up to 15 per cent of their output. In year 2002, the Board of Directors of RAO established the Federal Network Company (Rb. 121 billion of authorized capital). There is also planned to create the Federal Company of System Operator (Dispatcher). The reform of generating companies (JSC-energo) is directly linked to the problems of corporate governance.

First, to make 72 JSC-energос manageable, the holding shall considerably redistribute assets and enlarge generating structures. Reorganization (merger, takeover, or division of existing JSC-energос will result in a significant intensification of the market of corporate governance and more serious corporate conflicts at large.

Apart from effective procedures aimed to protect the rights of shareholders in the course of takeovers (which are virtually absent in the current Russian legislation), there arises a complicated complex of problems in the framework of achievement of general balance of interests – shareholders of all types, managers, regional authorities. In the framework of the reform of RAO, there appears yet another subject – managing companies (and, respectively, a broad range of unsettled problems related to trust management).

Second, there exists an obvious problem of real strategic importance. 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 the restructuring of “UES of 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 – metal-

¹⁷ For details see: Rubchenko M. Proraby reformy (Foremen of Reform). – Ekspert, 2002, No. 4, p. 32.

lurgy” permits to effectively direct financial flows from all links to exports and “optimize” tax policy.

The **regional** reactions to the expansion of the federal center certainly are of mixed nature; however, there is observed a general trend towards the demonstration of loyalty to the federal authority. Below, there are cited only two examples of many.

On the one hand, many regional leaders had to adequately react to the federal center’s demand to unify federal and regional legislative acts. For instance, in the spring of 2001, M. Shaimiyev, the Tatarstan President, revoked the moratorium (in effect over nine years) for sale of shares in 21 enterprises strategically important for the Tatarstan’s economy. This moratorium was related to the special privatization procedures in the Republic, where privatization vouchers were complimented with “registered privatization deposits” for the population of Tatarstan. These deposits could be exchanged for shares in local enterprises. At the same time, there was prohibited to sell shares purchased by employees, for which they paid with local vouchers. However, in 2001, this unification was purely formal, since de fact the prohibition was easily circumvented (via agent agreements with authorized Republican agencies, commandite companies run by issuers, and various “gray” schemes). The Republican commission for securities explained the revoking of the moratorium was caused by due to the necessity to equalize the rights of holders of same tranches, what, however, was obvious from the start.

On the other hand, regional authorities (similarly to a number of private groups, what often is the same) regarded the property expansion of the federal center rather negatively and strove to bring under their control key financial flows. A striking example is the reaction of M. Nikolayev (Ex-President of Yakutia) to the attempts of the federal center to put under property and financial control the Russia’s diamond monopoly closed JSC “ALROSA.”

At present the shares in the “ALROSA” authorized capital are distributed as follows: RF - 32 per cent, Yakutia – 32 per cent, employees – 23 per cent, local administrations – 8 per cent, the Fund of Social Guarantees for Servicemen under the RF Government – 5 per cent. According to the available data, the federal center planned to increase its share to obtain the controlling interest in “ALROSA” and to transfer leasing payments from local to the federal budget (in particular, via transfer of assets of the former NPO “Yakutalmaz” to the federal ownership in order to subsequently lease them without participation of Yakutia). As a counter measure, Yakutia planned to transfer blocks of shares in the Republican ownership (including the block of shares in “ALROSA”) to “Sakhainvest” fund (the formal number of shareholders at 200000) for trust management, what would

create a considerable obstacle for the federal expansion. After the December elections in the Republic, it is unlikely that these plans will succeed, especially taking into account the fact that V. Shtyrov (Ex-President of ALROSA), who replaced M. Nikolayev as the Yakutia President, is rather loyal to the plans of the federal center.

In its turn, the federal center more actively interferes in regional ownership disputes via its representatives in federal okrugs. For instance, in January of 2001, the representative of the President in the Ural federal okrug made a statement that the RF subjects in the Ural region inefficiently managed state-owned property and 50 per cent of SUEs in the okrug operated at a loss. He proposed to considerably limit property rights of regional administrations. For instance, there was proposed to deprive regional executive agencies of the territorial functions of the Property Ministry, apply more strict requirements to state representatives at JSCs, introduction of a legislation governing the withdrawal of "excessive" real estate from under the operative control, introduction of the institution of professional trust management of state-owned blocks of shares, replacement of representatives of regional administrations in registers with representatives of the Property Ministry.

In July of 2001, there were announced even more radical proposals. For instance, the office of the President's representative in the Ural okrug proposed to transfer a part of shares in closed JSC "Karabashmed" to the state ownership as a way to settle the conflict related to JSC "Karabashski Medeplavilny Kombinat" and closed JSC "Karabashmed."

In the context of facts described above (it concerns both federal natural monopolies and reorganization of private groups), it shall be noted that legislative innovations in the area of reorganization, mergers, and takeovers gather in importance. The problem of improvement of legislation on insolvency still remains an urgent problem.

In particular, it is necessary to develop further the sphere of regulation of corporate takeovers. While corporate governance at large may accept the OECD Principles of Corporate Governance as a certain guideline, the protection of shareholders' rights in the course of takeover requires the study of the broad EU experience related to the supranational regulation of mergers and takeovers, which was formalized in the Code "On Corporate Takeovers" (the draft was approved on June 6, 2001 and shall probably come into effect in 2006). The most important part of the Code ideology is the shift from the interests of "aggressors" (these interests are easy to satisfy because many EU countries do not set significant constraints on takeovers) to the interests of companies being taken over and

their shareholders. According to the Code, minor shareholders of such companies shall have the right to block a number of decisions in case their interests are infringed upon. The continental orientation towards “social partnership” was responsible for stipulations requiring preventive notification of employees of the companies being taken over.

The urgent problem of the degree of regulation (control) of “economic concentration” (in terms of the anti-monopoly legislation) and operations of owners (and their managers) actually controlling their companies in order to protect other groups of shareholders from potential damage (dividends, transfer price formation, too low export prices, withdrawal of assets, taxes, export of capitals, etc.) remains unsettled.

The trend towards property expansion and putting under control key financial flows in the Russian economy (in more broad terms, the attempt to make business dependent on state institutions and implementation of the “state capitalism” model in spite of decisions aimed to promote deregulation and further privatization) demonstrated by the authorities in 2001 and 2002 makes even more urgent the problem of protection of ownership rights, court reform, and efficient law enforcement.

The uncertainty in these areas remains an important factor behind persisting high risks of corporate governance and investment in Russia. Accordingly, the court reform (ideally resulting in independent and transparent courts, where the prosecution arguing with the defense must prove the necessity of procedural actions, which only the court may authorize), period of limitation for privatization transactions, clear legislation on nationalization are at present the *objective* indicators of *true* aims of the authorities.

4.3 Sources of Financing in the Corporate Sector

This important aspect of the problem is directly related to the more active operations of the largest companies in the sphere of improvement of corporate governance. According to a survey of largest Russia’s enterprises conducted in 2000 through 2001, 80 per cent of the surveyed enterprises indicated their demand for shared investments, although only 14 per cent of companies practice them, mainly via ADR – GDR programs, 66 per cent have no possibilities to attract them, and 20 per cent are not interested in such investments. Debt financing

(borrowings) are used by 59 per cent of enterprises. However, internal funds remain the major source of investment (91 per cent of enterprises)¹⁸.

The highest demand for external shared investment is demonstrated by “investment depressive” industries with obsolete fixed assets and high capital intensity (telecommunications, power engineering, mechanical engineering). At the same time, these industries demonstrate least actual results. The most active in attraction of external shared investment are “investment growing” sectors with short production cycles, which are close to end consumers (consumer goods, retail trade). Lower demand for shared investment was registered in “investment static” industries disposing of considerable amounts of internal funds (raw material industries, petrochemistry, metallurgy).

It is interesting to note that according to the data provided by the Bureau of Economic Analysis (BEA) the consolidation of joint stock capital is most characteristic of mechanical engineering and least characteristic of light industry. In oil industry and metallurgy, the process of consolidation is practically completed. It is also registered that consolidation of property has no positive effect on investment activity.

As concerns sources of financing, the data provided by the BEA sample is less optimistic. The following trends were registered for 289 investment active enterprises (in 1997 through 1999): an apparent growth in the use of internal funds (275 enterprises in 1999 as compared with 257 enterprises in 1997), rehabilitation of pre-crisis level of attraction of bank credits (37 and 38 enterprises respectively), decrease in shared investment at the expense of issues of corporate securities (1 and 8 enterprises respectively), increase in external financing from Russian private investors (14 and 5 enterprises respectively), and decrease in financing from foreign private investors (0 and 2 enterprises respectively). The increase in the share of Russian private investors is characteristic of enterprises where a significant share of control is exercised by other industrial enterprises (shares in the capital, members of the Board of Directors).

May significant shifts be expected in a short time period? The problem has several aspects.

¹⁸ Rol nezavisimyykh chlenov Sovetov Direktorov v upravlenii rossiyskimi predpriyatiyami (The Role Played by Independent Members of Boards of Directors in Management of Russian Enterprises), Assotsiatsiya Menedzherov, Assotsiatsiya po zashchite prav investorov, M., 2001.

The mentality of “wild director” as a psychological problem of investment attraction was important in the 1990s. Practically every researcher of psychological specifics of Russian directors registered their attitude towards external investors based on the principle “give me your money and do not interfere in my work,” at the same time, all of them welcomed the inflow of investment to their enterprises. As it was mentioned above, the rotation of “old” general managers in Russia occurred at a rather high rate. At many enterprises there changed owners and the very concept of the investment process. In other words, “wild” (and, therefore, hopeless cases) are mostly past history. A modern director, who became an owner or is closely related to the controlling group fully understand that in the situation of uncertainty investments may be only exchanged for property, what is psychologically difficult after ten years of struggle and dangerous because it is possible to loose control.

The problem of objectively limited possible sources of sources of financing is much more important. It is apparent that the overwhelming majority of enterprises in processing industries, if only in theory, are interested in external joint stock financing. The latter is only one of the many types of corporate financing available in transitional economies; however, Russia has no luxury of choice¹⁹. The opportunity to use the banking system as the engine of corporate governance and financing was employed in the mid-1990s and brought negative results. At present, banks are still unable to finance the real sector for a long time due to insufficient internal funds and short liabilities.

Some economies in transition were able to use direct foreign investment to stimulate corporate investment and restructuring. At the same time, the corporate governance model based on the massive presence of strategic foreign investors in key sectors of the economy requires a stable and thoroughly cultivated political climate (exactly stability is the key element, as confirmed by the Chinese experience). Although the attraction of direct foreign investment shall remain the priority in certain sectors, there is low probability of a massive inflow in the short term outlook.

At the same time, under the present conditions in Russia real external financing (both joint stock and borrowed) sharply increases the threat of hostile

¹⁹ See: Nestor St., Jesover F. (2000): *Printsipy korporativnogo upravleniya OESR v oblasti prav i ravnopraviya aktsionerov: ikh aktualnost dlya Rossiyskoi Federatsii – Krugly stol po voprosam korporativnogo upravleniya dlya Rossii (OECD Principles of Corporate Governance on Shareholders Rights and Equitable Treatment: Their Relevance to the Russian Federation – Russian Corporate Governance Round Table).* OECD, World Bank. Moscow, February 24 – 25, 2000.

takeovers (via purchase of shares, creditor indebtedness, promissory notes and / or bankruptcy). In 1998 through 2001, such takeovers became a usual phenomenon.

The schemes of buying up of shares, financial bills, and creditor indebtedness, appointments of “loyal” irremovable arbitration managers (in the framework of current legislation) and bankruptcies – i.e. actions aimed to take over enterprises are well known. In 2001, there was used a new method – merchandise bills, which were issued in accordance with the Presidential Decree “On Merchandise and Finance Bills” in 1995 through 1997²⁰. Originally, merchandise bills were viewed as order papers transferable by endorsement and denominated in goods. In 1999, after several conflicts the Supreme Arbitration Court ruled that merchandise bills were “debt written liabilities” transferable under cession agreements and registered in accounting (creditor and debtor indebtedness). At the same time, debts overdue more than 3 months should be included in the profit tax base. Since it was not done, all participants of bill payments automatically could be accused of concealment of indebtedness and tax evasion. In 2001, this opportunity was used by “Alfa Eco” to take control over Orsko Khalilovski integrated iron and steel works (NOSTA). Taking into account the fact that in 1997 the amount of merchandise bills in circulation was 2.5 to 3 times over M2 aggregate, the potential of this takeover method becomes quite clear. The only natural limitation of this method is that potential aggressor has to involve regional authorities, FSFO, and tax agencies, i.e. to mobilize “administrative resource” in order to detect debts to the budget originated over the period of bill payments and to initiate bankruptcy procedures.

In this connection, the self-purchase of shares and intentional accumulation of creditor indebtedness (resulting in the concentration of shares or all liabilities in an affiliated company) becomes a wide-used method to prevent hostile takeovers. Obviously, it results both in undermining of self-financing capacity, and in lower attractiveness of enterprises for external investors. Yet another constraint on external joint stock financing is the market undervaluation of many companies (regardless of reasons).

In this connection, it is of interest to refer to the results of an IET survey on the dynamics of enterprises’ indebtedness conducted in 1999 and 2000. Thus, 82 out of 109 surveyed enterprises responded that they either had no debts to suppliers and the budget in year 2000, or could decrease the debt in

²⁰ See: Rubchenko M. “A ved preduprezhdali! (Why, There Was A Warning!) – Ekspert, 2001, No. 25, pp. 36 – 37.

comparison to 1999 figures. Although this trend may be initiated by many factors, it may be an indirect evidence of growing anticipation of debts as an instrument of corporate takeovers.

In this situation, corporate bonds become the only safe way to attract external financing. Among advantages of this method of financing, what caused the surge of interest to it in 2000 and 2001, there may be indicated the following:

- relative safety in terms of retaining corporate control;
- deficit on the market of corporate instruments with fixed yields in the favorable business situation (budget surplus, low inflation rates, decreasing rates on the market of public debt);
- interest of Russian investment agents (broker and dealer companies and banks) to promote new instruments of the stock market;
- lesser dependence of borrowers on one creditor;
- more flexible system of management of liabilities, longer terms of credit, and lower cost of borrowed resources;
- tax-related advantages over bank credits and bills;
- formation of (via “trial” and, most importantly, repaid relatively small loans) credit history and image of a first-class borrower;
- absence of defaults, which would result in higher yields on the market, in the post-crisis history of the market segment (although the very amounts of issues of 2001 are a growth-generating factor).

The FCS register lists 370 issues. In the post-crisis period, the first issue of Ruble-denominated corporate bonds was carried out by NK “Lukoil” (May of 1999). “Gazprom” and TNK followed the suit in hope to attract funds of non-residents to “C” accounts. By mid-2001, more than 40 companies issued bond in the aggregate amount above Rb. 110 billion. In the first half-year of 2001, the FCS registered 66 issues (Rb. 11.5 billion). In the second half-year of 2001, the rate of issue was maintained at the same level (not less than 20 issuers, some of them issuing several tranches).

In 2001, there were registered changes on the secondary market. Prior to the autumn of 2001, the overwhelming majority of issues was placed with previously chosen investors, who were not inclined to sell bonds before the repayment time, i.e. was of the closed nature and placed over a very short period of time. These issues were often used as an alternative (to crediting) way of financing of various projects in the real sector related to takeovers carried out via subsidiaries and affiliated structures, or to optimize tax payments. Not more than 10 issuers (about Rb. 6 billion worth of issues) were present on the

secondary market. MICEX became the main trading ground (80 per cent of the market), since 1998 there have been placed bonds worth about Rb. 60 billion. By end-2001, more issuers offered their bonds on the open market (public issues), while the amount of the market increased threefold (secondary turnover at about Rb. 20 billion). The bond boom resulted in revaluation of the liquidity of this market segment: the share of liquid bond in rankings increased from 1/5 to 1/3. According to estimates, by the end of summer of 2001 50 per cent of bond issues were publicly placed²¹.

As a result, over 2 years the amount of external funds attracted by enterprises and banks has reached US \$ 2 billion, or about 3 per cent of gross investment in the Russia's fixed assets. At the same time, in G 7 countries 30 to 60 per cent of investment projects are financed at the expense of bond issues. A number of problems hinders the development of this market: the tax on operations involving corporate bonds (0.8 per cent of face value of the issue prior to its registration); the lengthy registration process in the FCS; general standards of additional issues of stocks, ordinary and convertible bonds; the problem of difference between the authorized capital and assets of the company (the amount of issue can not exceed the registered charter capital); in some cases the feasibility to guarantee bond issues; the danger of saturation of investment demand and related necessity to intensively develop the secondary market in order to secure the inflow of new investment, etc.²²

Besides, in the short term outlook, the largest Russian companies will retain their dominating position in this segment of the market (although the number of largest and medium-sized companies-issuers present on the market is almost equal). In terms of demand, the market is dominated by commercial banks (up to 75 per cent of issues placed on the market) and various institutional investors. The participation of private investors is minimal. It seems that incentives for attraction of individuals to the market may be, first, effective guarantees with regard to bonds, second, the introduction of the institution of collective (group) claims. The fact that the civil procedural law still lacks this institution even after the collapse of financial pyramids in mid-1990s is not

²¹ *Finansovaya Rossiya*, 2001, No. 41.

²² There were used the following materials: FCS (Federal Commission for Securities) Round Table "Pravovoye regulirovaniye rossiyskogo rynka korporativnykh obligatsiy. Materialy i tezisy vystupleniy. (Legal Regulation of the Russian Corporate Bond Market. Materials and Summaries of Presentations). M., April 17, 2001; Conference "Razvitiye rynka obligatsiy v Rossii (Development of Bond Market in Russia)". M., Ekspert, June of 2001.

only an evidence of inability to learn from experience, but also about a serious opposition to this obvious and simple idea.

Therefore, there are two most typical options for a medium term outlook: 1) self-financing, including the return of internal funds as credits and shared joint stock participation as the “base” source for “independent” enterprises outside any technological chains or conglomerates united by formal or informal property control (i.e. “groups”); 2) quasi-external investment in various forms for the enterprises included in the “groups” and receive part of centralized financial resources regardless of their place in the group hierarchy. In the latter case the possibility of direct self-financing is often limited due to the specifics of organization of financial flows within the group, therefore, it is possible only as a “measured” return of previously withdrawn financial resources (assets), i.e. a substitute of self-financing²³.

Apparently, this conclusion does not provide grounds for an optimistic evaluation of perspectives of development of an efficient model of corporate governance (i.e. transparent and oriented towards the equality of all shareholders). The self-sufficient financing within an enterprise or a group (even out of necessity) automatically removes the question of shared joint stock financing, which is, in fact, the financial pillar and incentive of corporate governance as it is classically defined.

It shall be also taken into account that the effect of devaluation for extracting industries and advantages of high oil prices will run out in 2002 – 2003, while the problems of structure of sources of financing will persist. Moreover, there will remain liabilities, which were accumulated over the period of post-crisis growth: credits guaranteed by oil deliveries at current prices, bond-related payments, promises of lavish dividends, etc., as well as unsettled problems of restructuring and financing of taken over enterprises. As euphoria of growth passes and there arise financial difficulties, the problems are traditionally solved at the expense of minor shareholders and creditors. Therefore, the issue is still open.

²³ This does not concern the “old” bank and industrial FIGs of 1993 – 1998. For more details on new post-crisis structures see: Radygin A. Concentration of Property and Integration in the Corporate Sector. – Russian Economy in 2000. Trends and Perspectives. M., IET, 2001. In this context one of the conclusions from the aforementioned BEA survey is of special interest: enterprises with higher share of other Russian enterprises in their authorized capitals are characterized by the worst (according to official statistics) indicators of productional and financial operations; however, at the same time, these enterprises demonstrate relatively high levels of investment from private Russian investors.

4.4 Legal Innovations of 2001 in the Sphere of Corporate Governance

A lengthy process of discussion and opposition to new amendments to law “On Joint Stock Companies” was completed. Federal law No. 120 FZ of August 7, 2001, “On Amendments to Federal Law “On Joint Stock Companies” has been in effect since January 1, 2002²⁴. Among the most important innovations in the sphere of protection of shareholders’ rights are the following:

- a special provision grants shareholders the right to sell their shares without approval on the part of other shareholders and the company (Article 2);
- there is stipulated the possibility to limit closed subscriptions in open JSCs (in charters or RF legislation);
- closed subscription (Article 39) may be approved only by a decision of the general meeting of shareholders (3/4 vote quorum in case it is probable that there will be more votes favoring the decision);
- ordinary stocks placed via open subscription (in case there are placed more than 25 per cent of previously placed ordinary stocks) require the implementation of the same procedure;
- there is introduced the provision on the open subscription privilege for shareholders (previously this privilege was granted only if it was stipulated by the JSC charter);
- there was introduced the provision on the closed subscription privilege for shareholders who voted against it or did not take part in voting;
- the shareholders exercising their subscription privilege (within 45 days since the notification) have the right to pay for additionally issued shares with money even in case the decision on the issue requires the payment with non-monetary means;
- it was prohibited to convert ordinary stocks into preferred stocks, bonds, and other securities.

Therefore, for the first time since the age of corporatization and mass privatization of the first half of 1990s there were set in place legislative mechanisms preventing the most well known method to infringe upon the rights of shareholders used in the 1990s – dilution of outsiders’ shares by new issues of shares. In this connection, it is worth to recall the history of discussion of these amendments. In fact, these measures had been elaborated since 1997. The first draft was approved by the State Duma at the third reading on June 2, 2000,

²⁴ Articles 48 and 49 have been in effect since the date of official publication on August 9, 2001.

however, it was blocked on the initiative of several largest companies. The new version of amendments, approved by the State Duma in end-2000, also did not come in effect. What has changed?

It is obvious that factors behind the approval of amendments were economic ones. The majority of largest companies completed consolidation of property (transition to the single share, increase of shares in subsidiaries up to almost 100 per cent, juridical fixation of holdings as closed JSCs and limited liability companies, etc.) in 2001 through 2002. In this situation the dilution as an instrument lost in importance. In the result, minor shareholders obtained a legislative instrument for protection of their rights when its use is already limited. Moreover, there remain a number of technical ways to circumvent this innovation. On the whole, the stress the new law makes on formal protection of minor shareholders only intensifies the perception that these amendments are somewhat obsolete.

Nevertheless, the fact that the law came into effect only on January 1, 2002, favors many companies, which were late to implement various schemes prohibited by the new law. For instance, "Sibneft" and TNK settled their conflict concerning the rights for "ONAKO" by issuing additional shares in the company, while denying small shareholders the subscription privilege (i.e. they initiated the dilution of shares of minor stockholders). The reorganization of TNK holding in December of 2001 carried out as consolidation of shares in subsidiary extracting companies (and not as affiliation via single share) will result in compulsory redemption of fractional shares and a decrease in the share of small shareholders. According to TNK estimates, their share in the reorganized company will be below 10 per cent. In September of 2001, NK "YUKOS" initiated the decision of the Board of Directors of the Angarski oil and chemical integrated works (ANKhK) to consolidate shares (the face value is to be increased 1000000 times), and used the same instrument with regard to other subsidiaries (open JSC "Bryansknefteprodukt," "Novokuibyshevski NPZ," "Voronezhnefteprodukt," "Orelnefteprodukt"). Although many minor shareholders complain about "YUKOS" policy with regard to ANKhK (traditional causes of complaints are the withdrawal of assets, increasing creditor indebtedness, and transfer prices), it seems that there is no feasible alternative for portfolio investors due to non-liquidity of ANKhK shares and impossibility to exchange them for "YUKOS" shares (which have significantly gone up since recently). On the whole, it shall be noted that in majority of cases the financial terms of exchange (redemption) are not discriminatory with regard to small shareholders (if the fact that they are forced to exchange shares is disre-

garded). This even may be viewed as a certain progress in protection of the rights of minor shareholders achieved in 2000 through 2001.

The law is very cautious about the problem of transparency. The new version of the law settles this problem similarly to the problem of dilution of shares (Article 91). The right to inspect accounting documents of JSCs and minutes of Boards of Directors was granted to shareholders jointly owning not less than 25 per cent of voting shares (as compared to 10 per cent in the previous version of the law). The law also stipulates that in case the number of shareholders exceeds 50, a specialized registrar shall keep the JSC register.

One of the most frequently used ways to “exclude” outsiders in 1998 through 2001 was reorganization. The new version of the law stipulates that:

- shareholders of reorganized JSCs (separated or divided), who voted against reorganization or had no opportunity to vote shall be granted the right to receive shares in each newly created JSC in proportion to the number of their shares in the reorganized JSC;

- JSCs may be transformed both in a limited liability company and productional cooperative, and non-commercial partnership (in case of unanimous voting).

The positive effect of the first innovation is very important. Evidently, it would be also feasible to amend the RF Civil Code and / or elaborate federal law “On Reorganization of Companies.” The second innovation is also important, since it addresses the objective process of transformation of open JSCs, which were forcibly created in the course of mass privatization in other organizational and legal forms more suitable for concrete enterprises in terms of their size, sectoral specifics, functions, etc. In the future, it is necessary to stipulate available options in more detail, at the same time addressing the issues of protection of all subjects of corporate relations.

It is of equal importance to define large transactions and set in place the respective rules. Article 78 for the first time includes loans, credits, pledge, and guarantee in the list of large transactions. The general meeting and the Board of Directors have the right to approve or disapprove a large transaction, but not to initiate it.

As concerns authorized capital, the law stipulates that it may be increased via additional issues of shares at the expense of JSC assets (i.e. capitalization). The authorized capital may be increased via increase in face value of shares only at the expense of JSC assets (Article 28).

Yet another problem in the sphere of authorized capital is the problem of fractional shares, which, alongside with consolidation of shares became a new

instrument used to drive out outsiders in 2000 through 2001. This problem has not been completely settled and became even more important since there had been taken the decision granting shareholders subscription privileges concerning additional issues of shares. The new version of the law stipulates that fractional shares ensure the rights in proportion to the whole share part of which it represents. While this approach is quite suitable with regard to dividends, there arise apparent difficulties with regard to voting on the principle “one share – one vote” (however, it is possible to sum up fractional shares).

There persists dualism with regard to JSC dividend policies. The decision on the payment of dividends may be taken only once a year (not on quarterly basis, as before). However, the general meeting still has no competence to exceed the amount of dividends recommended by the Board of Directors. Accordingly, the decisions on dividends taken by general meetings are only of formal nature.

One of the most important tasks of the corporate law (as others) is to prevent the creation of “ephemerid” and “bogus” JSCs in order to guarantee creditors relying on JSC authorized capital the repayment of their losses, what would improve the protection of interests of creditors as financial investors in JSCs. However, in this respect the new version of the law makes a step backwards, since it stipulates that from January 1, 2002, 50 per cent of shares in the JSC distributed at the moment of its creation shall be paid off over 3 months since the date of state registration (not prior to the date of registration, as before).

Accordingly, it is already clear that it would be feasible to make a number of amendments to the law in the future:

- to prohibit joint stock companies to carry out any transactions not related to the establishment procedures until the full repayment of their authorized capitals;

- to tighten repayment of shares – they shall be fully repaid in three months after the date of state registration; additional shares shall be fully repaid at the moment of placement;

- to stipulate that it is mandatory to use the services of an independent appraiser in case dividends are paid in non-monetary form, to make founders, members of the Board of Directors, and independent appraisers responsible in case the value of assets used to repay shares is evaluated too high.

A number of innovations concern JSC management:

- there was introduced a clear procedure for suspension of powers of the general manager (Article 69);

- the Board of Directors was granted the certain right to amend JSC charter and approve the registrar;
- the Board of Directors shall have the right to increase authorized capital via additional issues of shares only if the charter stipulates it (the decision shall be unanimous);
- the Board of Directors shall have no right to take decisions on participation in other organizations;
- only physical persons shall have the right to be members of the Board of Directors (Article 66), it is also expressly prohibited to transfer voting rights;
- “the exclusive competence of the general meeting” (Article 48) was replaced by the rule, according to which the issues of the meeting’s competence can not be transferred to the Board of Directors and executive bodies, while the meeting now has the right to discuss issues outside its competence;
- the general meeting shall have the right to approve internal regulations;
- the mixed form of the meeting is excluded, the law stipulates two options – general meeting and absentee voting.

From the viewpoint of protection of interests of large shareholders (represented in the Board of Directors) the innovation stipulating that executive directors may be suspended by the Board of Directors without an extraordinary meeting of shareholders (Article 69) is of certain importance. This regulation may be used in case the general meeting of shareholders forms the executive body. In case it is in the jurisdiction of the Board of Directors to form executive bodies, the Board has the right to suspend the powers of the executive body at any time. The new version of the law also attempts to settle collisions arising from the obsolete Labor Code (general jurisdiction courts base their decisions on this Code). For instance, the law stipulates that relations between JSCs and their executive bodies (general managers, etc.) shall be subject to the RF labor legislation only if they do not contradict the law on JSCs.

However, the problem of protection of interests of large shareholders is more related to procedural aspects of the law.

The new version of the law sets a number of regulations aiming to prevent corporate blackmail, however, an analysis of legal means of defense did not reveal any effective defense measures²⁵. It does not mean that the law needs special respective amendments. The defense shall primarily rely on court proceedings.

²⁵ A shorter period of limitation (6 months) was set for appeals against decisions taken by general meetings, etc.

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-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.

To cite only a few among numerous examples: JSC “Kristall” (appointment of a new general manager), “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), JSC “Polimerstroimaterialy” (attempt to ignore a court ruling), RAO “Gazprom,” open JSC “Mosenergo” was prohibited to hold an extraordinary meeting (appointment of a new general manager), preventive arrest of a block of shares in open JSC “Severstal,” open JSC “Transneft” was prohibited to transport “Lukoil” oil, etc.

In September of 2001, A. Volski, the President of the Russian Union of Entrepreneurs and Industrialists (*Russ. abbr.* RSPP) sent a letter to the RF Supreme Court asking, first, to limit the right of shareholders – physical persons to file claims with courts having general jurisdiction over places of their residence and transfer proceedings to arbitration courts having jurisdiction over areas where JSCs are registered, and, second, to prohibit general jurisdiction courts to impose preventive arrests on companies’ assets.

In formal terms, this was aimed to avoid juridical collisions arising in case arbitration courts and general jurisdiction courts (the latter – basing on claims of individuals) make contrary rulings. In the course of subsequent court proceedings the shares are under arrest as a preventive measure. In terms of economy, it is trivial seizure of property. It results in uncertainty of JSC economic operations, destabilization, and redistribution of ownership rights. The urgency of the problem is apparent, therefore as a temporary compromise measure (until the new RF Arbitration Procedural Code and the RF Civil Procedural Code come into effect) the Plenum of the RF Supreme Court recommended the gen-

eral jurisdiction courts to refrain from banning meetings of shareholders in compliance with claims lodged by shareholders – physical persons²⁶.

At the same time, the possibility that the federal legislation will be in fact modified by the ruling of the Plenum of the RF Supreme Court basing on the RSPP letter (as a precedent) challenges the necessity to adopt new APC (approved at the first reading in the spring of 2001). Yet another problem is closely related to systemic corruption. In case the new procedure is implemented, the interested parties will just turn to arbitration courts to achieve the same goals²⁷.

At the background of innovations approved in 2001 and their potential development the popular idea to adopt a Russian Code of Corporate Governance (Practices) does not seem urgent²⁸. The existing OECD Principles of Corporate Governance summarizing the best corporate practices suffice as a guideline for corporations under the present conditions in Russia.

The formal advantage of companies intending to follow the recommendations set by the Code will be the formation of a positive image for the foreign investment community. In this sense, the national Code is a usual formal signal for potential investors about the situation in the country. According to a McKinsey survey of 200 largest world investors (aggregate assets at US \$ 3.25 trillion), 75 per cent of investors rank the quality of corporate governance at the same level as financial and economic results, while giving priority to the factor of corporate governance in transition economies. As concerns the price of shares, 80 per cent of investors are ready to pay extra price for the quality of corporate governance with the resulting capitalization premium reaching from

²⁶ The draft Arbitration Procedural Code of RF contains a provision setting a full list of cases within the competence of arbitration courts involving citizens not being individual entrepreneurs. The list includes disputes between shareholders and joint stock companies related to the operations of such companies (except labor disputes). For details see: Gros L. *Proyekt APK 2000: mneniya, suzhdeniya, predpolozheniya* (Draft APC 2000: Opinions, Assessments, Assumptions). – In: *Khozyaistvo i pravo*, 2001, No. 9, pp. 54 – 68.

²⁷ At the same time, the rejection of preventive measures will pose the obvious danger that defendants may “dilute” capitals in the process of trials. Defendants may use such an effective measure as counter-claims for eventual losses in case courts take decisions on implementation of preventive measures (see: *Finansovaya Rossiya*, 2001, No. 37, p. 3).

²⁸ *Kodeks korporativnogo povedeniya. Materialy dlya obschestvennoi diskussii* (Code of Corporate Practices. Materials for Public Discussion). M., FKTsB, 2001.

20 per cent (in countries with developed corporate culture) to 50 per cent and more (emerging markets)²⁹.

For these purposes, many largest Russian companies already adopted similar codes in 2000 and 2001. Moreover, Russia's companies will adopt certain provisions of the unified Code only in case they become interested in these provisions due to a number of factors and in the course of consolidation of corporate control. The observations made in 2000 through 2001 demonstrate that the formal transparency and openness of many companies for minor shareholders increased as they consolidated overall control and, in particular, assets of their subsidiaries. The determining factor is, obviously, consolidation. Therefore, the "squeezing out" of minor shareholders becomes a prerequisite of improvement of their protection.

Such a Code may exist only in the form of recommendation, however, it seems impossible that a company involved in corporate conflicts or in anticipation of hostile takeover would comply even with legislative regulations, not to mention recommendations. It means that the formation of corporate culture spontaneously progresses as Russia overcomes the objective problems arising in the course of ownership redistribution. This argument is directly related to the general problem of protection of shareholder rights.

On the other hand, attempts to use the Code's provisions as a mandatory external mechanism of corporate governance (in this case via the stock market) will not become effective for a long time yet. For instance, the requirement to allow access to listings of stock exchanges only on condition of compliance with the Code's provisions is not feasible as a mass standard instrument because the market is non-liquid and extremely narrow. First, an apparent trend to concentration of joint stock capital, and, second, the process of "closing" open JSC created in the process of privatization are the objective base for this.

Therefore, it is apparent that there are the objective limitations for implementation of the Code. The assumption that the Code will only contribute 5 to 10 per cent in the development of the Russian stock market and its attractiveness for long term investment³⁰.

²⁹ McKinsey site (www.mckinsey.com/features/investor_opinion/index.html).

³⁰ Mirkin, Ya., Losev S.: *Zaschita investorov: granitsy vozmozhnogo i novye idei* (Protecting Investors: Constraints and New Ideas). In: *Rynok tsennykh bumag*, 2000, No. 22, pp. 43 – 47.

On the other hand, the educational significance of the Code may prove useful already at the current stage, while its effectiveness will depend on compliance with the following principles:

- the Code's requirements shall be viewed only as recommendations and shall not imply any penalties for non-compliance (stipulated by the legislation or departmental regulations);
- there shall be no overlapping of corporate and related legislation;
- in the process of accumulation of positive practices, there shall be selected viable (under Russia's conditions) provisions of the Code for subsequent incorporation in the legislation.

4.5. Banking Sector

The banking sphere showed controversial tendencies in 2001. On the one hand, in the past year the Central Bank of Russia registered almost three dozens of new credit institutions. Given a smaller number of revoked licenses, the overall number of banks increased (from 1,311 as of 1.01.01 to 1,319 as of 01.01.02). In the past year, ARCO completed rehabilitation of a number of banks that fell under its administration as a result of the 1998 crisis (Table 1). At the same time, the list of banks that forfeited their licenses came to include MOST-bank which no earlier than in the mid-2000 was rated as one of the top thirty banks by the level of assets. The failed attempt by Vneshtorgbank to rehabilitate this bank appears to suggest that by far not all effects of the 1998 banking crisis have been overcome, despite the favorable environment in 2001.

Over 11 months of 2001, assets in the Russian banking systems grew in constant price terms by 12.8% (in 2000, over the same period, assets grew by 25.5%). In percent of the GDP, aggregate assets of all active banks stood at 31% (in 2000, the value was 30.3%). For the first time in recent years, the capital of the banking system grew at a higher rate (Fig. 2). The net worth of the active Russian banks increased over 11 months by 23.7% in constant prices. In the same period of 2000 the growth constituted 19.2% in constant prices.

The capital ratio of active banks improved from 14.1% at the end of 2000 to 15.4% by the end of 2001. The pre-crisis level, however, has not yet been achieved (by the end of July 1998, the ratio stood at 19.1%). As for the capital adequacy ratio stipulated by the Central Bank of Russia, because of the low risk of assets, the overwhelming majority of banks had no problem in complying and even topping the requirement.

Table3**Disposal of banks under ARCO administration in 2001**

Name of bank	Date of sale	Buyer	ARCO's interest in the capital prior to auction (in %)	Sold (in % of authorized capital)	The amount paid (mln. rubles)
Chelyabkomzembank	April	Rosselkhozbank	76.3	76.3	57.2
Avtovasbank	April	Transneft	88.11	12.95	n/a
Investbank	May	Komekotsentr		75.16	120
Petr Pervyi (Peter the First)	May	Baikraif	25%+1 share	85.15	85.145
Kuzbassugolbank	June	Belginvest	75%+1 share	96.6	96.605
Eurasia	June	Bashkreditbank	91%	82.215	284.75
RNKB	June	Bashkreditbank	50%+1 share	75	76.8
Voronezh	September	Moscow inter-republican distillery	46,1	36.596 and an option for 9.5	99.557 25.835
	December	Almas-trust (trustee of NRB)	99	99	1.25
Total					847.142

Source: Finmarket

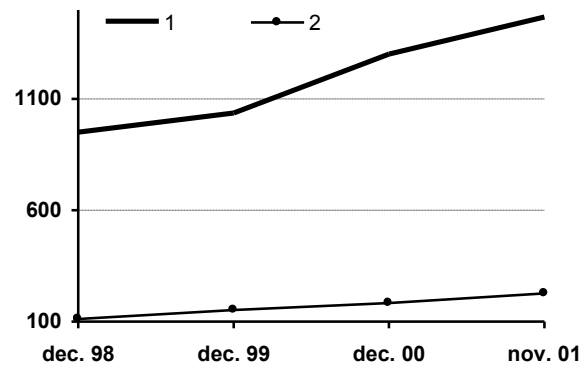
The aggregate balance capital of active Russian banks as a percentage of the GDP was 4.8%³¹, which is slightly higher than the value of the ratio as of the end of 2000 (4.2%). However, capital to GDP ratio and capital to aggregate assets ratio are still off the pre-crisis mark (about 5% at the end of 1997). For the change in the asset aggregate and capital in constant prices, see Fig. 1.

Still another typical pattern in the Russian banking sector in the past year was almost a two-times faster growth of the aggregate balance capital compared to the growth of authorized capital, which during 11 months of the year had only a 5 % rate. This fact suggests that capitalization of Russian banks in 2001 was rather from internal sources of finance (e.g., revenues) than from additional contributions by shareholders.

³¹ The ratio is calculated as balance capital of active banks as of 1 December 2001 to the tentative estimate of the GDP in 2001.

Fig. 1

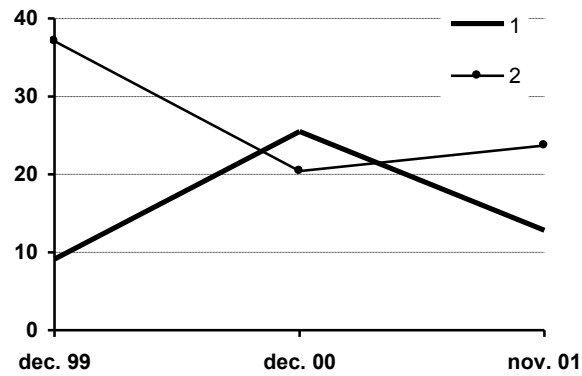
Changes in the level of asset aggregate and balance capital of active Russian banks (in billion rubles of constant prices)



1 - assets
2 - balance capital

Fig. 2

Rate of growth of asset aggregate and balance capital of active banks in constant prices (%)



1 - assets growth rate
2 - rate of growth of balance capital

But the most tangible positive shift in the post-crisis tendencies affecting the banking system was a *relative expansion in lending to the non-banking sector*. The aggregate loans portfolio over 11 months of 2001 in constant prices stood at 25.4%. It is less than in 2000 when the ratio was 34.6%. However, in 2001 credits to the real sector of the economy grew faster than the overall growth of assets. As a result, the share of loans to the non-banking sector in the assets rose from 40.8% in the beginning of the year to 45.4% in early December (11% growth). At the same time, banking analysts were proved wrong in their forecasts: the share of bad loans in the banks' loan portfolios did not change much (3.0% in the beginning of the year, and 2.9% in December). If one is to exclude Sberbank and banks under ARCO administration, the growth in the share of loans to the non-banking sector continued: at the start of 2000 it grew at a rate of 36.8%, and by December, it was 42.7% (a growth of 16%), whereas the share of bad loans in loans to the non-banking sector both in the beginning of the year, and by the end of November remained at 2.1%.

Typical for the foreign exchange structure of the loan portfolio was the continued growth in ruble loans. While early in 2001 their share in the overall loans to the non-banking sector was 64.5%, by December it reached 68.1% (less Sberbank and ARCO-administered banks: 58.7% and 61.5%, respectively).

At the same time, the maturity structure showed a higher proportion of shorter loans due to fewer loans with a maturity of more than a year. As it follows from Table 2, the tendency is due primarily to the smaller proportion of loans extended by the banks in foreign currency for a term of more than a year. The maturity of less than three months was more frequent in ruble loans (the proportion of loans maturing under three months in the overall amount of ruble loans increased from 21.7 to 24.5%). However, in currency loans too the proportion of shorter credits grew from 8.0 to 10.1%.

The faster rate of growth in loans to the non-banking sector was supported by a *relative reduction in the proportion of deposits made available to the banking sector*. The proportion of deposits in the banking sector's assets lowered over 11 month of the year from 35.8 to 31.8%, (or from 43 to 39%, less Sberbank). This was mostly the effect of the diminished proportion of assets on corresponding accounts with the CBR (from 5.9% at the start of the year to 2.9% as of 1 December). The share of deposits in commercial banks did not change significantly: from 21.4% early in the year to 20.7% by December.

TABLE 4

Maturity structure of loans to non-banking sector*

Structure of loans to non-banking sector, in % to total loans	01.01.00	01.01.01	01.12.01
Loans to non-banking sector maturing under 90 days	17.8	16.9	20.0
Loans to non-banking sector maturing between 90 and 180 days	10.8	15.7	15.3
Loans to non-banking sectors maturing between 180 days and 1 year	33.2	34.4	35.0
Loans to non-banking sector for more than a year	38.2	33.0	29.6
Loans in foreign currency			
Loans to non-banking sector maturing under 90 days	9.5	8.0	10.1
Loans to non-banking sector maturing between 90 and 180 days	9.0	8.4	11.8
Loans to non-banking sector maturing between 180 days and 1 year	25.1	28.1	30.5
Loans to non-banking sector for more than a year	56.3	55.4	47.6
Ruble loans			
Loans to non-banking sector maturing under 90 days	24.5	21.7	24.5
Loans to non-banking sector maturing between 90 and 180 days	12.2	19.6	17.0
Loans to non-banking sector maturing between 180 days and 1 year	39.8	37.7	37.1
Loans to non-banking sector for more than a year	23.5	20.9	21.5

*good loans less banks under ARCO administration.

Estimated from data of the CBR and STiK.

Additionally, banks reduced the proportion of securities in their portfolios. Despite the promising figures on the stock market (RTS grew 58.1% over 11 months) and the high yield of the currency-denominated government debt, the proportion of stocks and debt paper in the bank assets dropped from 17% to

15%, where the proportion of federal debt shrank even more: from 14.7 to 12.7%.

Let us look closer at banking operations in various segments of the Russian debt market.

Banks on currency-denominated federal debt market

Since 1996 the RF Government placed 9 issues of Eurobonds for the overall amount of USD 13.59 billion, DM 3.25 billion and и ITL750 billion. The issues mature between 2001 and 2028. Additionally, pursuant to the debt-restructuring arrangements with the London Club, in 2000 converted into Eurobonds were the principal of the debt to foreign creditors (viz., PRINs) and outstanding interest (IANs) for the overall amount of ca. USD 20 billion, maturing in 2010 and 2030. As a result, the capacity of this market is much higher than that of currency-denominated federal debt.

At the same time, Russian investors are facing a number of important obstacles to their entry on the market mostly due to the effective foreign exchange regulations which segregate Russian investors in different categories. In actual fact, banks with foreign exchange licenses have significant advantages, if they decide to enter on Eurobond market, compared to other Russian investors. The analysis suggests that some of them have actively exploited the advantage.

While instruments offering a fixed interest in hard currency may easily attract investors at times of destabilization of the ruble, with the stable exchange rate they are much less enticing. But in 2001, the market was exceptionally good for the investors. The growing prices for Russian Eurobonds and currency-denominated federal debt ensured high yield in ruble terms not only in the times when ruble was weakening to dollar but also when it grew stronger. While at the start of the year, **Eurobond prices** ranged at 38 - 98% depending on the issue, by the end of 2001 Russian Eurobonds cost at least 58% of the par value, and yield to maturity was from 5 to 12% p.a. in currency, respectively, depending on the issue.

Out of the five traded tranches of the **federal currency bond**, with maturities from 2003 to 2011, the most fast-appreciating in 2001 was the shortest fourth tranche. While by the end of 2000 the average price for this tranche was 57.6%, by the end of 2001 it went up to 90.75%. Overall, by the end of 2001, the federal currency debt, depending on the issue, ranged in price between 49 and 91% of the par value.

Investment qualities of the federal currency bond issues in 2001 continued to differ significantly from those of Eurobonds. Price comparisons for Russian Eurobonds and federal currency bonds for issues with similar maturities show that Eurobonds are priced considerably higher. The price difference may be as high as twofold for tranches with the longest maturities. For instance, Eurobonds and federal debt paper maturing in 2003 were priced at the end of the year at 106.8% and 90.8%, respectively, while for longer issues (maturing in 2010 - 2011) the gap widens significantly (86% vs. 48.5%). The shrinking spread tendency is to be found only for issues with shorter maturities (Fig.3 и 4).

Fig. 3

Average prices for Eurobonds and federal currency bonds maturing in 2003.

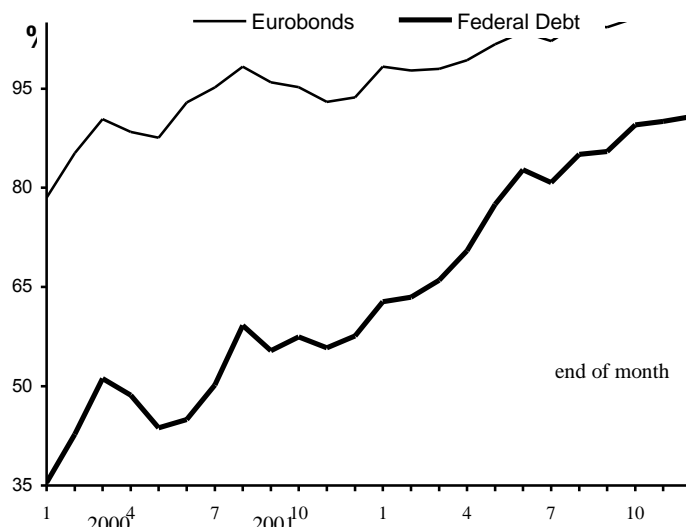
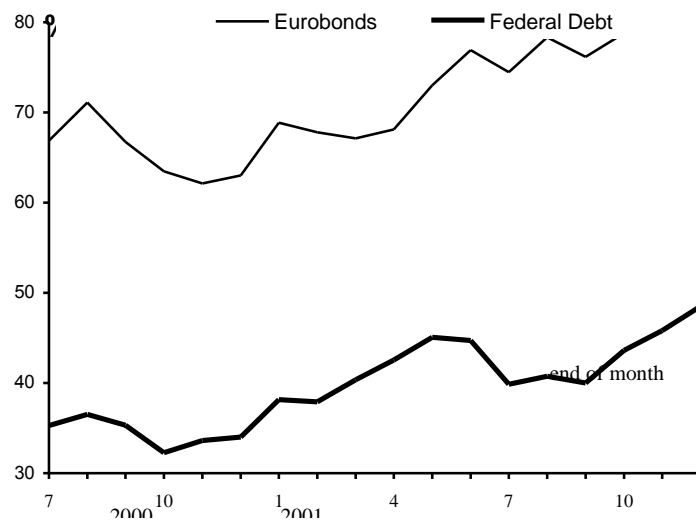


Fig. 4

Average prices for Eurobonds and federal currency bonds maturing in 2010 -2011.



Estimated from Finmarket data

Lower priced federal debt offered higher yield to maturity compared to Eurobonds despite the higher coupon yield of the latter. By investing in the federal currency debt to hold till maturity, the banks could expect to get 17 - 30% p.a. in the beginning of the year and 10.2 - 13.4% at the end of the year depending on the issue, despite the seemingly large price spread (from 48.5 to 90.8% depending on the issue).

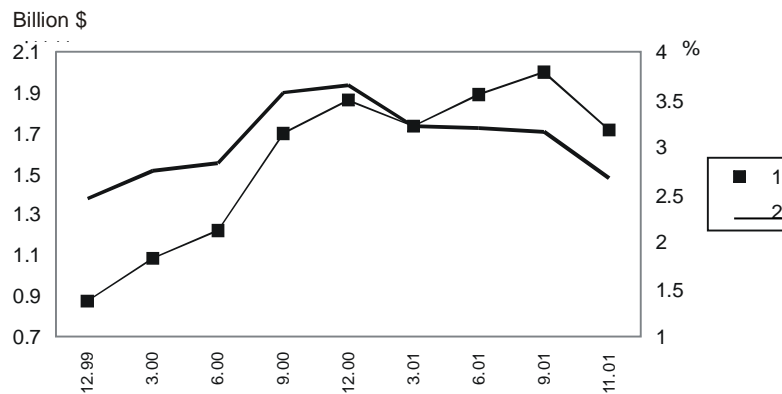
Still another distinguishing feature for the federal debt market was a higher spread between the buy and sell price (from 0.7 to 1.3% depending on the issue against 0.3 - 1.2% for Russian Eurobonds at the end of the year).

As a result, currency-denominated federal debt remains an attractive financial instrument. The largest portfolios of federal currency bonds are with Sberbank and Vneshtorgbank. They account, by value, for approximately 74% of all Russian federal currency debt in the Russian bank holdings. The currency federal debt attracted the bulk of the assets that Vneshtorgbank received from its principal shareholder, the Central Bank of Russia, as part of the 1999 capital increase.

To appreciate the extent to which other banks find this instrument attractive for investment, let us study the dynamics of the portfolio of federal currency debt in 2000 - 2001 in absolute values in dollar terms and as a percentage of assets, broken down to quarters of the year till 1.12.01 (Fig. 5).

Fig. 5

Dynamics of federal currency debt portfolios of Russian banks (less Sberbank, Vneshtorgbank and banks under ARCO administration) in 2000 - 2001



- 1 – Federal currency debt, in bln. Rubles (left-hand axis)
- 2 – Proportion of federal currency debt in assets, in % (right-hand axis)

The number of banks (less banks under ARCO administration) with federal currency debt holdings remained virtually unchanged throughout the year: there were 233 banks at the start of the year, and 230 by December. With some banks foreign currency-denominated government debt accounts for up to 60 - 90% of the assets. But this is not a massive trend: there are hardly 30 banks with more than 15% holdings in federal debt, and only 4 banks with 50% federal debt holdings, including Sberbank and Vneshtorgbank.

Let us discuss the sample of the banks that lead in their federal foreign currency debt holdings.

The following criteria applied to the selection process: the proportion of federal currency debt holdings at the end of September and November 2001 exceeded the average for all active banks (less Sberbank, Vneshtorgbank and banks under ARCO administration); the bank should have had non-zero balances in this

item at the start of the year and carried out active transactions with hard currency-denominated government paper on the market, i.e., demonstrated non-zero turnover³² for this item in the period discussed. Since, as already mentioned, both Sberbank and Vneshtorgbank were the absolute leaders in terms of their federal currency debt holdings, and their inclusion in the sample would be severely distorting the results, they were excluded. As a result, 71 banks qualified under the above selection criteria. The sample is characterized by a high degree of concentration. More than half of all federal currency debt holdings in the sample group belong only to 5 banks. And 20 banks account for more than 84%.

Let us consider some financial indicators in the sample group of banks. Average assets by December 2001 stood at Rbs 5.8 billion, which is by a few times higher than the level in the peer group (Rbs 1.5 billion). Federal currency debt holdings accounted for 9.6% assets at the start of 2001, which is 2.7 times higher than in the peer group; over three quarters of the year the proportion of the holdings rose to 11.4%. However, in two months of the fourth quarter it dropped almost to the start-of-year level of 9.5%. For an average Russian bank, the trend towards a lower proportion of federal currency debt holdings in total assets was more pronounced through 11 months of 2001: it was 3.6% at the start of the year and 2.7% at the end of November 2001 (Table 3).

Over 9 months the aggregate federal currency debt holdings grew by 7.1% whereas assets grew by 23.7% (both indicators are in dollar terms). However, at the end of 11 months the situation changed considerably: the growth in the federal currency debt holding reversed to a slump (by 7.8%), while assets continued to grow almost at the same or even higher rate (up to 25.8%). As a result, over two months the overall federal currency debt holdings of Russian banks shrank in dollar terms by 3.5% (from USD 7.8 to USD 7.5 billion, less ARCO banks). If leaders – Sberbank and Vneshtorgbank – were to be excluded, the slump would be even more tangible (14%). Banks in the discussed sample also show a reversal in the tendency by the end of the year: over 11 months federal currency debt holdings in the assets lowered by 0.4% (although over 9 months there was a 19.4% growth). At the same time average assets in 11 months grew 23.4%, with the growth accelerating steadily throughout the year.

Thus, in October – November federal currency debt holdings in the portfolio of Russian banks reduced. The slump was caused not only by the sell-off of their currency-denominated government debt holdings, but because average assets at Russian banks in absolute values grew faster than federal currency debt holdings

³² Here and henceforth the turnover was calculated as a sum of purchase and sale.

and their prices. Still another explanation could be served by the redemption late in November of the first tranche of Russian Eurobonds for more than USD 1 billion.

A group of banks working with government hard-currency paper in 2001 with more than average federal currency debt holdings in the 9 months of 2001 cut their turnover with debt. While in 9 months the balances grew 43.8% in dollar terms, the turnover dropped by 3.3%.

However, in November the turnover grew almost by 60% in dollar terms from USD 2.3 to 3.8 billion. This heightened activity over the period could be attributed to the redemption of the first tranche of Russian Eurobonds.

During the three quarter of the year prices for federal currency bonds and Russian Eurobonds grew faster than the federal currency debt holdings of the Russian banks. Prices for federal currency bonds grew over 9 months between 17.6% and 48.8% depending on the issue, and for Russian Eurobonds between 11.3% and 25% while Russian federal currency debt holdings of an average Russian bank (less ARCO banks, Sberbank and Vneshtorgbank) grew almost 7% in dollar terms.

For a group of banks dealing in government debt with more than average federal currency debt holdings, the annualized weighted average revenue to assets ratio over 11 month of 2001 was 1.77%. At the same time, for the entire 2000 the ratio was only 1.54%. For an average Russian bank the ratio stood at 1.3% in 2000 and 2.1% annualized over 11 months. As a result, banks with federal currency debt holdings higher than Russia's average which dealt on this market appear less profitable after 11 months of 2001 compared to an average Russian bank.

Apart from lower profitability, banks that preferred to invest in federal currency debt look on the whole less capitalized by comparison with an average Russian bank (their capital ratio is 12.6% against 18.65%). The gap though is gradually closing.

The capital ratio in this group of banks was on average 11.8% at the start of 2001 to reach 12.6% by December. Over 9 months assets grew almost at the same rate as the balance capital (25.6% vs. 26.7%). But then in the subsequent 2 months there was a major shift: assets grew by 4.3%, whereas the capital rose by a whole 10.2%. An average Russian bank in October – November also increased their capital ratio from 17.9% to 18.65%, although falling slightly short of the level at the start of the year (18.8%).

Table 5

Some indicators of the balance where federal currency debt holdings in assets are higher than average (in percentage of assets by the end of the month)

Indicators in % of assets**	Russian banks*		Banks with higher than average federal currency debt holdings in assets	
	12.00	11.01	12.00	11.01
Foreign currency assets	44.3	41.7	53.2	52.1
Assets in the banking sector,	43.3	38.9	38.4	38.5
of which denominated in currency	22.6	20.5	23.0	22.8
Loans to non-banking sector,	37.4	43.3	34.6	37.1
of which denominated in currency	15.3	16.2	15.7	15.9
Debt and stocks,	8.4	6.7	17.8	14.3
of which denominated in currency	4.8	3.2	12.7	10.4
Federal debt,	6.2	4.3	13.1	11.6
of which denominated in currency	3.6	2.7	9.6	9.5
Accounts of non-financial sector,	27.9	25.4	25.6	30.7
of which denominated in currency	7.2	5.6	6.8	9.4
Deposits,	20.5	23.4	29.1	28.2
of which denominated in currency	14.7	16.4	23.8	21.0
Deposits of legal entities,	14.5	15.3	23.5	19.8
of which denominated in currency	10.9	11.4	19.9	15.2
Private deposits,	6.0	8.1	5.6	8.4
of which denominated in currency	3.7	5.0	3.9	5.8
Balance capital	18.8	18.6	11.6	12.3
<i>For reference:</i>				
<i>Average assets in billion rubles</i>	<i>1.11</i>	<i>1.47</i>	<i>4.46</i>	<i>5.84</i>

Estimated from data of CBR and STiK.

*less Sberbank, Vneshtorgbank and banks under ARCO administration

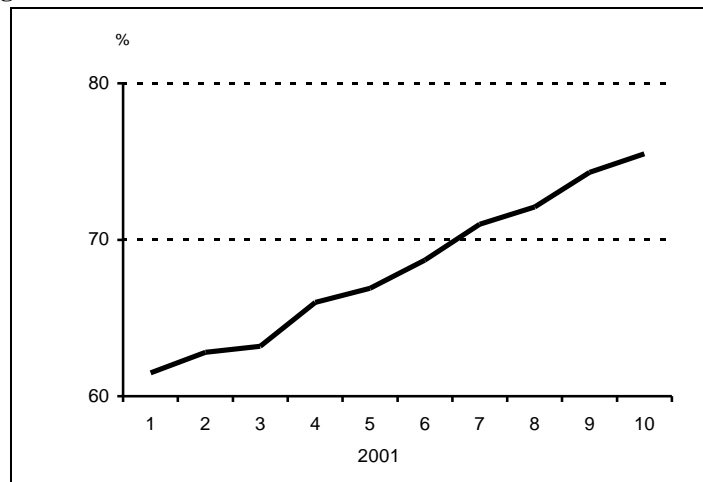
** here and henceforth a weighted average for the group of banks

Banks on ruble-denominated government debt market

In the structure of players on the GKO-OFZ market, the share of the banking sector from the start of the year tended to grow while the proportions of non-residents and non-banking sector dwindled. By the end of October 2001, the banking sector accounted for 75.3% (against 61.5% at the start of the year – see Fig. 6), which continued the 2000 trend where the proportion of the banking sector grew, among other things, at the expense of non-residents.

FIG. 6

The changing proportion of the banking sector in the aggregate GKO-OFZ holdings in 2001



Source: Central Bank of Russia

However, the data published by the Central Bank of Russia about the holders of the government bonds include its own, Central Bank's, share in the aggregate GKO-OFZ holdings. The participation of commercial banks proper in the aggregate GKO-OFZ holdings can be derived from their balances. Various indicators of their participation point to a fall in what never was an active involvement of the banks in this segment in 2001.

At the start of the year out of more than 1,300 active banks, 680 banks had in their holdings ruble-denominated federal debt paper³³. By the end of September, the number of banks with ruble federal debt holdings dropped to 612. At the same time, the aggregate GKO-OFZ holdings with Russian banks, in three quarters of 2001, grew 35% - from Rbs 103.2 billion to Rbs 139.4 billion.

Instead, there were more banks dealing in GKO-OFZ: while in December 2000 the turnover in those transactions was reported by 378 banks, in September 2001 they numbered 421. In absolute terms, the aggregate turnover of all active Russian banks showed a different pattern: while in December 2000 the turnover was Rbs 54 billion, in September 2001 the amount dropped to Rbs 41 billion. At

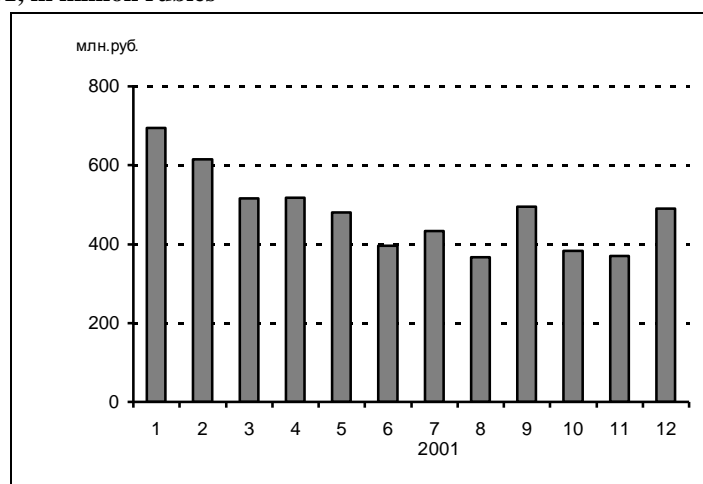
³³ Further consideration excludes banks under ARCO administration.

the same time, if one discounts an almost 100 percent reduction in the government debt turnover reported by Sberbank (from Rbs 26.5 billion in December 2000 to Rbs 13.9 bln. in September 2001), there will be no significant reversal in the turnover of the rest of the dealing banks in three quarters of 2001: Rbs 27.4 billion in December 2000 and Rbs 27.2 billion in September 2001.

GKO-OFZ are traded at eight Russian trading floors where MICEX is a leader. Banks are actively trading on the secondary ruble debt market. At MICEX, over 90% dealers are banks. The December turnover in ruble government debt was about Rbs 12 billion, which is 15% more than in December 2000. Figure 7 shows that the average daily secondary trading turnover in 2001 was going down throughout the first half of the year. There was no clear-cut pattern in the later half.

Fig. 7

Average daily secondary trading in GKO-OFZ at MICEX in 2001, in million rubles



Note: November and December values are less voluntary swaps of issue 25030
Source: Finmarket

Let us discuss the operations of the Russian banks that are the leading players on the GKO-OFZ market at the respective MICEX section. The sample is based on the lists published by MICEX and comprising GKO-OFZ dealers with the highest trade turnover on the secondary market, which includes both trades on account of dealers and the ones made for the clients. In August and September,

the list had 29 banks and 1 investment company. Among the top five dealers were Sberbank, DeutscheBank, Credit Suisse First Boston, Vneshtorgbank and Citibank. We dropped Sberbank from the discussed samples since it accounts for more than 70% of ruble federal debt holdings of Russian banks.

The list of active dealers in the GKO-OFZ section at MICEX is relatively stable. According to September – August and December – November data in 2001, 21 banks *comprised the permanent group of active players in the period and were included in all lists drawn at that time.* The banks in this group were used for further analysis.

The aggregate turnover for the selected banks in September accounted for 28% of the aggregate turnover in GKO-OFZ by all active Russian banks with the exception of Sberbank (Table 10).

The proportion of ruble federal debt holdings in the assets of the leading GKO-OFZ operator banks was higher than that of an average statistical Russian bank (3.2% vs. 6%). In the first six months the proportion dropped 1.4 times to 2.3% by 1 July (less Sberbank). In the third quarter, the decline continued so that by October the relevant value was 1.8%, a 1.8-fold reduction over three quarters of 2001.

Shrinking ruble debt holdings in the three quarters of 2001 were equally typical of an average Russian bank. The ruble federal debt holdings in the assets of an average statistical Russian bank (less Sberbank) by the end of September accounted for 1.75%, having dropped almost 32% since the beginning of the year.

As a result, the year 2001 showed a trend towards a closing gap between the ruble federal debt holdings of the more active GKO-OFZ operator banks and that of an average Russian bank. By quarter four, the difference was a meager 0.05% (the ruble federal debt paper held by the active GKO-OFZ operator banks accounted for 1.8% of the assets against Russia's average of 1.75%). Given the universally decreasing proportion of ruble debt paper in the assets of Russian bank, the holdings of the GKO-OFZ group of banks were more pronounced (44% vs. 32%). In absolute terms, the ruble federal debt holdings of the leading operators of the GKO-OFZ market at MICEX also dropped almost 27% over the three quarters of 2001 while overall for all Russian banks (less Sberbank and banks under ARCO administration) the respective value was 12.1%.

The average amount of assets for the sample group of banks by the end of the third quarter was by an order of magnitude higher than the average value for Russian banks (Rbs 27.5 billion vs. Rbs 1.5 billion).

The banks that were incorporated in the sample group proved more profitable over 9 months of 2001 by comparison with an average statistical Russian

bank (revenues to assets ratio, annualized, stood at 2.6% vs. 1.9%), or an average Moscow bank³⁴, with its 1.7% ROA annualized over three quarters of 2001.

The current activity of the GKO-OFZ operators is low. Suffice it to say that the turnover for the above instruments is lower than balances on accounts while pre-crisis a monthly turnover exceeded 2 to 3 times the balances on accounts used to record GKO-OFZ trades. In 2001, the turnover to balances ratio stood at 69% at the start of the year, to grow slightly to 78% by October.

The sample group of banks showed the overall drop in the turnover and ruble balances for federal debt. However, turnovers were falling slower and as a result the turnover to balances ratio in the group had a 35% growth in September compared to December 2000 (Table 4). An average Russian bank (less Sberbank) showed a different pattern: GKO-OFZ trades turnover was falling while balances grew. At the same time, the turnover to balances ratio increased 12% in September 2001 compared to December 2000. If one was to consider the pre-1998 period, one would notice in the GKO-OFZ turnover (Table 5) a very sharp fall by a factor of 4.3. The Russian ruble debt turnover to balances ratio fell to almost one third.

Table 6

Indicators of trading activity of banks operating on GKO-OFZ market through MICEX

	December 2000	September 2001
Monthly turnover to GKO-OFZ holdings at the end of month, %	53.7	72.6
Dynamics of turnover (change in the value against December 2000), %	-	-1.4
Dynamics of the absolute value of the holdings (change in the indicator against December 2000), %	-	-27.0
Dynamics of turnover/holding ratio (change in the indicator against December 2000), %	-	35.1

Table 7

Indicators of trading activity of Russian banks on GKO-OFZ market

	February	June 1998	December	September
--	-----------------	------------------	-----------------	------------------

³⁴ Here and henceforth, unless otherwise specified, Sberbank and banks under ARCO administration are not included.

	1998	2000	2001
Aggregate turnover in GKO-OFZ, end of month (bln. rubles)	117.6	153.2	27.2
Aggregate GKO-OFZ holdings, end of month (bln. rubles)	51.7	46.9	34.9
Monthly turnover to GKO-OFZ holdings at the end of month, %	227.6	326.7	78.0
Dynamics of turnover (change of indicator against June 1998), %	-	-	-82.2
Dynamics of the absolute value of holdings (change of indicator against June 1998), %	-	-	-25.6
Dynamics of turnover/holdings ratio (change of indicator against June 1998), %	-	-	-76.1

Note: less Sberbank and banks under ARCO administration

Table 8

Aggregate turnover of banks operating with ruble federal debt on major trading floors

Banks operating on GKO-OFZ market	Proportion of the aggregate turnover in ruble federal debt (%)		
	December 2000	June 2001	September 2001
Leading MICEX operator banks *	27.9	24.0	27.8
Participating banks at St Petersburg currency exchange	10.1	10.9	9.5
Participating banks at Urals currency exchange	3.9	5.0	5.0
Participating banks at Nizhniy currency and stock exchange	4.0	1.3	2.5
All banks with non-zero turnovers over the item of ruble federal **	100.0	100.0	100.0

Note:

* banks that were the most active participants in GKO-OFZ secondary trading in September – December 2001 (less Sberbank).

** - less Sberbank

Apart from MICEX, the other three most active GKO-OFZ trading floors are St. Petersburg, Urals and Nizhniy Novgorod currency exchanges. The rest of the trading floors, as of September 2001, accounted for merely 1.8% of the total GKO-OFZ turnover.

Banks participating in secondary GKO-OFZ trading at St. Petersburg currency exchange show a much smaller turnover compared to MICEX. The aggregate turnover recorded by GKO-OFZ operator banks at St. Petersburg currency exchange in September accounted for 9.5% of the total turnover of all banks

(barely one third of the MICEX figure). It constitutes 61% of the balances on accounts by the end of quarter three whereas at the start of the year it was up to 74%. The absolute value of the turnover did not change much throughout the year.

At another regional exchange, NNCSE, the aggregate ruble federal debt turnover by GKO-OFZ operator banks in September accounted for 2.5% of the total turnover of all banks. The aggregate turnover in ruble feds to the balances on accounts by the end of September stood at 60%. However, early in 2001 the picture was totally different, with the ratio of 150%. The turnover dropped 11.5% over the three quarters of the year, while balances grew 61%.

Of interest is also the situation at the Urals currency exchange. There, GKO-OFZ operators in September 2001 accounted for 5% of the total ruble federal debt turnover by banks. The ratio of the ruble federal debt to balances on accounts was 151%. The dynamics in this ratio since the beginning of the year were negative too: while in December 2000 the ratio was 411%, in June it dropped to 193%. The three quarters' turnover did not grow significantly (24%) while the balances on account in the same period grew 240%. The proportion of balances in total assets over the same period grew 2.5 times from 3.6% to 9%.

Thus, in the mid-and long-term perspective, the investing Russian banks will continue to regard the government debt paper denominated in hard currency as the most attractive of all federal debt instruments, the fact proved by a considerably higher proportion of currency-denominated federal debt over ruble debt in the total federal debt holdings of the Russian banks (for an average statistical Russian bank (less Sberbank) currency-denominated federal debt by the end of quarter three in 2001 accounted for 74% versus 26% of the ruble federal debt).

Banks on corporate and bank debt market

Over the past two years the market for ruble corporate and bank bonds (CBBs) has been growing fast. The amount at par of all corporate debt offerings grew in a year from Rbs 38.9 to 65.6 billion. The secondary corporate paper market is growing fast too. For instance, at MICEX in 2001, the total secondary trades turnover for corporate bonds exceeded Rbs 27 bln., and in St. Petersburg trades turnover in CBBs in 2001 accounted for more than Rbs 500 million.³⁵

Nevertheless, this is the segment of the market that is only emerging, and its deals are still highly risky. Specifically, the CBB market shows low liquidity and

³⁵ Source: Finmarket Information Agency

high variations in the volume of trades. In addition, a number of events throughout the year had a negative impact on the corporate debt market. Late in March, the Central Bank of Russia banned non-residents from using their Type "C" accounts to purchase bonds of some Russian issuers (Inkor-Finans, BFA, Silicon). At the legislative level, there are as yet unresolved issues of secured bonds and the high bond issuance tax.

Banks were getting more actively involved in this segment of the Russian capital market over the discussed period. Banks engage in a variety of transactions at this segment: they issue their own bonds, act as underwriters, invest in corporate and bank debts acting as buyers at the time of initial placement, and deal on the secondary market.

The total turnover of Russian banks ³⁶ on the CBB market in November 2001 reached Rbs 13.5 bln., which is 2.9 times more than in December 2000. Additionally, the number of the banks operating on the CBB market with non-zero turnovers almost tripled by December since the beginning of the year (from 43 to 121), although it still remains a fraction of GKO-OFZ operators.

Note an important reduction in the gap between the banks' turnover in ruble corporate debt and in government paper. While in December last year the ratio between the government debt and corporate debt turnovers by the *banks* was 5.5 : 1, it was already 2.7 : 1 in November.

Let us discuss a sample of the banks that invested in ruble CBBs throughout 2001. The number in 11 months increased from 61 to 138 banks.

The amount of investment made by banks in corporate debt increased in 11 months 8 times (from Rbs 1.6 billion to Rbs 13.3 bln.), growing at a faster rate than turnovers. The proportion of CBBs holdings in the assets of banks investing in corporate debt grew almost 4.6 times (without Sberbank, this value is slightly lower: 4 times), while the ruble government debt in the assets of CBB holders had a reverse tendency and dropped by December 1.3 times (less Sberbank, the value would have been 1.9 times). Note, however, that the dwindling ruble federal debt holdings are typical of the banking sector in general.

The banks dealing in CBBs are much larger (less Sberbank) than an average Russian bank: the assets of the CBB-holding banks accounted for 63% in the aggregate assets of active Russian banks at the end of November 2001. A similar ratio for revenues was 67%.

For some of financial indicators describing CBB-holding banks, see Table 9.

³⁶ Less banks under ARCO administration

Table 9**Some indicators of CBB-holding banks ***

	01.01.01	01.12.01
Investment in non-government debt, in bln. rubles,	1.63	13.25
of which in resident corporate debt , in bln. rubles.	1.28	12.03
As a percentage of assets:		
Non-government debt in rubles,	0.26	1.04
of which debt of resident banks	0.06	0.10
of which debt of resident corporates	0.20	0.94
Ruble federal debt	2.61	1.36
Promissory notes in rubles	3.51	4.53
by banks	0.15	0.34
by corporates	3.36	4.19
Balance capital	15.61	16.70
Revenues (annualized)	1.96	2.26
<i>For reference:</i>		
<i>Average assets, billion rubles</i>	10.5	9.34
<i>Number of banks</i>	60	137

* less Sberbank

estimated from data by STiK

Let us discuss in more detail a group of banks acting as *bonds underwriters*³⁷ (16 banks) and bond *issuers* (16 banks at the end of September).

Data on 2001 bond offerings underwritten by banks is shown in Table 8.

The overwhelming majority of bond underwriters are major Moscow banks.

Let us discuss the group of *banks that underwrote corporate debt* in 2001³⁸.

Aggregate assets of the corporate debt underwriters among banks in 2001 stood at the end of November at Rbs 467 billion, or 23% of total assets of all active Russian banks. The average assets in this group of banks are Rbs 29 billion, which is 3.1 times that of the CBB-holding banks.

Table 10**List of bank underwriters of corporate bonds in 2001**

Banks	Bond issuers
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³⁷ The banks that underwrote their own bonds issues are not included here

³⁸ The group derives from the published data as of 1 December 2001

Avtobank	Urals-Siberian bank (Bashkreditbank)
Alfa Bank	ALROSA, Lianosovo Dairy Plant, OMZ
Zenith Bank	RITEK, Nizhnekamskneftekhim, SIBUR, Moscow City Telephone, Tatneft, Bashkreditbank
VBRR	MMK
GUTA-Bank	Invest-Inkor, Inkor-Finans , Moscow City Telephone
Trust and Investment Bank	Tyumenenergo, Moscow City Telephone, RTK-Leasing, ALROSA
NIKoil	OGO Grain
Impex-Bank	Tulachermet, Tatneft
ING Eurasia	TNK
MDM-Bank	NTMK, Bashinformsvyaz, Tsentrtelekom
Promsvyazbank	Krasnaya Presnya sugar factory
Promstroibank (St. Petersburg)	Murmansk Shipping Company
Reiffeizenbank	SIBUR, Tsentrtelekom
Rosbank	Aeroflot, MMK
Northeastern investment bank	Silicon
Bank of Moscow	Moscow Bakery Factory

Sources: www.micex.ru, www.cbonds.ru, Finmarket Information Agency.

Underwriters, as a rule, are active investors. Throughout the year, corporate debt holdings of bank-underwriters grew 7 times in absolute terms, and by the end of September amounted to an average of Rbs 6.1 billion. The proportion of CBBs in the assets of these banks rose from 0.3% to 1.3%, thus exceeding a similar indicator for CBB-holding banks by 20%. Of all CBB holdings with CBB underwriting banks only 4% were bank debt, which is understandable since bank debt accounts for a smaller fraction of the non-government paper market.

However, profitability of the CBB-underwriting banks in 11 months amounted to 1.61% annualized, which is considerably less than Russia's average (2.3%).

The bulk of CBB-underwriting banks (14) have also holdings of ruble government debt. Bond underwriters among banks in the past year cut by half the proportion of ruble federal debt holding in the assets: from 2.6% to 1.14%. It was a bigger reduction than both at an average Russian bank and in the group of banks operating on the CBB market.

The conclusion then is that the CBB-underwriting banks this year were keen to rather acquire corporate debt than ruble government debt, compared to banks that simply traded in corporate bonds. There is an ever growing interest on part of potential investors to both corporate and bank debt. Banks are no exception, and

among professional operators on the corporate and bank debt underwriting market, the leaders are banks. The leading commercial banks have been underwriters or co-underwriters of many bigger corporate and bank debt issues.

However, some investment companies are taking over the banks in the number of underwritten issues. As a result, more competition is expected between banks and investment companies for CBB underwriting.

Some of the financial indicators of debt-underwriting banks are shown in Table 11.

Table 11

Some indicators of CBB underwriter banks

	01.01.01	01.07.01	01.10.01	01.12.01
Investment in non-government debt, in bln. rubles,	0.84	2.67	4.27	6.12
of which in resident corporate debt, in bln. rubles.	0.77	2.46	3.91	5.87
As a percentage of assets:				
Non-government debt in rubles,	0.25	0.66	0.99	1.31
of which debt of resident banks	0.02	0.06	0.08	0.05
of which debt of resident corporates	0.23	0.60	0.91	1.26
Ruble federal debt	2.64	1.91	1.28	1.14
Promissory notes (wechzels) in rubles	4.12	3.77	3.45	3.51
by banks	0.35	0.16	0.12	0.13
by corporates	3.77	3.61	3.32	3.38
Balance capital	15.94	13.97	14.03	13.32
Revenues (annualized)	2.13	1.77	1.86	1.61
<i>For reference:</i>				
<i>Average assets of a bank in the group, billion rubles</i>	20.79	25.47	26.98	29.18

Let us discuss now the bond-issuing banks. In 2001, the number of banks that issued their bonds ranged between 12 and 16. By the start of 2001, banks issued a total of Rbs 4.7 billion in debt, Rbs 5.6 billion by the start of quarter two, Rbs 3.3 billion by the third quarter and Rbs 4.2 billion by the fourth. The proportion of the issued debt in the liabilities of the this group of banks also diminished since early in the year (from 3 to 2%)³⁹.

³⁹ Less Vneshtorgbank, the proportion of issued debt paper in the liabilities of the issuer banks dropped from 8.5 to 4%

The regional pattern of issuer banks is quite regular (as of the end of November): half of all issuing banks are located in Moscow and Moscow Oblast, three banks in St. Petersburg, and the rest in other regions.

In the later half of 2000 the few banks that resorted to the instrument preferred long-maturing debt (with more than 3 years maturity). By the start of 2001, of all the bank bonds, bonds maturing between one and three years accounted for Rbs 1 billion, and those with more than 3-year maturity, for Rbs 3.5 billion. The bonds maturing in under one year accounted for less than Rbs 200 million. By the end of September, the maturity structure changed somewhat: those maturing between 1 and 3 years accounted for almost Rbs 2 billion, and those with more than 3-year maturity, for only Rbs 1.3 billion. The amount of outstanding debt with a short maturity grew to Rbs 900 million. Thus, in 2001, debt-issuing banks showed a preference for shorter maturities.

Let us apply certain indicators to characterize issuer banks.

The assets of bond issuers accounted for 10% in the overall assets of active Russian banks by the end of November of 2001 года, while average assets of issuer banks were 8 times as high as those of an average statistical Russian bank (less Sberbank).

The group of debt issuers throughout 2001 showed a very high proportion of federal debt in their assets: almost 30% at the start of the year and about 25% by the end of November⁴⁰. The bulk of this amount is composed of the currency-denominated government debt: on average, 94% of the total. The pattern is largely due to Vneshtorgbank: it accumulated 98% of all currency federal bonds in the group at the start of the year, and 88% by the end of November (in terms of its currency federal debt holdings, Vneshtorgbank is followed by the bank Novaya Moskva, which has only 1/12th of the amount). Less Vneshtorgbank, the ruble federal debt holdings in the assets of the issuer bank groups is close to Russia's average (by December, ruble federal debt holdings accounted for 1.5%, with 1.6% average for all banks).

For purposes of analysis, we shall exclude Vneshtorgbank, the uncontested leader, from the discussed group of issuer banks. Note that deposits in the liabilities of the resulting group account for a smaller percentage than with an average Russian bank. Specifically, private deposits in this group accounted for 7.5% of liabilities, and corporate deposits, 11.9%, while in an average Russian bank the values are 8.1% and 15.3%, respectively. Therefore, bonds in the liabilities of issuer banks

⁴⁰ For comparison, in an average Russian bank, less Sberbank, investments in government paper at the start of the year accounted for 8.6% to drop to 6.2% by the end of November.

“substitute” for another time instrument for the mobilization of resources, viz. deposits.

The issuer banks have also shown preponderance for such a financial instrument as ruble promissory notes (wechzels). By the end of December their proportion in the liabilities of the issuer banks grew to 6.5% versus 5.1% of an average Russian bank. The preference is for this wechzel-based financing: the volume of outstanding wechzels from issuer banks is 1.6 times bigger than the outstanding bonds, and at the start of 2001 the gap was even wider: 2.7 times (Table 13).

Table 12

Some indicators of bond-issuing banks

	01.01.01	01.07.01	01.10.01	01.12.01
Outstanding ruble bonds, in billion rubles	4.70	3.34	4.20	4.07
Outstanding ruble wechzels, in billion rubles	12.61	7.27	8.59	7.83
As a percentage of assets:				
Non-government debt in rubles,	0.27	0.04	0.49	0.35
of which debt of resident banks	0.10	0.00	0.16	0.00
of which debt of resident corporates	0.16	0.04	0.33	0.35
Ruble federal debt	1.40	0.37	1.94	1.54
Promissory notes (wechzels) in rubles	14.23	8.94	8.83	8.76
by banks	0.99	0.81	0.38	0.35
by corporates	13.24	8.13	8.45	8.41
Outstanding ruble bonds	8.48	3.09	3.08	4.00
Outstanding ruble wechzels	8.18	7.81	6.83	6.47
Balance capital	17.69	19.64	17.37	21.76
Revenues (annualized)	0.99	1.01	1.01	1.64
<i>For reference:</i>				
<i>Average assets of a bank in the group, billion rubles</i>	<i>4.37</i>	<i>5.83</i>	<i>7.40</i>	<i>5.11</i>

* less Vneshtorgbank

Estimated from data by STiK

Banks on corporate deposits market

The overall corporate deposits market in Russia at the start of 2001 was estimated to be worth Rbs 220 billion . By the end of the third quarter, the amount

grew to Rbs 290 billion. After the 1998 crisis year, this is one of the faster growing segments of the banking market.

In 2000, the volume of assets placed in time deposits by corporates grew 80%, in 11 months of 2001, another 39%, which, in constant prices, was 50% and 18.5%, respectively. In the bank liabilities, the share of corporate deposits grew from 10% early in 2001 to 13% by December 2001.

Corporate ruble deposits

The ruble segment of this sector of the banking market is relatively small. By 2001, the overall amount of deposits made by corporates stood at Rbs 57.8 billion plus another Rbs 21.6 billion of deposit certificates. Throughout 2001, the amount of the deposits raised from corporates more than doubled, and deposit certificates, tripled. By the fourth quarter of 2001, the ruble component of the corporate deposits amounted to Rbs 78.7 billion, having grown 36% in three quarters.

The ruble deposit market is not highly concentrated, on the one hand, and shows a relatively small group of banks working there, on the other. Corporate deposits were raised by slightly more than by half of the banks. If one is to exclude banks under ARCO administration, by 2001 the leader – Rosbank – accounted for about 20% of the total ruble deposits raised. Sberbank and MMB held another 6% each. As a result, three leaders had 32% of the market, and the top 10 players on the market accounted for 53%. Of the top 10 leaders, apart from Moscow banks, there were 3 regional banks (Urals-Siberian bank, Promstroibank from St. Petersburg, and Zoloto-platina bank), and one 100 percent foreign equity bank (Citibank). Overall, Moscow-based banks (less Sberbank) held nearly 64% of corporate deposits by value. By the end of quarter three, the situation changed as Rosbank's market share plummeted, and it dropped to the second place, with 7.3% of the market, ceding its leadership to MMB with 8.6%. The MMB's growing market share was not directly related to its merger with the Bank of Austria, since ruble deposits of the latter accounted for less than 1% of such deposits at MMB. The third place went to BIN Bank, which moved up from its 87th place having raised its share from 0.11% to 5.5%, and jumped ahead of Sberbank, which had only 4.5% of the total corporate ruble deposits. The summary share of the three leaders increased slightly to 21.5%, while top 10 banks had 42% of the market between them.

The structure of the deposit certificates market, although smaller, has a higher degree of concentration. Over half of all certificates of deposit issued by 2001 were issued by only two banks: Trust and Investment Bank and Menatep

(St. Petersburg), whose business is not exactly independent, since both belong to the same group. The third place went to Sberbank (5% of the market); all in all, the product was offered by less than 100 banks. Over three quarters of 2001, the situation changed little: only Sberbank's share of the market grew to 7.7%, and the number of banks on that market increased to 109.

Market structure by maturity

The ruble deposit market is short-term: most of the capital raised was for the maturity of under three months (over 43%, of which about 60% was raised by Moscow banks) (Table 11). The second most popular term of the deposits is over 12 months. Regional banks raised deposits for longer terms than Moscow banks. Over 40% of the raised deposits had a maturity of over one year, while those under three months accounted for 17% of all ruble deposits.

Table 13

Maturity structure of corporate ruble deposits by the start of 2001 (in percent)

Deposits by resident corporates:	Banks raising ruble deposits (less banks under ARCO administration)			
	All active banks	All active banks less Sberbank	Banks in Moscow and Moscow Oblast, less Sberbank	Regional banks
Oncall deposits	2.5	2.2	2.9	0.9
Maturing in 90 days	43.8	43.4	57.5	16.1
Maturing between 91 and 180 days	17.1	17.1	15.8	19.7
Maturing between 181 days and up to one year	13.6	13.5	9.1	22.1
With a maturity of more than a year, of which with maturities over 3 years	23	23.7	14.6	41.3
<i>For reference:</i>				
<i>Average assets (in current prices, billion rubles)</i>	3.08	2.15	4.32	0.91
<i>Number of banks</i>	593	592	216	376

Source: estimated from data by STiK

Data as of the end of September 2001 suggests that the situation has somewhat changed. The proportion of short deposits with a maturity under 3 months with the Moscow banks dropped, triggering a change in this ratio for all of the banks, despite a growth in this proportion at regional banks from 16.1 to 21.6%. At the same time, regional banks saw a smaller proportion of deposits with a ma-

turity over one year which dropped from 41% to 29%. Moscow banks, instead, improved their ratio to 23.9% from 14.6%. They also had fewer deposits maturing between 6 and 12 months. As a result, maturities for corporate deposits somewhat lengthened.

Table 14

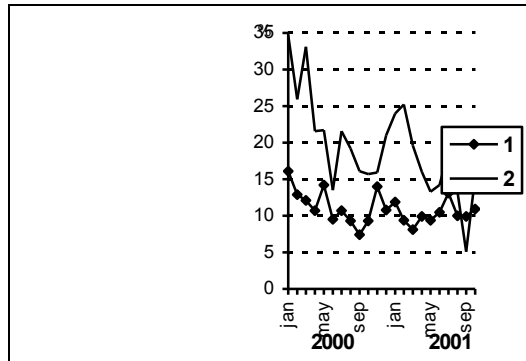
Maturity structure of corporate ruble deposits as of 01.10.2001 (in percent)

Deposits by resident corporates	Banks raising ruble deposits (less banks under ARCO administration)			
	All active banks	All active banks less Sberbank	Banks in Moscow and Moscow Oblast, less Sberbank	Regional banks
Oncall deposits	2.6	2.4	3.2	1.2
Maturing in 90 days	31.2	31.5	38.0	21.6
Maturing between 91 and 180 days	23.8	23.5	21.4	26.7
Maturing between 181 days and up to one year	17.1	16.6	13.5	21.4
With a maturity of more than a year, of which with maturities over 3 years	25.4	25.9	23.9	29.1
	13.0	13.5	13.6	13.3
<i>For reference:</i>				
<i>Average assets (in current prices, billion rubles)</i>	3.28	2.35	4.18	1.02
<i>Number of banks</i>	778	777	327	450

Source: estimated from data by STiK

The return on deposits with a maturity over one year in 2000 – 2001, according to the Central Bank of Russia, was noticeably higher than that on more popular three-month deposits (Fig. 8).

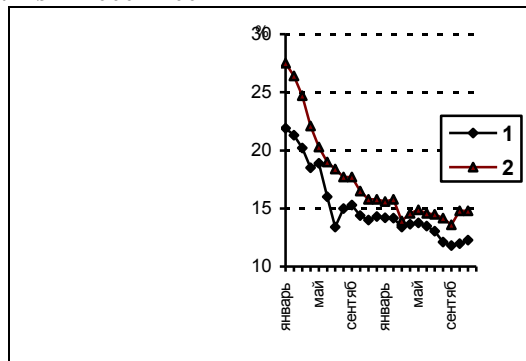
Fig. 8
Offered rate for corporate ruble deposits in 2000 - 2001



1 – maturities between 31 and 90 days
 2 – maturity over 1 year
 Source: Central Bank of Russia

Sharp variations in the offered deposit rates seen in the series published by Central Bank of Russia for all deposit maturities as well as for other instruments will smooth out, if one is to analyze the dynamics of the rates offered by Moscow banks and published by Finmarket Information Agency (Fig. 9).

Fig. 9
Dynamics of corporate ruble deposit rates offered by Moscow banks in 2000 - 2001

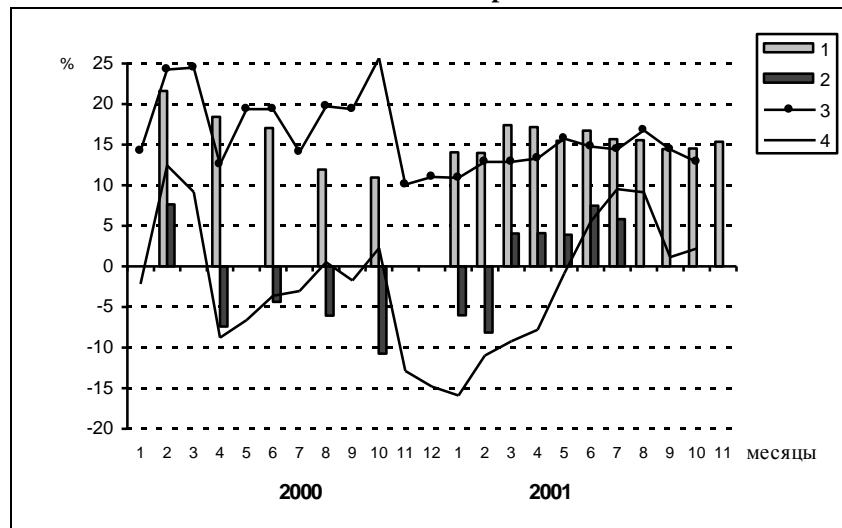


1 – 3 month maturity
 2 – maturities up to 6 months
 Source: Finmarket

The analysis of Russian statistics suggests that open market investments prior to 1998 had a higher rate of return than bank deposits. This was no longer true in 2000 - 2001. The yield of GKO issues placed in that period was, for the most part, close or lower than the deposit rates in the same period. For comparative returns on deposits and GKO, provided the latter were purchased at any of 2000 – 2001 auctions, see Fig. 10.

Fig. 10

Nominal and real rate of return on ruble deposits and GKO in 2000 - 2001



1 – nominal non-redeemed GKO yield

2 – effective GKO yield

3 – nominal rate of return on corporate ruble deposits maturing between 91 and 180, subject to re-investment

4 – real rate of return on corporate ruble deposits maturing between 91 and 180 (for calculation purposes, the term of deposits is 3 months).

Source: estimated from data by the CBR and Finmarket

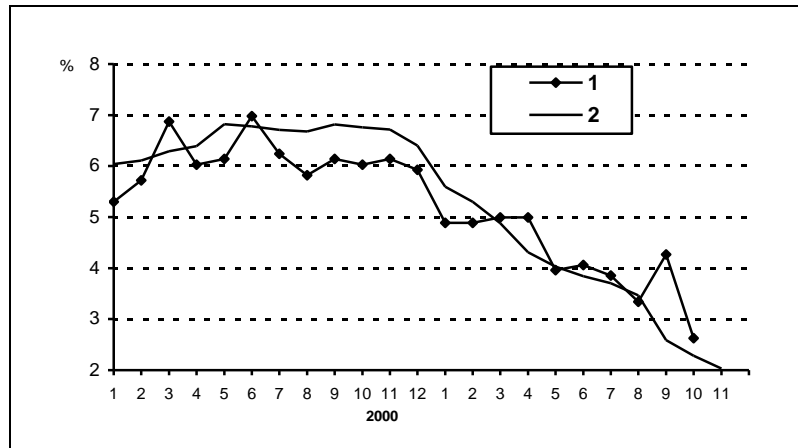
As the figure shows, the lower inflation rates offered better conditions both for GKO investors and depositors, from the point of view of real rate of return. Starting with the auctions in March 2001 and deposit contracts from June 2001, the rate of return for these instruments, adjusted for inflation, remained positive.

Corporate currency deposits

Despite the trend towards de-dollarization of the balances, the foreign exchange segment of the corporate deposits market remains more capacious than the ruble segment. As of the end of quarter three of 2001, it amounted to about USD 7.2 billion. However, given a more stable or stronger ruble, the offered deposit rates fail to result in positive rates of return in real terms.

Fig. 11

LIBOR and corporate currency deposit rates in 2000 - 2001



1 – deposit rate in dollars for maturities between 30 and 90, subject to reinvestment

2 – 3 month LIBOR, in USD

Source: CBR, Finmarket

The rates that banks offered for these deposits were close to 3 month LIBOR in US dollars (Fig. 11). Taking into account the changing ruble-to-dollar exchange rate, for the most part of the year the rate of return on such deposits was close to that of the ruble deposits in the same period, in contrast to 2000, when the ruble-denominated rate of return of currency deposits for the most part of the year was smaller than the offered rates for ruble deposits in the same period. However, as a result of price growth, the rate of return on currency deposits remained negative for the most part of the year (Fig. 12). At the same time, rates that Moscow banks offered for dollar deposits varied significantly, ranging in 6 month maturities from 5% to 13.75% in March and from 2.5 to 12% in November.

Fig. 12

Compared rates of return for ruble and currency deposits in 2000 - 2001



1 – rates for ruble deposits with 30 – 90 days maturities, subject to reinvestment

2 – nominal rate of return on currency deposits adjusted for ruble-dollar exchange rate

3 – rate of return on currency deposits, adjusted for ruble-dollar exchange rate and inflation in Russia (real rate of return of currency deposits converted to rubles)

Note. For calculations, the deposit maturity was three months

Source: CBR, Goskomstat of Russia

The most widespread maturity for currency deposits raised by banks in 2001 was from 30 to 90 days (Table 14). Maturities in Moscow banks distributed relatively evenly, and longer deposits with maturities over 12 months accounted for more than a quarter of all raised amounts. The overall amount of currency deposits raised by the banks for a term of 12 months and longer at the start of the year stood at ca. USD970 million.

By the end of quarter three of 2001, both Moscow banks and regional banks significantly increased the share of currency corporate deposits with maturities over one year. While at regional banks, the proportion of deposits with maturities under 3 months remained virtually unchanged, at Moscow banks it dropped considerably (from 26% to 16%). All banks definitely increased their proportion of deposits with maturities over 6 months as the proportion of deposits with maturities between 3 and 6 months shrank. As a result, during the year clients of the Russian banks opted for longer deposits.

Table 15

Maturity structure of US dollar deposit at the end of 2000 года (in percent, less banks under ARCO administration)

Maturity	Banks raising deposits from resident corporates			
	All active banks	All active banks less Sberbank	Banks in Moscow and Moscow Oblast, less Sberbank	Regional banks
Oncall	0.5	0.4	0.6	0
Up to 90 day	49.3	51.4	26.4	86.2
From 91 to 180 days	16.3	15.5	22.9	5.2
From 181 days to 1 year	16.2	16.4	23.5	6.5
Over 1 year,	17.7	16.4	26.6	2.1
of which over 3 years	6.2	6.7	10.7	1.0
<i>For reference:</i>				
<i>Average assets (in current prices, billion rubles)</i>	<i>10.11</i>	<i>6.70</i>	<i>8.99</i>	<i>3.40</i>
<i>Number of banks</i>	<i>160</i>	<i>159</i>	<i>94</i>	<i>65</i>

Table 16

Maturity structure of USD corporate deposits by the end of September 2001 (in percent, less banks under ARCO administration)

Maturity	Banks raising deposits from resident corporates			
	All active banks	All active banks less Sberbank	Banks in Moscow and Moscow Oblast, less Sberbank	Regional banks
Oncall	0.8	0.7	1.2	0.0
Up to 90 day	44.1	46.2	16.2	84.2
From 91 to 180 days	8.7	7.5	12.1	1.8
From 181 days to 1 year	21.8	21.6	31.1	9.5
Over 1 year,	24.7	24.1	39.5	4.5
of which over 3 years	8.2	8.6	14.8	0.8
<i>For reference:</i>				
<i>Average assets (in current prices, billion rubles)</i>	<i>10.36</i>	<i>7.03</i>	<i>9.72</i>	<i>3.44</i>
<i>Number of banks</i>	<i>216</i>	<i>215</i>	<i>123</i>	<i>92</i>

Source: database by STiK

Apart from the low rate of return (below the one offered by currency government debt or Eurobonds) and shorter maturities, the currency deposits market had at least one other unfavorable feature, viz., the high level of concentration at this segment of the market. The two leaders, Surgutneftegasbank and MMB – at the start of 2001 accounted for about 60% of the capital raised by the banks. By the fourth quarter, the situation did not change much: the same two banks continued to hold almost 60% of the raised capital, whereas the top five banks (the two together with Trust and Investment Bank, Gazprombank and Sberbank) had virtually $\frac{3}{4}$ of the hard currency deposits.

4.6. Russian real estate market: the year of sustainable growth⁴¹

The analysis of the Russian real estate market in the aftermath of the August 1998 crisis, which was performed a year ago⁴², made it possible to draw the conclusion that by the end of the year 2000, the real estate market had passed the phase of *depressive stabilization* and entered the phase of *sustainable growth*.

The preliminary results of the sample monitoring of the residential property market in 10 cities were summarized in December 2001.

The obtained data showed that, as at the end of last year, the average specific bid price for apartments (in the US Dollar equivalent) had been rising through 2001 in all the sampled cities (Table 18).

⁴¹ This section makes use of the data obtained through the monitoring of residential property performed in 2001 by the Russian Guild of Realtors (RGR) jointly with the Russian Real Estate Agency SAVA, RMLS, the real estates agencies “Kontakt-Nedvizhimost”, “Miel”, NITsA (Moscow), the Information Publishing Group “Real Estate Bulletin”, the Information Publishing Center “The Peterburg Real Estate” (St.-Petersburg), the Realtor Information Center “The Urals Chambers of Real Estate” (Ekaterinburg), the agency “The Kaliningrad Real Estate” (Kaliningrad), “The Internet-laboratory” (Nizhny Novgorod), the Siberian Real Estate Agency (Novosibirsk), the Perm League of realtors and Appraisers, the OAO “Kamskaya Dolina”, the APN “Perm Real Estate Trading House” (Perm), the TITAN Agency (Tver), the ZAO “Real Estatet Center” (Ulyanovsk), the Real Estate Agency “Best-Realty” (Omsk) (the AEKSIP Agency of the Industrial Insurance company also participated in the calculations).

⁴² See: «The Russian economy in 2000. Trends and prospects». Issue 22. Institute of Economies in Transition, 2001.

Table 17
Changes in the average bid price for residential property in 1997-2001 (in the US Dollar equivalent)

Cities	Average specific price of apartments, \$/sq.m					Index				
	December 1997	December 1998	December 1999	December 2000	December 2001	1998/1997	1999/1998	2000/1999	2001/2000	2001/1997
Moscow	950	890	656	670/ 720*	890/ 940*	0.94	0.74	1.02/ 1.10*	1.33/ 1.31*	0.94**
St.-Petersburg	560	565	370	370	490	1.01	0.65	1.00	1.32	0.88
Ekaterinburg	535	335	220	336	484	0.63	0.66	1.53	1.44	0.90
Kaliningrad	620	470	330	323	360	0.76	0.70	0.98	1.11	0.58
N.Novgorod	538	450	265	280	301	0.84	0.59	1.06	1.08	0.56
Tver	355	265	186	203	260	0.75	0.70	1.09	1.28	0.73
Novosibirsk	490	280	210	263	435	0.57	0.75	1.25	1.65	0.89
Perm	505	180	182	287	390	0.36	1.01	1.58	1.36	0.77
Omsk	375	170	130	152	275	0.45	0.76	1.17	1.81	0.73
Ulyanovsk	340	135	134	158	230	0.40	0.99	1.18	1.46	0.68

Notes:

* - Data regarding Moscow: in the numerator the calculations were performed according to the methodology of 1993-1999, in the denominator the calculations were performed according to the new methodology;

** - To ensure the comparability of data, the index of average bid price for residential property in Moscow in 2001 as compared to 1997 was computed basing on the price of 2001 obtained through the old methodology.

The record price increase was registered in Omsk (1.81 times), and the lowest growth was recorded in Nizhny Novgorod (8%). The prices in St.-Petersburg had risen only slightly (by 11%). In Moscow the index exceeded 30%. The prices started to grow almost in all of the sample cities in 2000, but their dynamics were not synchronized: at the beginning of 2000, the residential property prices began to mount in Ekaterinburg and Perm, in the middle of same year - in Novosibirsk, Ulyanovsk, Omsk, Moscow and Tver, by the year end – in St.-Petersburg and Kaliningrad, and only in the middle of 2001– in Nizhny Novgorod.

However, in most of the cities, the residential property prices at the end of 2001 were by 10-40% lower than in the pre-crisis December of 1997. Moscow, Ekaterinburg, Novosibirsk and St.-Petersburg most closely reached the pre-crisis price level, while Kaliningrad and Nizhny Novgorod stood farthest.

The growth rates of real estate prices in Russian cities are linked to the rate of their reduction during and after the crisis: the closer (as compared to the pre-crisis level) the prices got to the lowest point, the sooner they began to grow and the faster are the growth rates (Table 18).

Table 18

Typical points of price dynamics in Russian cities between December 1997 and December 2001

City	12.97 \$/sq.m (=1)	Lowest point		Price level as at 12.2000	
		Index by 12.1997	Index reduc- tion against the 12.1997 level	Index by 12.1997	Index in- crease from the lowest point
Moscow	950	0.65	0.35	0.71*	0.06
Ekaterinburg	535	0.40	0.60	0.63	0.23
Novosibirsk	490	0.41	0.59	0.54	0.13
St.-Petersburg	560	0.62	0.38	0.66	0.04
Perm	505	0.33	0.67	0.57	0.22
Tver	355	0.48	0.52	0.57	0.09
Omsk	375	0.32	0.68	0.41	0.09
Ulyanovsk	340	0.37	0.63	0.46	0.09
Kaliningrad	620	0.47	0.53	0.52	0.05
Moscow	950	0.79*	0.14	0.94*	0.29
Ekaterinburg	535	0.78	0.38	0.90	0.50
Novosibirsk	490	0.70	0.29	0.89	0.48
St.-Petersburg	560	0.71	0.09	0.88	0.26
Perm	505	0.69	0.36	0.77	0.44
Tver	355	0.62	0.14	0.73	0.25
Omsk	375	0.48	0.16	0.73	0.41
Ulyanovsk	340	0.57	0.20	0.68	0.31
Kaliningrad	620	0.55	0.08	0.58	0.11

* - the indices were computed basing on the average bid prices for residential property in Moscow in 2000-2001 according to the old methodology.

The local economic and political environment imposed its specifics on the general regularity, provoking the acceleration (as in Novosibirsk or Moscow) or deceleration (as in Kaliningrad and Nizhny Novgorod) of the above scenario.

The first signs of the slowing growth rates appeared at the end of 2001 in those cities where the real estate prices most closely reached the pre-crisis level, i.e. in Ekaterinburg, Novosibirsk, to a lesser extent in Moscow; the growth rates

of the bid prices went down and, according to experts and heads of some Moscow real estate agencies, the actual transaction prices came to a standstill.

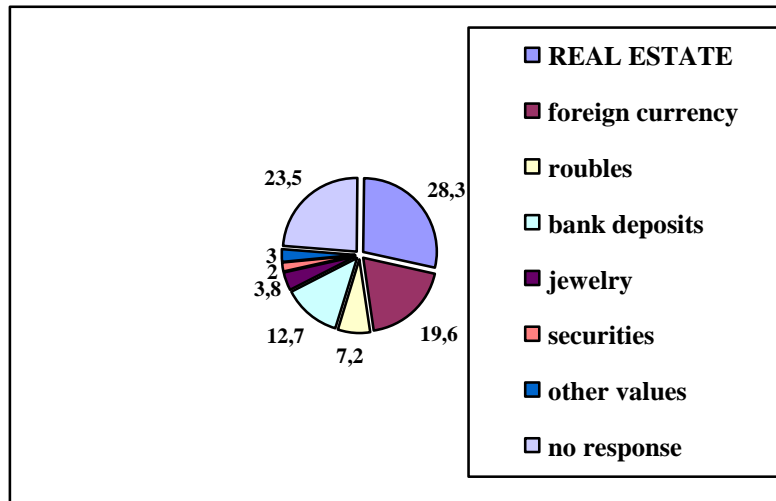
Correlation between demand and supply in the real estate market against the overall economic background

The favorable results of the social and economic development of Russia in 2000 made it possible to conclude that the real estate market in 2001 would be characterized by a steady growth of residential property prices. This forecast was supported by the upsurge of residential property prices in Ekaterinburg, Perm, Novosibirsk and other cities. In Moscow and St.-Petersburg, however, these projections were met with a fair share of skepticism, that is why the price boom in May 2001 was regarded as critical. The dramatic change in the real estate market was caused by the following two factors: *the growing demand* and *the falling supply*.

The rise of the market in 2000 was contingent upon the continued economic growth, which started in 1999, as well as the social, political and financial stabilization, which set in after the presidential elections in the spring of 2000. In 2001, the government predicted the deceleration of the economic growth rates as compared to the previous year, with a simultaneous reduction of the inflation rate and a growth of the rouble-to-dollar exchange rate.

However, the record high world oil prices during the first nine months of 2001 had ensured an influx of funds in the national economy, the growth of the people's real incomes and effective demand. The lack of other attractive investment targets had to inevitably affect the real estate market. Real estate agencies registered the increasing number of potential property buyers that at times provoked further escalation of the demand. For instance, according to the opinion poll of 500 adult Muscovites that was performed by the independent research center "The Russian public opinion and market research" (ROMIR - Gallup International) in the August of 2001, the purchase of real property remained the most popular personal savings scheme (Picture 1).

Picture 13
Muscovites' favorite personal savings schemes



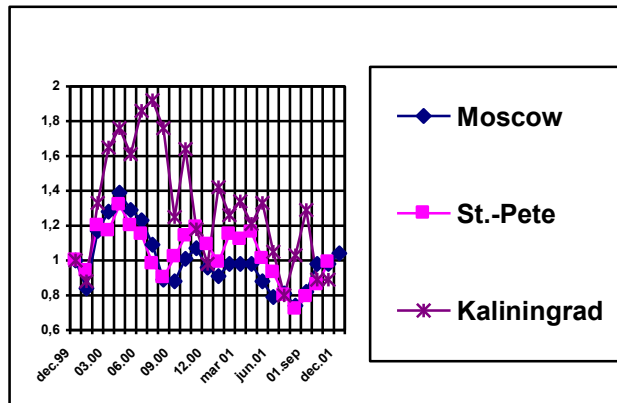
Data source: ROMIR - Gallup International, August 2001

The satisfied demand (i.e. the number of purchase and sale transactions) in the secondary residential property market during the first six months of 2001, as compared to the same period a year before, had grown in Moscow by 43% and in St.-Petersburg by 35%, and at the end of 9 months – by 31% and 30% respectively. The number of investment contracts in the Moscow primary market had grown during the first six months by 40%, and at the end of 9 months – by 31%. As a result, the actual growth rates of the residential property prices in Moscow and in the other sample cities (except for Kaliningrad and Nizhny Novgorod) had exceeded the expected rates, and as a result in June the projections for some cities were readjusted upward.

Starting from mid July 2001, the real estate markets of the two capitals demonstrated a steady increase of supply. In Moscow, supply almost regained the level of late 2000, while in St.-Petersburg it still fell short by 10-15%. At the same time, according to experts and heads of real estate and developing companies, the demand in the secondary and primary real estate markets in Moscow stabilized in October-November 2001. In Kaliningrad, where the prices are growing slowly, the supply continues to shrink (Picture 14).

Picture 14.

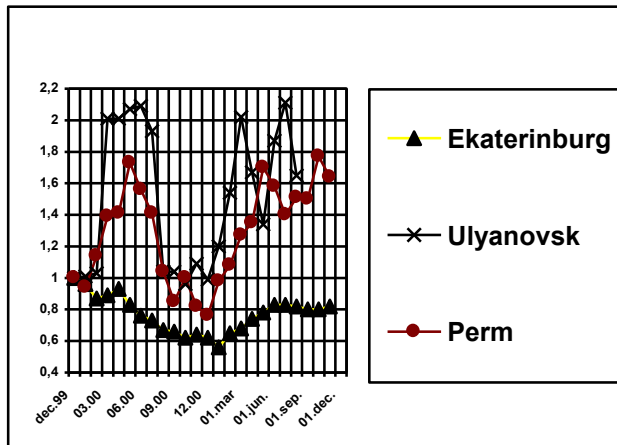
The dynamics of the supply index in the secondary residential property markets of Moscow, St.-Petersburg and Kaliningrad



The volume of supply in Perm, Ekaterinburg and Ulyanovsk had reached the level of mid 2000 even earlier (Picture 15).

Picture 15.

The dynamics of the supply index in the secondary residential property markets of Ekaterinburg, Perm and Ulyanovsk



That became the turning point in the tendency for the supply reduction in the residential property market, which started back in 1999 and at times caused confusion among the realtors (it climaxed in 2000 in Ekaterinburg and Perm, and in 2001 - in Moscow and St.-Petersburg). That was why quite a few experts were predicting another collapse of the real estate market.

A closer market analysis in Ekaterinburg revealed that the supply began to decline in 1999 (when the prices were falling slowly or remained stable) and continued to decline throughout 2000 (when the prices were growing fast), and in 2001 the supply turned upward and was accompanied by the ever growing prices (Picture 15).

The subsequent reaction of the real estate markets in most of the cities to the price escalation has confirmed the conclusions made in the autumn of 2000 (basing on the Ekaterinburg data) about a correlation between demand and supply in the residential property market:

- *the reduction of supply during the period of falling prices was **caused by** the sellers' reaction to the market situation because they did not wish to sell their property at low prices;*

- *the continued **reduction of supply during the period of growing prices was caused by the inertia of the market players**, which created a time lag (of almost one year) between the changed cause and the beginning changes of the effect;*

- *the subsequent growth of supply was **caused by** the sellers' reaction (albeit delayed) to the growing market prices;*

- and, consequently, **that reason** (*the increasing supply*) will entail as effect the transition of the market to the stage of *slow price growth and stabilization* (because according to the macroeconomic theory, the correlation between the changing supply and the changing prices manifests itself only at this stage of market development);

- these developments will occur with approximately the same time lag, i.e. from six months to one year from the starting point of supply growth.

The macroeconomic parameters and residential property prices

The macroeconomic parameters are indubitably a meaningful factor that affects the behavior of prices in the real estate market.

Table 3 below shows data for the last two years in the form of indices (as compared to the baseline period of December 1997) of the following parameters:

- The consumer price index (*the rouble inflation rate*);

- The rouble-to-dollar exchange rate index (*the rouble devaluation against the dollar*);

- *The dollar inflation rate* (the ratio of the rouble inflation rate to the rouble devaluation index);

The index of the dollar purchasing capacity in Russia against the consumer goods basket (the ratio of the rouble devaluation index to the rouble inflation rate).

Table 19

The dynamics of annual and accumulated macroeconomic indices

Macroeconomic indices	Annual indices				Accumulated indices			
	1998/ 1997	1999/ 1998	2000/ 1999	2001/ 2000	1998/ 1997	1999/ 1997	2000/ 1997	2001/ 1997
The rouble inflation rates	1.844	1.365	1.202	1.186	1.844	2.51	3.03	3.59
The rouble-to-dollar devaluation rate	3.365	1.34	1.044	1.076	3.365	4.51	4.71	5.07
The dollar inflation rate in Russia	0.55	1.02	1.15	1.10	0.55	0.56	0.64	0.71
The dollar purchasing capacity in Russia	1.82	0.98	0.87	0.91	1.82	1.80	1.55	1.41

Data source: the Goskomstat of Russia, the authors' estimates.

Following the sharp increase in August-September 1998 of the dollar purchasing capacity in Russia as compared to the consumer goods basket (by 82% in December 1998 as compared to December 1997), that index had remained stable through 1999, starting to decline in March 2000. In 2000 that index dropped by 13%, and by another 9% in 2001. These developments prompted the analysts to assume that the upsurge of the residential property dollar-denominated prices had been provoked by the dollar inflation. Nevertheless, the data listed in Table 3 shows that the dollar purchasing capacity, having grown in 1998 by 82%, at the end of 2001 still exceeded the pre-crisis level by 41%.

Consequently, the expected strengthening of the rouble position, similarly to the period of 2000-2001, will promote the growth of the dollar-denominated prices (*but not necessarily of the prices as such*) for all goods and services, including real estate. Basing on the macroeconomic parameters for 2002 adopted by the Russian Government, i.e. with the rouble inflation rate set at 12-14% and the rouble devaluation rate being equal to the average annual exchange rate of 31.5 roubles/dollar, the dollar purchasing capacity index may fall during the year by 3-5 p.p.

The reaction of the real estate markets to the macroeconomic parameters is expected to differ in the cities with rouble-denominated residential property pric-

es (Russia-2) and in the cities with dollar-denominated residential property prices (Russia-1).

In the cities of **Russia-2**, the similar escalation of residential property prices was observed during the upsurge of consumer prices (the inflation rate) in the autumn of 1998. The dynamics of dollar-denominated prices (as compared to the dynamics of rouble-denominated prices) in those cities was fully contingent on the changes in the rouble-to-dollar exchange rate. Consequently, this factor, given the 12-14% growth of consumer prices in 2002, will promote the increase of the residential property prices in this group of Russian cities by 10-14%, with the dollar-denominated prices (given the 5-7% increase of the rouble-to-dollar exchange rate) growing by 3-6%.

In the cities of **Russia-1**, the link between the price dynamics and the macroeconomic parameters is not that obvious. The index of dollar inflation in Russia is, to a certain extent, the driving force behind the dollar-denominated prices, similarly to the impact of the rouble inflation on the rouble-denominated prices. However, when comparing the dynamics of the dollar-denominated prices in Moscow with the dollar inflation rate during the past two years, it becomes obvious that between June 2000 and June 2001, when the dollar was weak, the residential property prices started to grow, albeit slowly, while during the second half of 2001, when the actual dollar exchange rate and purchasing capacity remained stable, the residential property prices sky-rocketed. With the dollar purchasing capacity declining at the rate stipulated in the official macroeconomic forecast for 2002, this factor should not significantly affect the price dynamics in the cities with the dollar-denominated residential property prices. The possible deviation of the actual consumer price index from the budgetary estimates (which the January 2002 inflation rate is indicative of) may promote the growth of the dollar-denominated residential property prices in both city groups.

The conversion of the indices of the changing nominal dollar and rouble prices into the comparable prices of the baseline period (with due account of the rouble as well as the dollar inflation rates) will help obtain the IGS⁴³ index (i.e.

⁴³ The IGS index was computed according to the following formula: $IGS = \frac{Irp}{Ici} = \frac{Idp}{Idi}$, where Irp is the rouble-denominated residential property price index, Ici is the consumer price index, Idp – the dollar-denominated residential property price index, $Idi = \frac{Ici}{Irdd}$ – denotes the index of dollar inflation in Russia (in relation to the dynamics of consumer prices), and $Irdd$ – the rouble-to-dollar devaluation index.

the index of the changing residential property value as compared to December 1997) (Table 20).

Table 20

Indices of changes in the nominal and relative value of residential property (in comparable prices) in Russian cities between 1997 and 2001

City	Indices of nominal value of residential property			
	1998/ 1997	1999/ 1997	2000/ 1997	2001/ 1997
Moscow	0.94	0.69	0.71*	0.94*
Ekaterinburg	0.63	0.41	0.63	0.90
Novosibirsk	0.57	0.43	0.54	0.89
St.-Petersburg	1.01	0.66	0.66	0.88
Perm	0.36	0.36	0.57	0.77
Omsk	0.45	0.35	0.41	0.73
Tver	0.75	0.52	0.57	0.73
Ulyanovsk	0.40	0.39	0.46	0.68
Kaliningrad	0.76	0.53	0.52	0.58
N.Novgorod	0.84	0.49	0.52	0.56

City	Indices of value of residential property in comparable prices of December 1997 (IGS)			
	1998/ 1997	1999/ 1997	2000/ 1997	2001/ 1997
Moscow	1.71	1.24	1.10*	1.32*
Ekaterinburg	1.14	0.74	0.98	1.28
Novosibirsk	1.04	0.77	0.84	1.25
St.-Petersburg	1.84	1.18	1.03	1.24
Perm	0.65	0.65	0.88	1.09
Omsk	0.83	0.62	0.63	1.04
Tver	1.36	0.94	0.89	1.03
Ulyanovsk	0.72	0.71	0.72	0.95
Kaliningrad	1.38	0.95	0.81	0.82
N.Novgorod	1.53	0.88	0.81	0.79

* - the indices were computed basing on the average bid prices for residential property in Moscow in 2000-2001 according to the old methodology.

The index values for December 2001 show that the value of residential property in Moscow in comparable prices, while growing over 1.7 times in December 1998, in December 2001 still exceeded by one-third the level of December 1997. In St.-Petersburg, Ekaterinburg and Novosibirsk, this index exceeded

the pre-crisis level by 24-28 p. p.; in Perm, Tver and Omsk the increase accounted for almost 10 p.p. as compared to the pre-crisis level. By contrast, in Ulyanovsk in December 2001, the residential property value in the prices of the baseline period was 5 points less than the 1997 level, and in Kaliningrad and Nizhny Novgorod the same parameter was lower by about 20 points. In 2001, this parameter stagnated in Kaliningrad and declined only in Nizhny Novgorod.

Thus, basing on the assumption that the market is gradually regaining the stability of 1996-97, one can expect the following changes in the residential property value during the next two or four years (in the comparable prices of December 1997):

- in Moscow, Novosibirsk, Petersburg and Ekaterinburg - a decline by 21-27 p.p.;
- in Perm, Tver, Omsk and Ulyanovsk – a stable level within the limits of +/- (6-7) p.p.;
- in Kaliningrad and Nizhny Novgorod – an increase by 20-22 p.p.

In other words, the transfer to the stable real estate prices approximating the pre-crisis level in Moscow, Novosibirsk, St.-Petersburg and Ekaterinburg should follow the "leading" scenario (similarly to the market situation in Moscow back in 1995), and the "lagging" scenario in the other cities.

The summarized projections of price dynamics in the Russian cities in 2002

As in the previous years (after the 1998 financial crisis), the projected changes in the residential property prices in the Russian cities in 2002 were calculated heuristically basing on the RGR methodology of price calculation. This methodology includes the analysis of the impact of various factors on the price dynamics, and the generalization of the findings by computation or logical techniques⁴⁴.

The forecast for 2002, given the unfavorable situation with the world fuel prices, the increasing payments of Russia's external debt, and the decelerating economic growth of the developed countries, takes account of the following factors:

⁴⁴ Since the end of 1998, the factual data have confirmed the high accuracy of these projections, and only in June 2001 the estimated values were adjusted towards the increasing price growth rates.

- the general economic outlook for the country (retardation of the growth rates as compared to 2001: the GDP rate will decline from 5% to 3-4%, and the growth rate of the actual individual revenues will decline from 5-6% to 2-4%);

- the estimated macroeconomic parameters (the reduction of the inflation rate from 18,6% in 2001 to 12-14%, a further 7-9% devaluation of the rouble against the dollar. As a result, the dollar purchasing capacity in Russia, which in 2001 dropped by 9%, is expected to decline by another 3-5% in 2002).

The implementation of the aforementioned macroeconomic factors will serve to *slow down the price growth rates* in most of the sample cities, except for those where the growth potential has not been realized yet.

Basing on this approach, it is possible to forecast that:

- Moscow, St.-Petersburg, Ekaterinburg and Novosibirsk will follow (not quite synchronously) the "leading" stabilization scenario, i.e. at the year start the growth of the supply prices (in the dollar equivalent) will slow down, although for a short time the actual prices will exceed the pre-crisis level (by 5-10%), while in spring and summer the prices will slightly roll back, reaching the stable level of December 2001 by the year end;

- in Perm, Tver, Omsk and Ulyanovsk the stabilization will follow the "lagging" scenario, i.e. in January-February prices (in the dollar equivalent) will start slowly growing up to 80-95% of the pre-crisis level;

- in Kaliningrad and Nizhny Novgorod prices will be growing in 2002 at first at a rapid rate (by 20-25%) and then at a slower rate, and the expected stabilization may occur after 2002.

Thus, in 2002 the real estate market in most of the Russian cities will complete *the growth phase* and will enter *the recession phase*, i.e. the retardation of the growth rates and the subsequent price stabilization, which would mostly be oscillating. The beginning of the recession phase in Ekaterinburg, Perm and Ulyanovsk may already be expected this winter, in Moscow and St.-Petersburg - in the spring-summer of 2002. Those cities, which have not yet realized their growth potential and have not approximated the pre-crisis price level (Kaliningrad, for instance), will experience a further price growth, and some stabilization may be expected after 2002.

The Russian real estate market in late 1990-s and its role in the sector of new market services

In 2001, the RF Goskomstat continued the publication of official data on the real estate market performance, including the institutional aspects thereof with one-year lag.

Table 21

The number of intermediary real estate transactions concluded in 1996-2000

	1996		1997		1998		1999		2000	
	Thou.	% of total	Thou.	% of total	Thou.	% of total	Thou.	% of total	Thou.	% of total
Total transactions	862,3	100.0	371,3	100.0	171,5	100.0	201,0	100.0	236,6	100.0
Including transactions with										
- residential property	846,1	98.1	333,7	89.9	164,1	95.7	192,3	95.7	220,8	93.3
- non-residential property	7,2	0.9	7,2	1.9	6,8	4.0	6,4	3.2	14,0	5.9
- land (land plots)	9,0	1.0	30,4	8.2	0,6	0.3	2,3	1.1	1,8	0.8

Data source: the RF Goskomstat.

The official statistical data show that in 2000, similarly to the entire period of 1995-1999, the residential property transactions reigned supreme in the intermediary real estate market, accounting for 93.3% of the total number of said transactions. As compared to 1999, the completed residential property transactions had grown almost by 15%. Nevertheless, according to the official statistics, the residential property market performance still had not regained its pre-crisis level of 1997, accounting for about two-thirds thereof.

In 2000, the non-residential segment of the real estate market demonstrated a marked progress, with the number of relevant transactions growing 2.2 times. The indices of 1997 had practically doubled, while the share of these transactions within the total number of completed intermediary real estate transactions had approximated 6%, which was three times more than in 1997.

By contrast, the share of land transactions had dropped below 1%, approaching the level of 1998. The absolute number of land transactions in 2000 reduced by over 20% as compared to 1999.

It would be relevant to wonder about the role of intermediary services in the real estate market, as a type of economic activity in Russia.

The answer to this question may be derived from the RF Goskomstat data about the principal performance indices of service-providing organizations, after the conversion of said indices into the relevant foreign currency equivalent at the average annual exchange rate

(Table 22). Such adjustment of data collected in late 1990-s, a period characterized by a macroeconomic instability, is reasonable not only for the technical reasons of convenience of data presentation, but also due to the high rate of dollar-paid services provided by that market (intermediary services in real estate transactions, auditing services, advertising).

The RF Goskomstat defines the scope of the above activities as follows:

Intermediary services related to real estate transactions include the selection of possible options, the formalization of all the documents required for the conclusion of such transactions, the legal counseling provided by lawyers and experts of real estate agencies to the contracting parties on all the pertinent issues. Real estate transactions include the purchase and sale, rent, lease, privatization, donation, and inheritance of immovable property.

Audit is understood to mean the registration of commercial operations for the benefit of organizations; preparation, analysis and authentication of financial accounts; and the formalization for legal entities and individuals of the income tax forms.

Advertising is understood to mean the creation and publication of clients' advertisements in periodical printed editions, newspapers, on the radio and television, on street posters, the shop window design, the representation of clients in mass media, the lease of advertising space.

Table 22

Net proceeds from the sale of goods, products and services (net of VAT) by major types of market services and the turnover of commodity exchanges in 1995-2000, in the dollar equivalent (mln UD Dollars)

	1995	1996	1997	1998	1999	2000
Intermediary services in real estate transactions	26,1	67,0	156,1	147,4	106,5	135,5
- including from the principal line of business - %	23,2	47,6	111,2	133,1	98,2	125,1
Auditing services	88,9	71,0	71,2	90,3	92,2	92,3
Advertising agencies	129,2	127,3	164,9	116,5	144,4	130,0
- including from the sale of advertising services - %	74,4	137,5	192,2	159,3	226,4	206,7
Turnover of commodity exchanges (net of futures transactions)	60,3	101,2	157,7	120,2	162,6	83,1
	81,0	73,6	82,0	75,5	71,8	88,6
	367,4	908,6	511,7	239,2	133,1	177,6

Data source: the RF Goskomstat, the author's estimates.

As it follows from Table 22, the performance indices of this sector of services, as registered by official statistics, feature very modestly against the other types of market services that emerged in the 1990-s.

In 1995-1997, prior to the financial crisis, the revenues from intermediary services in the real estate market (in the foreign currency equivalent) fell significantly short of the

profit derived by auditing and advertising companies, to say nothing about the sales proceeds of the commodity exchanges. However, in 1997 said revenues became commensurate with the revenues of auditing companies and the proceeds of advertising agencies from the sale of advertising services proper, although the revenues derived by intermediary companies from their principal line of activities in the real estate market still fell short of the latter.

In 1998, i.e. during the financial crisis, real estate intermediaries demonstrated a higher adaptability to the crisis environment. Their revenues in foreign exchange equivalent dropped less than by 6% (showing even a 20% increase of revenues from the core line of business). In comparison, the revenues of auditing companies fell nearly by 30%, the revenues of advertising agencies reduced by 17% (their proceeds from the sale of advertising services proper went down nearly by 25%), and the sales proceeds of commodity exchanges fell by over 50%. During that period, the share of the core business revenues within the total revenues of intermediary companies, having dropped to 70% in 1996-1997, exceeded 90% and continued to grow in the next two years.

Nevertheless, the negative impact of the financial crisis caught up with the real estate market a year later, in 1999. The total proceeds of companies engaged in that line of business fell by nearly 28% (almost pro rata to the core business revenues). By contrast, the revenues of auditing companies grew 1.24 times, and the revenues of advertising agencies increased more than 1.42 times (with the proceeds from the sale of advertising services growing 1.35 times). The revenues of the commodity exchanges continued to decline.

In 2000, the economic performance of intermediary real estate companies significantly improved: the revenues rose by 27% (including the same increase in the revenues from the core activities). By contrast, the revenues of auditing and advertising companies dropped by 10%.

The aggregate revenues of real estate intermediaries in 2000 came out 13% less than in 1997, but the share of the core business revenues had increased by 12.5% (although it was still 6% short of the 1998 level). The auditing companies and commodity exchanges failed to reach their pre-crisis revenue levels (79% and 35% respectively, as compared to 1997). On the other hand, the revenues of advertising agencies exceeded the 1997 level by 7.5% and 16% (from the sale of advertising services proper). The absolute revenues of real estate intermediaries were comparable with those of auditing companies, just as in 1997, but fell by 25-35% short of the revenues of advertising agencies and commodity exchanges.

Being aware of the latent nature of many of the phenomena in the Russian economy in transition, it would be logical to assume that the RF Goskomstat data do not fully reflect the actual developments in the sector of new market services.

Annex 4

Monetary policy in the countries with economies in transition in the year 2001

After the currency crises of the 1990s, the mostly widely acclaimed has become the notion that the regime of currency exchange rate has a right to exist in the form of corner solutions: either free floating or currency board⁴⁵. The latter variant will probably become less popular in face of the recent events in Argentina in 2001 which by the end of the year had developed into mass riots, the president's and government's resignation and a default on the external debt. The free floating of a national currency's exchange rate, in the opinion of some specialists, including the leadership of the IMF⁴⁶, is linked up with the introduction of a regime based on direct goal-setting by the bodies responsible for monetary regulation of quantitative inflation guideposts.

In the IET's 2000 yearly review it was shown⁴⁷ that there exists a clear tendency not to resort to the use of the intermediate goals of monetary policy which can be observed in East European countries. Also it was pointed out that **Hungary** was planning to discontinue the fixed exchange rate regime, while the monetary policy in **Slovenia** was based not only and not really on the declared regime of targeting monetary supply. We also stressed the growing popularity of targeting of inflation as a form of organizing monetary policy. In the policy of these two countries in the year 2001 some modifications occurred which deserve a more detailed consideration.

In June 2001 considerable changes took place in Hungary's monetary policy. The first was related to radical liberalization of the system of currency regulation and capital control. On June 5 at the session of the Government of Hungary it was decided to lift all the previously imposed limitations on the operations with foreign currencies and to secure full convertibility of the forint. The corresponding decree was enacted on June 15.

⁴⁵ S.Fisher "Exchange Rate Regimes: Is The Bipolar View Correct", Distinguished Lecture on Economics in Government American Economic Association and the Society of Government Economists, Delivered at the Meetings of the American Economic Association New Orleans, January 6, 2001

⁴⁶ IMF Survey, Vol 30, No. 2, January 22, 2001

⁴⁷ Obzor denezhno-kreditnoi politiki v stranakh s perekhodnoi ekonomokoi (An overview of the monetary policy in countries with economies in transition) - M.:IET, Rossiiskaia ekonomika v 2000 g. Tendentsii i perspektivy . (Issue 22), Appendix 5, April 2001

We wish to remind here that until then in Hungary there had existed numerous limitations on a number of operations. As for monetary and financial markets, we can point out that there was the need for residents to apply for special permissions to attract funds. This requirement encompassed credits, placement of securities, leasing and other similar operations. Non-residents were not allowed to purchase government securities with the time of maturity under 1 year.

The operations of purchasing foreign assets, including crediting non-residents by residents, in many instances were subject to direct ban or special permission. A certain exception existed for authorized commercial banks to carry out operations with short-term instruments. Residents, with a few exceptions, were not allowed to open accounts with foreign banks.

This reform, among other matters, revoked the permitting procedure for opening accounts with foreign banks by residents. All the obligations of residents to repatriate currency incomings were annulled. Resident legal entities were allowed to freely purchase foreign currencies for any purposes. Among important issues one should mention lifting the limitations formerly imposed on short-term capital investments made by non-residents. Of great interest is also the permission to freely effect currency payments in any transactions between residents.

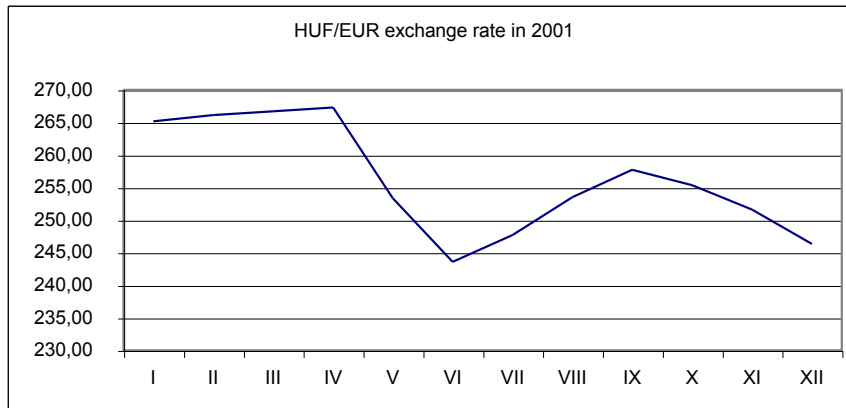
Another important innovation is the introduction of a new regime of monetary policy. On June 12 the Board of Directors of the National Bank of Hungary made the decision to switch over to the regime of inflation targeting. Even before that, on May 3, currency corridor limits (forint/euro exchange rate) were expanded from +/- 2,25% to +/- 15%. The sloping corridor system had existed in Hungary since 1995, having demonstrated considerable resilience when the forint was attacked in 1998.

The reason for this switching over to new forms of monetary regulation was the impossibility to achieve low inflation indices by means of a policy based upon currency exchange rate - since 1998 the level of inflation (CPI [consumer price index]) was about 10%, in April in relation to the corresponding month of the year 2000 when it was 10.3%, in May - 10.8%.

Within the framework of the new regime, both medium- and short-term inflation targets have been established - in the years 2004-2005 it is planned to achieve the level of 2%, in 2001 the planned inflation level is 7%. Acceptable deviations from this index are 1%.

As a result of introducing this new policy, the forint to euro exchange rate went up (Fig. 15). The following period of a decreasing rate has been associated with the problems emerging on the financial markets of the third countries: Argentine, Turkey, Poland.

Fig. 15



Note: Average monthly exchange rates are cited here.

However the National Bank of Hungary⁴⁸ decided that the negative consequences of this phenomenon suffered by exporters would be short-lived, this being an acceptable price to be paid for improving the situation as regards inflation. This standpoint is interesting enough, especially when compared to that of the Central Bank of the RF which during the same period of time was considering the possibility of setting the existing inflation targets at a higher level while maintaining the same policy of gradual rouble depreciation and increasing currency reserves. Besides, the dynamics of Hungary's foreign exchange and gold reserves (FEGR) is also of especial interest. It is still too early to make any conclusions but so far it has been obvious that neither the appreciation of the national currency nor opening capital account has produced any serious impact on the state of those reserves. The fact that there has been no further growth of the reserves after the reform was initiated is quite compatible with the antiinflationary policy.

⁴⁸ Statement on the new system of monetary policy, NBH, 12 June, 2001

Fig. 16

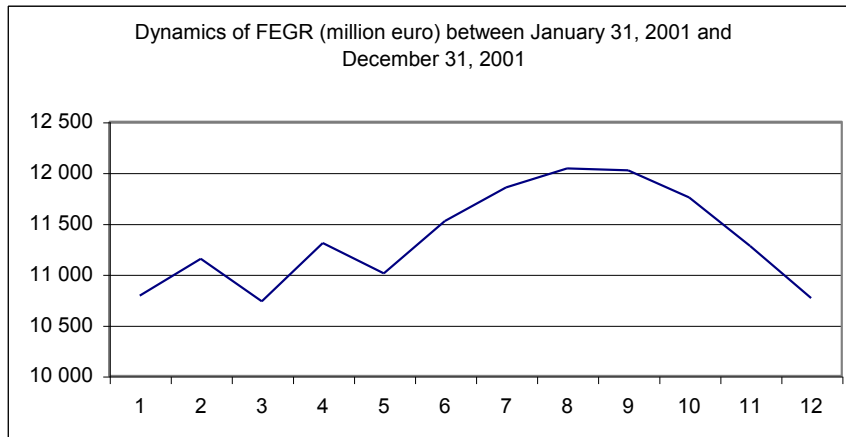
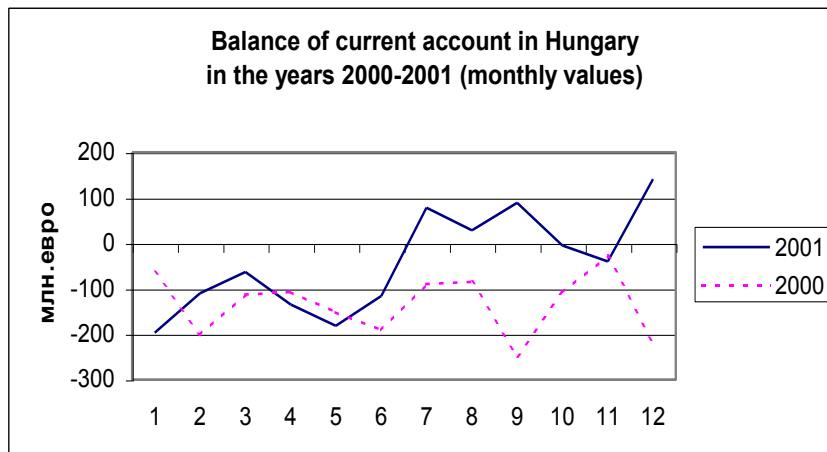


Fig. 17

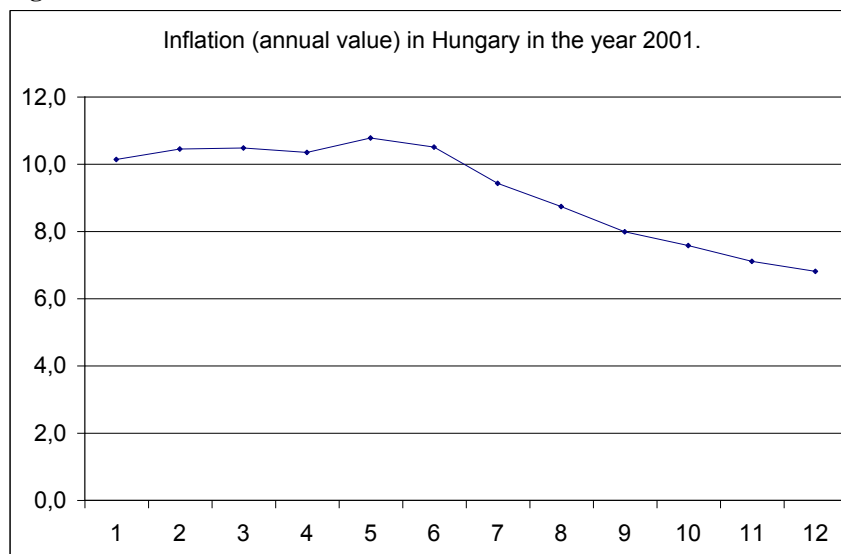


Also, the positive dynamics of the balance demonstrated by the current account in the balance of payments should be noted. Usually the real and nominal consolidation of a national currency is associated with the worsening of this index. As far as the situation in question is concerned, there is quite a reverse tendency (Fig. 17). To a certain extent this is of course compatible with the lowering

prices of energy carriers whose dynamics has been influencing the balance of payments in a manner quite opposite to that in Russia.

Inflation, having reached its peak value in May, began to go down.

Fig. 18



One of the factors responsible for its decrease, among others, has been appreciation of the forint. A certain role has also been played by external factors, one of them being the falling oil prices. On the whole, the inflation rate (CPI), according to preliminary data, during the year in question was 9.2%.

One of the main instruments of the policy of the National Bank of Hungary has been manipulating interest rates which is quite natural if we remember that the monetary market in that country is well-developed. Besides, it can be noted that manipulating short rates is a key instrument in most countries following the policy of inflation targeting⁴⁹. Stability on the interbank market of short-term resources is expressed exactly in the ability to maintain the corridor of interest rates. In practice this means that the National Bank grants and takes “overnight” credits on certain conditions and at certain interest rates. The upper limit of the corridor is established by REPO transactions, the lower limit - by the daily de-

⁴⁹ A. Schaechter, M. R. Stone, M. Zelmer, Adopting Inflation Targeting: Practical Issues for Emerging Market Countries, IMF Occasional paper 202, December 2000

posit rates set by the National Bank. From December 10, 2001 onward the basic interest rate of the National Bank went down, the corridor limits became 8.25-11.25%.

Within the framework of the antiinflationary policy some legislative reforms were carried out. In the summer of 2001 a new law on the National Bank was enacted where the principal goal of the central bank was stipulated as that of achieving and maintaining price stability. The law also imposed a ban on crediting the government bodies.

By the way, the policy of Russia's closest neighbor Kazakhstan has been developing approximately in the same vein. On December 8, 2001 the Board of the National Bank of Kazakhstan approved the Main Directions for the monetary policy in the years 2002-2004. This program document is medium-term, and the program itself has stated that beginning with the year 2002 the targets of the monetary policy are to be established by the National Bank for three years ahead, with subsequent annual adjustments every year, which is associated with a relative macroeconomic stability that has been achieved in that country.

The National Bank in its program declared a change-over to a new monetary policy regime. The main direction for the monetary policy of the National Bank of Kazakhstan in the next three years is to be a preparation and transition toward the principles of inflation targeting which means a gradual change-over from targeting the monetary base and gold and foreign exchange reserves to targeting inflation.

The main goal of the monetary policy will be to maintain inflation within the 5-7% limits in 2002 and the 4-6% limit in 2004. In three years, the total inflation level is going to be 18-20%. The history of inflation processes in Kazakhstan looks a little better than that in Russia.

Table 23

Inflation (December-to-December CPI) in Kazakhstan (%)

1998	1999	2000	2001	2002	2003	2004
1.9	17.8	9.8	6.4	5-7	4-6	4-6

Note: the index for the year 2001 is preliminary, those for the years 2002-2004 are target values.

Source: the National Bank of Kazakhstan

We should note that the antiinflationary policy so far has not been hindering the economic growth visible in Kazakhstan. It is expected that in the year 2001 the economic growth will exceed the 2000 index (9.8%) and exceed 10%.

The National Bank intends to maintain the regime of a freely floating exchange rate of the tenge and not to interfere with its level, keeping the tenge currency market at a minimum level.

It is supposed that the main instruments of the monetary policy in the years 2002-2004 will remain open market operations, official interest rates and rediscount bill transactions. The National Bank will place an especial emphasis on the operations on the open market. It is expected that with the increasing volumes of open market operations and rediscounts of bills the regulating role of the discount rate and the rates on REPO operations set by the National Bank will become more and more important, and these rates at the same time will be the official refinancing interest rates.

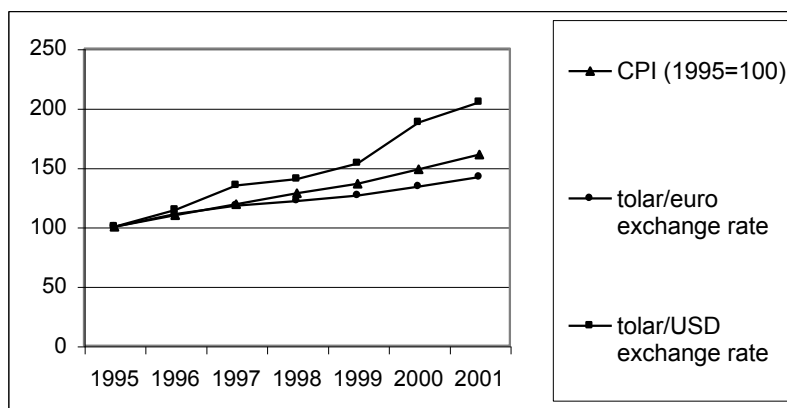
Another promising direction of the monetary policy, in the opinion of the National Bank, will also be further liberalization of exchange control which will primarily involve certain changes in currency exchange regulation and control over outward and inward investments. Liberalization of outward investments will include stage-by-stage abolition of licensing or expansion of the range of non-licensed operations concerning certain kinds of currency transactions relating to capital flow. It should be borne in mind that presently the residents-performed transactions classified as capital export are subject to compulsory licensing. Similarly, opening accounts with foreign banks by residents is subject to licensing. Compulsory sale of currency earnings was abolished in Kazakhstan on November 15, 1999. The actual steps to be taken by the National Bank as regards capital control regime have not yet been outlined.

Certain interesting changes have taken place in the monetary policy of **Slovenia**. Slovenia happened to be one of the few countries with economies in transition where the measures against inflation based upon money supply targeting turned out to be successful. Since 1997 the object of regulating has been the aggregate M3. Targeting was done throughout the 1990s in the form of corridor.

At the same time, the Bank of Slovenia has been intentionally and persistently engaged in regulating the exchange rate for two main reasons. The first one is the small size and high degree of openness of Slovenia's economy (the volume of foreign trade is over 100% of the GDP) which makes the exchange rate an important inflation factor. The problem of the competitive capacity of domestic goods is also very important, from the point of view of the Bank of Slovenia. The second reason which is common enough for all countries with economies in transition has been that at the initial stage of the transition, the presence of foreign currencies in a national economy is substantial, and besides, the financial and banking systems are underdeveloped. Thus the foreign currency market some-

times is the most (if not the only) efficient means of influencing the situation as regards money circulation available to the central bank. In other words, in addition to the explicitly identified monetary anchor, the Bank of Slovenia has been pursuing a certain exchange rate policy that can be characterized as guided floating. At the same time there occurs smooth depreciation of the tolar in relation to European currencies. The real effective exchange rate has remained practically unchanged since 1995; in part, this has been achieved due to the fact that inflation is kept within the corridor between exchange rate fluctuations as regards the euro and the USA dollar (Fig. 19).

Fig. 19



In 2001 the Bank of Slovenia published its medium-term monetary policy program. This document is of interest because the policy whose actual meaning could be judged mostly by its results has now been formulated more precisely: firstly, it is stressed that the policy is based on the country's desire to join the EU; secondly, the level of inflation is defined as the main goal of the monetary policy. The targeting goal is to bring its level by the end of the year 2003 to 4%. Thus, the elements of inflation targeting are clearly traced in the policy. Thirdly, the status of money supply (M3) has been lowered from an intermediate goal to reference value. Nevertheless the high significance of this index has been stressed again.

Conceptually significant is the stipulation that in an economy in the state of transition toward market the principal method of influencing the situation as regards money circulation on the part of the central bank is represented by the operations on the currency market.

The development toward liberalization of capital operations is under way. Primarily this is concerned with capital export, including foreign bank accounts opened by residents and purchasing of foreign financial assets by residents. The procedure of making long-term portfolio investments in Slovenia is being simplified. At the same time, the limitations imposed on the inflow of short-term investments have been preserved.

Slovenia's policy in the area of monetary policy is also of interest because on the surface it resembles the policy of the Bank of Russia. Naturally, we cannot compare here the two economies which are different in principle by their scopes and peculiarities. The subject discussed here is the formulation of their tasks and goals. One should remember that in the years 1999-2000 the Bank of Russia was also formally founding its policy on the basis of money supply (target M2). However in contrast to Slovenia which nevertheless could stay within the limits of a wide corridor, in Russia the deviation from the set goals was so great that it became clear that the policy from the very beginning had been based on other principles - on the operations on the currency market. In 2001 the CB of the RF also lowered the status of monetary aggregates to that of an information variable. Slovenia seems more successful from the point of view of achieving financial stability, and in the real sector she is one of the most (if not the most) successful among the countries with economies in transition. Due to the experience of the previous practice and the stimulating effect of the necessity to meet European criteria it seems likely that the established inflation targets can be achieved.

Touching briefly upon other East European countries, it can be said that **Romania**, within the framework of the above-mentioned world-wide trend in the monetary policy, has been planning a change-over to direct inflation targeting in the year 2003⁵⁰. At the present moment, as far as one can understand, the targets are set according to inflation and the monetary base. Great attention has been paid to the state of foreign exchange and gold reserves and exchange rate management (a real annual appreciation by 2-3% is considered acceptable), i.e. the so-called "managed floating" occurs. The inflation rate in Romania is high - in 2000 the CPI index (December-to-December) was 40.7%, in 2001 it is expected to be slightly below 30%.

In **Bulgaria** the currency board regime that was introduced in 1997 is still maintained. No serious problems have yet occurred, the inflation level in 2001 will be around 4.5% which is a sign of progress as compared to the previous level

⁵⁰ Romania – Performance and Perspectives for 2001 and Beyond, presentation made by M. Isaescu, NBR Governor, at the Conference in the Bucharest 7-9 May 2001

of 11.4% in 2000. However if we take into consideration the developments in Argentine, a number of alarming circumstances can be pointed out. The first one is the high level of external debt, the second - the on-going (since 1998) worsening of the situation as regards the balance of trade and the current account. The latter, according to the estimates made by the Ministry of Finance of Bulgaria, is going to decrease from the 5.8% GDP index in 2000 to 6.7% in 2001. This can be explained both by the slowed down economic growth in Europe and by the crisis in Turkey in early 2001. A compensating factor has been represented by the lowering prices of energy carriers on the world market.

Poland is still pursuing the policy of inflation targeting. In the "Guidelines on the Monetary Policy" for the year 2002 the inflation target was set at 5% with an acceptable deviation of +/-1%. The medium-term goal - an inflation level below 4% - has been confirmed. It is still too early to speak of the results of the year 2001, but it can be stated that the inflation level in the year 2001 has been continuously going down. A possible source of problems can be the situation as regards the state budget. The management of the National Bank has made a rather critical statement concerning the budgetary process in the year 2002⁵¹.

Certain changes have also occurred in the monetary policy of **Czechia**. This policy is still based on the principles of inflation targeting but there have been certain developments as far as the definition of the targeting goal is concerned.

Until the year 2001, the net inflation index had been applied for this purpose, i.e. the annual change in the consumer price index excluding the influence of state price regulation and hidden taxes. The gap between this index and the gross consumer price index had been gradually narrowing - in 1998 it was 5.1%, in 2000 - 0.9%. In April 2001 the National Bank, upon an agreement with the Government of Czechia, made the decision on setting the targets for the years 2002-2005.⁵² The general consumer price index was chosen as the target index. This decision was based on the assumption that the removal of control in the sphere of prices and tariffs had been almost completed. It was established that the impact of administrative decisions in this area was going to be 1-1.5%. The target was set as a corridor with a slight sloping, beginning with the level of 3-5% in January 2002 and finally coming to the level of 2-4% in December 2005. Such transition is expected to contribute to better public understanding of the monetary policy measures and to strengthen the regime's potential as regards the influence

⁵¹ Opinion of the monetary policy council on the project of the act on the state budget for 2002, 03.10.2001

⁵² The Setting of the Inflation Target for 2002-2005, CNB, April 2001.

exerted on the inflationary expectations. The change of the targeted index is characteristic enough - the same was done in 1997 by New Zealand.

Czechia's bodies responsible for currency regulation are rather concerned about the Czech koruna's appreciation - its exchange rate as regards the euro went up from 35 at the beginning of the year 2001 to 31.5 - 32.5 in December. One of the methods of influencing the exchange rate has been to establish the areas of using the currency earnings from privatization which is the subject of the on-going negotiations between the national bank and the government.

The Baltic states (Estonia, Latvia, Lithuania) have been further pursuing their once chosen policy of a fixed exchange rate. We wish to remind that in Estonia and Lithuania the exchange rate policy is based on currency board while in Latvia the exchange rate is rigidly pegged to the SDR basket. The inflation rate is very moderate, and there were no changes in 2001 as far as the policy was concerned.

Lithuania made the decision on changing its anchor currency on February 1, 2002. Until then, the exchange rate of the litas had been pegged to the USA dollar at the rate of 4 to 1. Now the pegging is to the euro at the rate LTL 3.4528 = EUR 1.

* * *

In the above-discussed countries the stabilization period has mostly been over. At the present moment medium-term programs are being introduced that are aimed at achieving quantitative targets, primarily in pricing. From Russia's point of view, it is the formulating of goals and tasks as well as the approaches to achieving them that is of especial interest. Naturally, in East European countries the goals are to a large extent, so to say, have been brought from the outside because their most important task is to meet the criteria set by the EU for the applicants for membership. However the important fact is that the central banks of East European countries are very serious about achieving these targets. The satisfaction with a particular policy can and should be assessed not only from the point of view of the development/avoidance of crisis-like phenomena which might nevertheless be correct during the period of stabilization and at the early stages of the transition toward market. An important criterion is also the matching of the achieved results to the declared goals.

From the point of view of utilizing the accumulated experience, the tendency of changing over to inflation targeting can be traced clearly enough, and Russia should probably pay very close attention to this particular form of monetary policy. If we take individual countries, the Hungarian experience is of particular importance. Here we must take a look at the balance of payments after a) appre-

ciation of the national currency, and b) radical liberalization of capital flow. It is peculiar that Hungary, with her negative balance of current account, did resort to such measures while in Russia, despite her very high balance value, the idea of gradual depreciation is very popular and the fears as regards the consequences of any liberalization of capital export operations are very strong. Slovenia's experience is interesting from the point of view of utilizing the currency market as the basis for achieving macroeconomic stabilization and the set targets. It is vitally important for Russia, with her underdeveloped financial markets, to further improve the methods of such an activity.