

**INSTITUTE FOR THE ECONOMY  
IN TRANSITION**

**RUSSIAN ECONOMY**

**in 2002**

**TRENDS AND OUTLOOKS**

**(ISSUE 24)**

**Moscow  
March 2003**

**Institute for the Economy in Transition**  
**Founded in 1992**

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**The publication of the present paper was sponsored with the grant from  
the United States Agency for International Development (USAID)**

**ISBN 5-93255-107-0**

**Publisher license ИД № 02079 of 19 June 2000**  
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# Table of Contents

<b>Introduction. Economic Growth and Challenges of the Coming Decade</b> .....	7
<b>Section 1. The Socio-political Background</b> .....	14
1.1. Economic policy in 2002 and the prospects for national elections.....	14
<b>Section 2. Monetary-credit and Budgetary Sphere</b> .....	32
2.1. Monetary Policy.....	32
2.2. Balance of Payments.....	54
2.3. Public Finances.....	58
2.3.1. State Budget.....	58
Appendix 1. Forecasting Tax Revenues in 2002.....	64
2.3.2. Federal Budget for 2003 and Macroeconomic Forecast of Social and Economic Development of Russia.....	68
2.3.3. Interbudgetary Relations and Sub-National Finance.....	77
2.4. Russia's financial markets.....	90
2.4.1. The public debt market.....	90
2.4.2. The Market for Municipal and Subfederal Borrowings.....	94
2.4.3. The Stock Market.....	107
Appendix 2. A Review of Changes in the Legislation Regulating Taxation Issues in the Russian Federation.....	116
Appendix 3. Reforming the Taxation of Small Businesses.....	141
Appendix 4. Analysis of Certain Results of the Personal Income Taxation Reform.....	151
<b>Section 3. The Real Sector</b> .....	154
3.1. Production Macrostructure.....	154
3.1.1. GDP Production: Dynamics and Structure.....	154
3.1.2. Use of the GDP: Dynamics and Structure.....	177

3.2. Situation in the Industrial Sector .....	184
3.2.1. Dynamics of the Principal Types of Demand in Industrial Products in 2002 .....	184
3.2.2. Development of Competition in Russian Industry in the Post-Default Period.....	193
3.2.3. Relationship Between Different Types of Competition at the Microeconomic Level .....	204
3.3. Investment Process in the Real Sector of the Economy .....	214
3.4. Agrifood Sector.....	230
3.4.1. Production trends in agriculture, upstream and downstream sectors .....	231
3.4.2. Financial performance of agricultural producers .....	233
3.4.3. Agricultural and food markets.....	235
3.4.4. Foreign trade in agricultural and food commodities .....	246
3.4.5. Changes in the agricultural policies .....	249
3.4.6. Outlook for agrifood sector development in 2003 .....	259
Appendix 5. Producer support estimate.....	259
3.5. Status of the Research and Development Sphere .....	262
3.6. The Social and Cultural Sphere .....	280
3.6.1. Public health .....	283
3.6.2. Education.....	288
3.7. Foreign economic activities .....	296
3.7.1. Russia's foreign trade with countries outside the CIS .....	299
3.7.2. Russia's foreign trade with CIS-countries.....	312
<b>Section 4. Institutional and Macroeconomic Challenges .....</b>	<b>320</b>
4.1. The Dynamics of the Privatization Process in Russia .....	320
Appendix 6. New Privatization Methods and Their Legal Provisions .....	324

4.2. Key Issues for Improving the Current Privatization Legislation in the Russian Federation .....	329
4.3. State property management .....	335
4.4. Sectoral Peculiarities of Unitary State Enterprises .....	349
4.5. Certain Trends in the Corporate Sector Development .....	362
4.6. The Banking Sector .....	380
4.7. The National Market for Housing in 2002 and up to 2003 .....	401
Appendix 7. The Progress in the Administrative Reform Area .....	413

## Introduction

### Economic Growth and Challenges of the Coming Decade

Whilst discussing socio-economic challenges facing modern Russia, it should be noted that the debate very often is conducted «out of context», i. e., with no account of other nations' experiences, primarily post-communist ones. One can have an impression that those conducting research into Russian realities ignore the respective experiences of almost three dozens of nations that after abandoning socialism face the challenges similar to ours<sup>1</sup>.

The above fully concerns the hottest issue of the debate on economic growth problems that has started in Russia in 1999. The domestic literature is dominated by two explanations of the nature of this particular growth: while the first one relates it to an actual depreciation of the Ruble following the 1998 crisis and a favorable state of affairs on the oil markets, the other attributes the growth to reforms the Russian government has pursued in the conditions of political stabilization in the wake of 2000 elections. No doubt, the reforms are important to ensure a long-term sustained growth, and indeed, the oil prices and the real exchange rate appear crucial macroeconomic policy factors that affect growth, however, the nature of the current growth appears different.

If one analyzes Russia's growth in the context of other nations' experiences, it becomes evident that at present practically all the countries of the post-Soviet zone have their GDP growing. Interestingly, none of them witnessed this particular process at the first stage of their abandonment of socialism, i. e. between 1992 to 1994. Since 1995 there have been the first signs of growth in place, primarily in the Baltic countries (Lithuania, Latvia and Estonia), as well as in the states that had earlier been involved in military conflicts or found themselves under blockade (for instance, in Armenia, Azerbaijan, and Georgia).

The period between 1996—98 saw first signs of economic growth in other post-Soviet states, though unsustainable and interrupted by slumps they were. Since 1999, however, their growth has become stable and took place across nearly all the countries, except Ukraine. Since 2000, growth has taken place everywhere (except for Kyrgyzstan in 2002) (*see Table 1*).

So, growth is not directly related both to a political regime (they are different in the said nations) and reforms similar to Russian ones of 2000-01, nor it is connected with oil prices (the group of post-Soviet countries comprises both net exporters and importers of oil and oil products). In addition, if one follows real exchange rate dynamics of the noted countries' national currencies over 1995-99, there are those that experienced a substantial real appreciation of their currencies (Kazakhstan, Kyrgyzstan, Moldova, and some others), while there also are those countries where the national currency has appreciated substantially (Azerbaijan, Armenia, Georgia, and the Baltic states).

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<sup>1</sup> More specifically, it is highlighted by L. Aron who commented that discussions on Russia, as a rule, are held 'out of the context' and their participants attribute this to a huge size of the country. (L. Aron, *Structure and Context in the Study of Post-Soviet Russia: Several Empirical Generalizations in Search of a Theory*).

*Table 1***The increment rates of the physical volume of GDP  
in the post-Soviet states between 1996–2001**

	1996	1997	1998	1999	2000	2001
Azerbaijan	1,3 %	5,8 %	10,0 %	7,4 %	11,1 %	9,9 %
Armenia	5,9 %	3,3 %	7,3 %	3,3 %	5,9 %	9,6 %
Belarus	2,8 %	11,4 %	8,4 %	3,4 %	5,8 %	4,1 %
Georgia	11,4 %	10,6 %	2,9 %	3,0 %	2,0 %	4,5 %
Kazakhstan	0,5 %	1,7 %	-1,9 %	2,7 %	9,8 %	13,2 %
Kyrgystan	7,1 %	9,9 %	2,1 %	3,7 %	5,4 %	5,3 %
Moldova	-5,9 %	1,6 %	-6,5 %	-3,4 %	2,1 %	6,1 %
Russia	-3,4 %	0,9 %	-4,9 %	5,4 %	9,0 %	5,0 %
Tadjikistan	-16,7 %	1,7 %	5,3 %	3,7 %	8,3 %	10,2 %
Uzbekistan	1,7 %	5,2 %	4,4 %	4,4 %	3,8 %	4,5 %
Ukraine	-10,0 %	-3,0 %	-1,9 %	-0,2 %	5,9 %	9,1 %
Latvia	3,3 %	8,6 %	3,9 %	1,1 %	6,6 %	6,5 %
Lithuania	4,7 %	7,3 %	5,1 %	-3,9 %	3,9 %	4,0 %
Estonia	4,0 %	10,4 %	5,0 %	-0,7 %	6,9 %	4,5 %

*Source:* Sodruzhestvo nezavisimyykh gosudarstv v 2001 g. Statistichesky ezhegodnik. Mezhhgosudarstvennyy statistichesky komitet SNG. Moskva, 2002; Transition Report 2001. EBRD, 2001.

*Table 2***The real exchange rate of national currencies to USD  
in post-Soviet states (calculated on the basis of CPI), 1995=100**

	1996	1997	1998	1999	2000	2001
Azerbaijan	126 %	135 %	131 %	104 %	99 %	93 %
Armenia	107 %	104 %	106 %	104 %	95 %	93 %
Belarus	110 %	89 %	44 %	56 %	39 %	46 %
Georgia	130 %	134 %	99 %	107 %	105 %	103 %
Kazakhstan	118 %	131 %	125 %	80 %	84 %	85 %
Kyrgystan	86 %	100 %	64 %	55 %	60 %	63 %
Moldova	113 %	120 %	70 %	72 %	86 %	87 %
Russia	120 %	125 %	45 %	63 %	71 %	78 %
Ukraine	166 %	187 %	113 %	89 %	113 %	134 %
Latvia	110 %	111 %	118 %	116 %	110 %	104 %
Lithuania	121 %	129 %	133 %	131 %	128 %	126 %
Estonia	110 %	103 %	118 %	102 %	95 %	93 %

*Source:* Calculated basing on the data from International Financial Statistics 2002. IMF, 2002.

Thus, each post-Soviet state bears its specificity, which manifests itself exclusively against the background of economic growth. This leads to an assumption that sources of both the given growth and the preceding decline in economic activity should lie with other processes.

Let us first attempt to analyze causes for the production slump in 1992-94 followed by economic growth.

The phenomenon of post-socialist recession is well studied into, and main factors that determine its intensity are fairly understandable. It is worthwhile to focus on the nature of so-



cialist gross domestic product. In fact, the traditional concept of GDP applicable to a market economy cannot be used for the purpose of evaluation of a socialist one. An accurate use of this concept implies the existence of certain constraining factors, such as: the presence of market economy, a relatively small share of the government (budget) in it, and the presence of democratic control over the formation of public expenditures. This in turn implies a fundamental principle used in computation of GDP: given that people (either individually, as consumers, or collectively, as taxpayers) pay for some goods and services, it means that the latter bear some value to them, which forms a necessary condition of inclusion the given produce in the computation of wealth<sup>2</sup>.

Obviously, the above does not match the socialist economy realities, where output and produce distribution are under strict control, with no markets and democratic control over public expenditures in place. Under such circumstances, a considerable volume of economic performance does not form a contribution to the overall growth in wealth. Rather, it often turns growth in GDP in a statistical illusion. In the Soviet time, the bay of Kara-Bogaz-Gol was drained to stop the lowering of water-level in the Caspian sea; then Volga-Chagrai channel was built to divert water from Volga and stop the rise of the Caspian sea. Should we consider both cases from the perspective of socialist economy, they both added to GDP.

So, as far as socialism is concerned, the concept of GDP appears very conventional, because socialism does not always allow the existence of basic prerequisites that would allow to consider a certain economic activity to be justified, sound and aimed at satisfying actual needs. In other words, needs and incentives in socialist economy and market one appear incomparable: what is sound in the former may prove to be an absolute nonsense in the other. This strictly limits the possibility to compare GDP=s measured in value units (money). Once socialist system collapsed, these qualitative differences became visible, and one understands that a considerable part of a socialist economic activity is such that under market and democratic conditions no one, whether acting as a consumer, or a taxpayer, would ever be keen to pay for it.

That is why the process of post-socialist transformation comprises primarily a gradual re-distribution of resources from those kinds of operations and those enterprises that are incapable to operate in market conditions in favor of those that enjoy an actual demand. At the first stage the volume of unfrozen resources is always in excess of the volume of their use in a new production, which predetermines a slump. The economy consequently passes through the 'inflection', when volume of resources involved in production becomes greater than the volume of resources freed out of earlier inefficient sectors. This is what constitutes the nature of the post-socialist transition and growth.

There consequently arises the problem of modernization associated with the collapse of an old economic system and the time period needed to get market institutions work. This is another important factor that determines the course of post-socialist recession. Once the market institutions have been established and begun functioning, there starts post-socialist recovery.

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<sup>2</sup> Discussions on a 'correct' measuring GDP sometimes involve paradoxical comments testifying to the importance of such assumptions: thus, A. Pigou argued that the marriage to the own housekeeper should contribute to a decline in GDP, because the housekeeper's spouse discontinues to buy the respective services, while S. Kuznets raised a question as to while measuring GDP in the ancient Egypt, it is appropriate to consider the specificity of funeral rites in ancient Egypt, i.e. to divide the nation's per capita output into the living population or to add the first generation of the deceased



The group of main factors that determine the length and intensity of post-socialist recession comprises:

- a) the scope of a sector of an economy whose goods and services are not demanded by markets;
- b) the scope of using market instruments under socialism;
- c) the information on pre-socialism market institutions existing in the population's social memory.

Proceeding from the above, one can understand, for instance, why the recession in Eastern European and the Baltic states that had experienced socialism just for two generations was shorter than in the most of the post-Soviet zone, where socialism had been lasting for as long as three generations.

In other words, the emergence of a market system of economic ties, redistribution of a critical mass of resources in favor of market sectors, management adapting to market conditions constitute major factors of the transition towards the stage of post-socialist growth. This particular process was taking place first in Eastern Europe in the early 1990s and consequently in the CIS countries in the late 1990s. While considering the process, one should also take into account specifics of a national macroeconomic situation, price dynamics for major exports and imports, and exchange rate policy. These particular parameters have a substantial impact on national paths of growth, but only with account and in the frame of the overall post-socialist recovery growth process.

The growth we see in the country today is not unique in Russia's history. It bears a great deal of similarity with the recovery growth noted under the New Economic Policy (NEP) that followed the October Revolution and the Civil War, which was also mirrored in economic debates of that time. More specifically, it was then that renowned Russian economists V. Bazarov and V. Groman introduced the concept for recovery growth to economics<sup>3</sup>. They found out that with all colossal losses during the Revolution and the Civil War, it was the collapse of economic ties that constituted the most crucial factor of the production decline at the time<sup>4</sup>.

Obviously, the current recovery growth in Russia appears substantially different from the one that had followed the Revolution and the Civil War.

First, the level of the production decline in 1991-98 was substantially lower than during the Revolution and the Civil War – that is why the current recovery rates are also lower than those of that time.

Second, with all its specificity, the Russian economy of the NEP period basically was a market one, as well as that of 1913. With all its specifics (a substantially smaller proportion of foreign trade in GDP, a smaller proportion of sales in the agrarian output, a greater role played by the public sector, etc.) it resembled the structure of the Russian economy of 1913 to

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<sup>3</sup> See: Bazarov V. O "vosstanovitelnykh processakh" voobsche I ob "emmissionnykh vozmozhnostyakh" v chastnosti//*Ekonomicheskoe obozrenie*, 1925. # 1; *Perspektivy nashogo narodnogo khozyastva na 1925/26 gjd.*//*Ekonomicheskoye obozrenie*, 1925, #8; Groman V. O nekotorykh zakonomernostyakh, empiricheski obnaruzhivaemykh v nashem narodnom khozyastve//*Planovoe khozyastvo*, 1925.# 1,2

<sup>4</sup> "No matter how great the direct destructions were in the fire and in battles of the Imperialist and the Civil Wars - deaths, destruction of buildings, machinery, final consumer items, they are far smaller than the functional breakup, i.e. a temporary discontinuation of economic creative processes".-see: Groman V. O nekotorykh zakonomernostyakh, empiricheski obnaruzhivaemykh v nashem narodnom khozyastve//*Planovoe khozyastvo*, 1925.# 1, p.101

a far greater extent than the structure of the current, basically market, Russian economy resembles the structure of the socialist economy of RSFSR of 1990.

Notwithstanding, a number of processes characteristic of the recovery growth of the NEP period manifest themselves in modern Russia, too.

According to Groman, none of Gosplan experts expected the economic growth rates to be so high between 1923 to 1924, right in the aftermath of the monetary reform and stabilization of money circulation. Gosplan projected that between 1923 through 1927, lacking large-scale investment, economic growth could boost the national income of the USSR to the level roughly accounted for the half of Russia's national income in 1913<sup>5</sup>. In reality, however, it hit the level close to 100 % of Russia's GDP in 1913<sup>6</sup>.

Likewise, in their 2000 budgetary projections, the current Russian government considered economic growth to be within the range between 0.2 % to negative 2.2 %, while yet in spring 2000 the IMF forecasted a 1.5 % rise in Russia's GDP. In reality, however, the country's GDP soared up to 9 %, while the industrial output rose by 11 %. (Notably, the IMF forecasted a 3.5 % growth in the Ukrainian GDP for the year of 2001<sup>7</sup>, while the actual rate accounted for 9 %.)

The causes for such inaccurate forecasts are understandable and appear closely connected with the nature of recovery growth. Whereas the GDP forecast methods are based upon extrapolation of tendencies of a prior period, as well as forecast dynamics of production factors and the state of affairs in an economy, it is easy to realize that they all are hardly applicable to forecasting a rise in economic activity determined by a stabilization of economic ties.

However, one consequently has to face another, unpleasant surprise. One finds out that recovery growth is a withering phenomenon by its nature, and growth rates begin to decline. The essence of this particular process is understandable: as recovery growth is secured by the use of existing, 'old' capacities and 'old' qualified workforce and takes place under relatively insignificant capital investment, the volumes of both resources tend to run out relatively fast and the problem of their shortage arises.

Thus, between 1998 to 2002 the number of those employed in the national economy grew by 8.9 mln. (from 58.4 up to 67.3 mln.) The shortage of qualified workforce was mirrored by a rapid rise in real salaries and wages: more specifically, over the period between 2000 through 2002 alone they grew 1.7 times, and the analogous trend was noted across other CIS states (*see Table 3*).

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<sup>5</sup> V. Groman. Konyunkturnyi obzor narodnogo khozyastva SSSR za pervoe polugodie 1924-25 goda//Planovoye khozyastvo, 1925, # 6.

<sup>6</sup> See: The Economic Transformation of the Soviet Union, 1913-1945, ed. By R.W. Davies, Mark Harrison, S.G. Wheatcroft. Cambridge University Press, 1994

<sup>7</sup> World Economic Outlook. October 2000. Focus on Transition Economies. International Monetary Fund

*Table 3***The increment rates in real salaries and wages in CIS countries between 1996–2001 rr.**

	1996	1997	1998	1999	2000	2001
Azerbaijan	19,0 %	53,0 %	20,0 %	20,0 %	18,0 %	16,0 %
Armenia	13,0 %	26,0 %	22,0 %	11,0 %	13,0 %	5,0 %
Belarus	5,0 %	14,0 %	18,0 %	7,0 %	12,0 %	30,0 %
Georgia	53,0 %	37,0 %	25,0 %	2,0 %	3,0 %	22,0 %
Kazakhstan	2,0 %	5,0 %	4,0 %	7,0 %	12,0 %	13,0 %
Kyrgystan	1,0 %	12,0 %	12,0 %	-8,0 %	-2,0 %	11,0 %
Moldova	5,0 %	5,0 %	5,0 %	-13,0 %	2,0 %	15,0 %
Russia	6,0 %	5,0 %	-13,0 %	-22,0 %	21,0 %	20,0 %
Tadjikistan	-14,0 %	-2,0 %	29,0 %	0,3 %	8,0 %	11,0 %
Ukraine	-5,0 %	-2,0 %	-3,0 %	-6,0 %	1,0 %	21,0 %

Source: Sodruzhestvo nezavisimyykh gosudarstv v 2001 g. Statistichesky ezhegodnik. Mezhhgosudarstvenny statistichesky komitet SNG. Moskva, 2002

Interestingly, in his papers of the 1920, V. Groman also referred to an advanced rise in real salaries and wages vs. labor productivity<sup>8</sup>.

The IET business surveys show a drastic change in the balance of estimates of sufficiency of production capacities for satisfying the envisaged demand over the period between 1998- 2001. As well, estimates of the need in workforce due to the envisaged growth also undergo changes: shortages of equipment and qualified staff are increasingly interpreted as a serious obstacle to the rise in output<sup>9</sup>.

A decline in growth rate after reaching peak values and involvement of the most accessible resources into economic turnover almost inevitably leads to economico-political debates on causes of the fading growth rates and the respective remedies. Given that the power and expert community conceive genuine extremely high growth rates as a pleasant surprise, consequently both the political elites and the society get accustomed to orient to these abnormally high rates as a policy landmark, a measurement unit for further evaluation of a policy underway.

The experts dealing with the 1920s, i. e. the NEP period, are well aware of such a situation<sup>10</sup>. The attempt to accelerate industrialization in 1925/26 that resulted in the rise of inflation in the fall 1925 and the collapse of the convertibility of the 'chervonets' was related to the eagerness to retain the growth rates. However, in 1925/26 recovery growth was still there and its rates were fairly high. That is why, even with the emergence of the respective problems – a strained budget and clear signs of inflation, – the conflict was remedied by means of deceleration of rates of investment and monetary expansion that helped stabilize the economy. But, when the next analogous economico-political dilemma occurred (1927), by the time growth rates had fallen several times compared with their peak values of the recovery period, and against such a background the attempt to boost them resulted in the collapse of the whole NEP mechanisms, rather than a new stabilization.

<sup>8</sup> Groman V. O nekotorykh zakonomernostyakh, empiricheski obnaruzhivaemykh v nashem narodnom khozyastve//Planovoe khozyastvo, 1925.# 1, p. 132

<sup>9</sup> Economic and political situation in Russia. Monthly Reviews. M., IET

<sup>10</sup> See: Mau V. Reformy i dogmy: 1924-1929 gg. M., 1993, pp. 152-78

Nowadays, luckily, the debates on what shall be done to stir 'fading growth rates' up so far have not led to such tragic consequences. However, they are capable of exercising a serious and dangerous impact on the overall economic policy.

A relative exhaustion of the sources of 'recovery growth' poses a new problem of securing an economic growth that goes beyond the boundaries of recovery itself, i. e. such an economic growth that already implies creation of new, rather than involvement of old, production capacities, capital assets renewal, and attraction of a new, qualified workforce.

The solution to this particular challenge lies with intensification of economic reforms. In our view, overall, the government actions in this area are sound, however, one should bear in mind that this is a long-lasting process with a long time lag between an action and its effect. In this regard, for instance, it is quite natural to consider the US economic growth in the '90s to be closely related to R. Reagan's economic reforms of the '80s, with the time lag accounting for nearly ten years.

In the meantime, those who would like to stir the current growth up are guided by the logic, as follows: 'President trusted the Government and invested a huge political capital in their program. The Government began implementing their program and launched some reforms, and, as a result, growth rates fell twice'. They proceed with a conclusion that there arises a need to change the course, and this is the threat that now poses a serious challenge facing Russia.

In light of the above, a possible break in growth over 2003-05 bears a certain risk. Such a pause by itself is not dangerous, for the significance of ways the economic growth rates in 2003-05 can affect Russia's long-term prospects appears fairly limited. Rather, it is a pause, if not a cease, in implementation of structural transformations, which, considering the current Russia's situation, when recovery growth resources have been practically exhausted, are far more important than short-term fluctuations of growth indices. The only sound option would be to accelerate structural reforms and retain a conservative monetary and financial policy to shape prerequisites for a sustained economic growth basing on a set of efficient market institutions.

At the same time, it should be remembered that structural reforms require a high level of complementariness. Establishment of a favorable investment climate requires not just a completion of a tax reform, maintaining a sound exchange rate policy and lowering public expenditures – one also needs an efficiently operating judicial system, a real protection of property rights, and less corrupted red tape. All this suggests a long spade-work, with zero growth rates to appear already in the coming years.

## Section 1. The Socio-political Background

### 1.1. Economic policy in 2002 and the prospects for national elections

#### Political developments

In 2002 Russia saw its political elite consolidate along with the strengthening of main government institutions. The processes were developing following the logic of the Western-type market democracy. This is proved both by the nature of recent economic discussions and political developments.

Last year, the political forces and institutions furthered their consolidation, and their structures continued to crystallize. That became notable both in the central and leftist parts of the political spectrum. The centrist factions in the State Duma ('Edinstvo', 'Otechestvo-Vsya Rossia', 'Regiony Rossii') gave a rise to the pro-presidential party 'Edinaya Rossia', whose target is to win the majority in the Parliament. That appeared a natural result of the evolution of its parent structures, as well as the post-revolutionary development of the Russian society as a whole<sup>1</sup>. Once the problem with a leader for the coming years has been unambiguously solved, the political structures differing just by names of leaders under whom they were established naturally undergo mergers. At the same time this party has launched a peculiar search for its ideological doctrine.

Meanwhile, the leftist wing of the political spectrum split into proponents of a close collaboration with the presidential power and those in favor of keeping CPRF's opposition image. The difference between these two stances lies mostly in tactics. Both leftist groups recognize the supremacy of the effective Constitution of RF and are not keen to change the fundamentals of the constitutional system (at least, in the foreseeable future). Furthermore, CPRF has already experienced certain evolutionary processes, with S. Glazyev moving to its forefront (apparently, not without some support of the authorities). Having drifted over the past decade from Ye. Gaidar and V. Chernomyrdin's governments through the alliance with A. Lebed to G. Zuganov's camp and having de-facto replaced Yu. Maslykov as a 'Chief Economist' of CPRF, Mr. Glazyev, in all likelihood intentionally, is not the party member. His economic concepts are dirigist (and in this sense anti-liberal), but not at all communist. Thus the party experiences a serious change in its ideology in the core practical area – that is, an economic sphere. Though appearing obsolete and advocating the realities of the accelerated industrialization of the early 20<sup>th</sup> century, Mr. Glazyev presents an economic platform that does not appear rigorously communist.

Against the background of the noted political processes, the Lower House of the Parliament (Duma) has undergone a consolidation: its was right after the 1999 Duma elections when the centrists and leftists formed a broad coalition to acquire the much-needed leadership in the crucial Duma committees<sup>2</sup>. It was then when the government's 'peculiar' *modus operandi* arose: in the Parliament, the Cabinet had to deal with the leftists and centrists who controlled the overwhelming majority of committees, while its practical economic policy was

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<sup>1</sup> At the initial stage of establishment of the structures currently incorporated into 'Edinaya Rossia', the major principles they proclaimed were their de-ideologization or centrism (the later obviously is a synonym to de-ideologization).

<sup>2</sup> For more details, see: Russian Economy in 2000: Trends and Outlooks. Issue 22. M.: IET, 2001, p. 8-9

based upon the liberal ideology. Between 2000 to 2001 such a situation regularly generated artificial obstacles to the government socio-economic policy, for the CPRF members – heads of the respective committees (especially those on economic policy, social policy, and constitutional legislation) had enough tools to block the governmental and presidential initiatives. In 2002, the former agreements were revised in the Duma. That resulted in the centrists and right-wing forces' acquisition of control over practically all the committees. That was the re-grouping towards the structure of power, which is inherent in mature democratic societies, where a government rests upon the majority in a parliament. Such shifts appear very important, as they signify *an actual growth of the importance of the role played by the Parliament* in Russian political life. Should this particular trend be continued, the government resting on the parliamentary majority would form a standard (tradition) in the country, rather than an episode, even though the respective provisions have not been stipulated in the Constitution.

Further consolidation of Russian political system to a significant extent will depend on the 2003 Duma election. The supreme power is unlikely to flow towards the leftist part of the political sphere (presented by Communists and their allies). As long as the future ruling coalition is concerned, it is the performance of both the right wing and centrists' that becomes crucial: either post-election government will be 'purely presidential' (and therefore opportunist for centrists are ready to 'swallow' and follow any ideology), or the government will be formed by center-right coalition and become more fastidious ideologically, more consistently resting upon the Western-type market democracy values.

The leftists' performance will be equally important. Should G. Seleznev's left-centrists succeed, the current 'party of power' would see new allies, however, they will urge it to drift leftwards. As far as tactic and program challenges are concerned, for the 'pro-Putin centrists' such an alliance would be much more natural than a potential collaboration with the Union of Right Forces. This can be explained by an ultimately low role played by the ideology underlying both centrist blocks. In the event CPRF proves its strength (which appears quite likely), one may expect consolidation of power in the right-center sector along with the presidential Administration will try to push the Communist Party further towards social-democratic values.

One of the possible and important outcome of the December 2003 election may be the establishing of 'party in power' in Russia, i. e. the one enjoying majority in the Lower House. That will not mean immediate formal reallocation of powers from the President to the Parliament: if such a party arises, its ruling position will not be explained by popularity of ideas it would promote. Rather, its popularity would rest upon Mr. Putin's personal rating. But, having won majority in the Duma, such a party would unlikely remain just an obedient 'voting machine' in the hands of the presidential Administration. Enjoying the majority in the legislature, most likely the party will be keen to attempt to realize its own corporate interests and take a far tougher stand in its negotiations with the executive branch. It was yet in 2002 that, upon strengthening themselves at the communists' expense, the centrist factions were eager to demonstrate their independence of the Kremlin and the Government and began to increasingly bargain with them about bills passed to the Duma.

While comparing with the Western standards, Russian democracy is often referred to as an immature one. However, while comparing the national political system with those of the Western world, one should consider specifics of the given phase of the democratic development. The contemporary Russian political landscape does not fully matches modern Western standards. But, if one draws a comparison with the stages of development of the Western so-



cieties that are qualitatively comparable with the current situation in Russia, it becomes possible to single out a whole range of similarities and regularities.

At this point, we wanted to draw attention to two conditions, which the democratic systems followed over the past decades. First, the specifics of democratic societies that have just recently abandoned totalitarianism or authoritarianism. Secondly, when such systems functioned under a tough conflict between the right-wing and leftist parties. A typical reflection of the first case is Italy. Over the past decades, the country has been fostering the 'one-and-a-half-party democracy' with a leading governing party staying in power – either alone, or in a block with smaller allies – while the second-rated party (communists) was always in the opposition. Such a regime is likely to take place in Russia over some time, too.

As the Italian experience shows, while creating the political stability in a country, 'one-and-a-half-party democracy' can ensure a sustained economic growth. However, this regime also has a built-in restrictor, for it creates bullion for a widespread corruption. If the same party stays in power over a lengthy period of time, this does not contribute to the development of democratic control mechanisms, while characteristic features of authoritarian system are lacked, too. The ability of such a regime to ensure economic growth is dependent on the extent to which the civil society has succeeded in keeping its relative independence of the power and ensuring an elementary public control over bureaucracy.

Back to the comparison of Russia with the mature Western democracies, another specifics of the former country is the maintenance of substantial differences between the right-wing and leftist forces. This particular difference has already overgrown the stage of an absolute antagonism when these groups had no field for discussion, because they found themselves in absolutely different coordinate systems, adhered to absolutely opposite values and concepts of the country's development. When the right-wing forces were dealing with building fundamentals of market democracy in the country, communists could outcry about 'overthrowing the anti-national regime' and nurse their nostalgia about the USSR and the enthusiasm of Stalin era. These days, the situation has changed both at the program level<sup>3</sup> and in the parties' practical policy area. However, despite some convergence of their stances and their ability to hold a dialogue, the gap between them still remains very big. It roughly resembles the one characteristic of the Western nations in the 1930-50s. Hence, a greater toughness in the relationship between the Government and the opposition compared to that currently typical of the mature democracies.

Nonetheless Russia's basic values have already become the same as those of the Western democracies. Different political forces in the country accept certain values, and this trend manifested itself during the past two Duma election campaigns. More specifically, it took the form of appealing to the European experiences; while in 1995 the 'Social Democracy' bloc proclaimed «If you want to live like in Europe – vote for Social- Democrats», in 1999, the URF campaigned under the slogan 'To live in Europe without leaving Russia'. Discussion intensively involves cross-country comparisons, the World Bank papers (the reference pool for dirigists), New Zealand experiences (which is important for liberals), etc. So, one can argue that *de-facto* the discussion on 'Mother Russia's unique path' is over. This has, at least, one important effect: given that in the past decade the use of Western experiences to a great extent was the matter of common sense, rather than an indicator of a party/ideology affilia-

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<sup>3</sup> For the comparative analysis of programs of the parties having seats in the Duma, see: Russian Economy in 1999: Trends and Outlooks. Issue 21.M.:IET, 2000. P. 313-19



tion, nowadays the choice has been made in favor of the Western values, and the economic policy options lie in this particular frame.

The above becomes visible while analyzing the ongoing debates on such crucial matters as: the ways to consolidate economic growth, on joining the WTO and prospects of rapprochement with the EU; on deregulation; on reforming natural monopolies and an anti-monopoly policy as a whole. Some of these debates will be considered in a greater detail below. At this point, we just need to note that each of the aforementioned topics could not be discussed under the said conflict between ‘universalists’ and ‘russophiles’ of the 1990’s.

This particular trend of ‘integration’ of economic ideas into the world space is also reflected by its analogues in other key spheres of public life. *First*, that is the Government’s eagerness to create a relatively open economy. This desire manifests itself both in the debate on a ‘Common European economic zone’ and in the negotiations on Russia’s accession to WTO. *Secondly*, this is the emergence of an ‘open policy’ analogous to the ‘open economy’. These two phenomena are closely interrelated. Many crucial events in the international affairs that happened last year also concerned Russia.

Economic and political stabilization is also reflected in the increasing government’s attempts to develop long-term projections. Since 2000 the government regularly developed and updated programs on socio-economic policy for one and three years, while the year of 2000 saw the beginning of the process of developing medium-term projections. In 2002 Cabinet twice (in spring and in December) discussed three-year budgetary projections. The latter became another sign of the country getting out of an enduring financial crisis and that the problem of debt was transforming from the political into primarily technical deal.

### **Discussion on economic growth**

It was economic growth that formed the core issue of economic and political debates in 2002. All prominent policy makers and economists, including V. Putin, have contributed to the discussion. There were important grounds for the discussions, as the country experienced a deceleration of growth rates over the past three years.

Since the early 2002, growth rates came to the forefront of the discussions. In the beginning, the common belief was it was related to the stagnation noted over winter 2001—02. It is worth noting that the seasonal stagnation happened between autumn through winter has been noted in Russian economy over some years, however, time and again the analysts put the same question as to whether such a cease is just a seasonality, or the country faces a full-scale recession. The urgency and importance of the question was yet aggravated by the fact that in 2001 the world economy had witnessed the signs recession. That raised concerns about development of the Russian economy.

By spring 2002 Russia’s economy once again demonstrated some growth, but at a lower rate than over the prior years: 9 % in 2000, 5.5 % in 2001 and by 4 % in 2002. The rate of investment was only 2.5 % — much lower than in previous years and below the GDP growth rate. There were no substantial structural changes in the economy; moreover in the 2<sup>nd</sup> half on 2002 one could observe stagnation in the production of investment and consumer commodities, while the growth in production of raw materials continued. But the demand for final goods (both for consumption and production) was still growing rapidly which could become the source of acceleration of economic growth in the future – but only of if is re-oriented inwards, from imports to domestically produced commodities.



Though the growth rate of the economy nevertheless was higher than the respective performance of the EC and North American economies (4 % while it was about 2 % in USA and below 1 % in EU), the government was strongly criticized by various groups of politicians and economists. This criticisms implied that such rates would not allow Russia to catch up fast even with the poorest EC nations (Portugal) and the country was surely loosing the competition to the fast-growing China. V. Putin also urged the Government to develop 'more ambitious goals'. So the debate highlighted the problem of growth as a political, rather than economic, challenge. It was the evaluation of the Government's performance and the problems of the Government's policy options and individuals carrying them out that formed a major issue.

However, with all due appreciation of the importance of economic growth, the debate cannot be limited just by its merely political nature. In 2002, a key challenge for the coming years (or even decades) was formulated clearly – that is, bridging the gap between Russia and the most advanced nations. The economic history of the past two centuries provides numerous examples of such challenges that are known as «catch-up development». The solution to this problem may form an idea that would unite the society. However, the fundamental specificity of the challenge facing the country now is the need in a breakthrough from the industrial to post-industrial society. None of the nations have ever faced such a challenge<sup>4</sup>.

The recognition of this particular challenge as a key one allows immediate singling out some characteristics of the growth Russia currently needs. First, the country is in need of a sustained growth in the mid- and long run; and it is crucially important to prevent the rise of populism that may cause short-term effects, i. e. ensure attractive growth figures in the short run, to be followed by a severe crisis. Secondly, growth must be accompanied by progressive structural changes. The later, thirdly, suggests the development of institutional system that increases and adaptation capacity of the national economy as well as of individuals to constantly mutating challenges.

Economic growth is a complicated problem, especially if one considers a country that has just started abandoning a long-lasting period of revolutionary turmoil and needs a deep structural transformation of its economy. Different political and economic groups that participate in a discussion on growth seek after solutions to their own, substantially different, goals.

The problem of growth forms a real battlefield for different groups longing for power. It is the leftist forces with whose stand such a struggle can be associated at the least. They of course have their own notion of a 'proper' (i. e. ensuring economic growth) set of measures, however, it was not CPRF that plays first violin in criticizing the economic policy of the Government. Rather, the groups associated with the existing administration and the ruling party were among the most active critics of the Government – those groups that have already found themselves in the power structures but keen to strengthen their position and to extend the sphere of their influence.

The discussion in 2001-02 emerged around four basic avenues for promotion of economic growth.

*The dirigiste model* is based upon fundamentals of the traditional industrial policy, including selecting sectoral priorities and the state support (financial and nonfinancial alike) of these sectors. This model was advocated by representatives of both the leftist forces and some government institutions, as well as by economists associated with them. This particular

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<sup>4</sup> For a more detailed review of post-industrial challenges facing modern Russia, see: May V. Postkommunisticheskaya Rossia v postindustrialnom mire: problemy dogonyashego razvitiya // Vorposy ekonomiki, 2002. N 7.

government institutions, as well as by economists associated with them. This particular model is based upon an étatist ideology and the belief in government's ability to be wise and non-biased in selecting the industrial priorities and shaping a long-term strategy of growth. Protectionism as the method to support domestic producers from competition on the part of stronger foreign firms appears equally important in this model. Thus, the model suggests pursuing a pro-active «industrial policy» in its traditional (sectoral) sense.

*Fostering the development of financial and industrial groups*, increasing an investment (and overall organizational) role played by conglomerates of the largest companies. It is suggested that such establishments secure concentration of resources (more specifically, financial and intellectual ones) as well as lower transaction costs (as they integrate financial, production and R&D organizations 'under the same roof').

*The radical lowering of budget burden* on the economy (reform of forming and spending of budget funds) and bringing the budget burden in line with parameters inherent in economies with the analogous level of development.

*Institutional reforms* aimed at the encouragement of entrepreneurial activity, pursuance of a proactive public policy on establishing favorable conditions for investors — domestic and foreign alike. This necessitates the shaping of an adequate system of institutions, including the respective laws and an efficient law enforcement system. The merit of this particular model lies with an implicit recognition of the fact that the current growth lies both with an increase of investment and with reforming a number of institutions that allows to attain growth along with a simultaneous increase in the current level of well-being. Or, in other words, it is administrative barriers that do not allow the economy to fully benefit from the existing capacity.

It is the later institutions-setting model, which Mr. Kasyanov's Government evidently opt for. This particular model to the greatest extent appears adequate to the post-industrial challenges. However, the model is the least spectacular, from the public policy perspective. The conservative macroeconomic policy, tax reform, the process of deregulation, negotiations on accession to the WTO and its integration into the Common European economic zone, the development of a new labor and pension laws, and a gradual infrastructural monopolies' reform, — all these and other areas of the Government's activity have been carried out, though inconsistently, since 2000. They solidified economic fundamentals and ensure the pursuance of structural reforms.

Such a policy forms an easy target for the critique on the part of those who believe in 'economic miracles' or prove to be merely interested in a change of the Cabinet. There arise various proposals either on intensification of the industrial policy that implies setting sectoral preferences and a financial and non-financial support of the state, or on a drastic decrease of the budget burden on the economy, or on a notable devaluation of the ruble as a means of protecting domestic producers from foreign competitors.

Consolidation of growth has several aspects important for policy-taking. First, it is the specifics of the modern technologies at the age of the post-industrial breakthrough. Secondly, there are some specifics of growth, which coincides with the needs of a serious structural transformation. Thirdly, in the age of globalization economic development and growth cannot help but reacted to the state of affairs in the world economy (and it would be strange to hope for high growth rates when the whole world is in recession). Fourthly, growth is also affected by specifics of the post-revolutionary situation. All these four factors have a direct impact on



the modern economic growth in Russia, while their interlacing to a significant extent pre-determines challenges which Russia nowadays.

While designing a growth policy, one has to recognize that the key problem is the post-industrial nature of the noted challenges. In the post-industrial world, the mechanisms of tackling challenges associated with catch-up development appear substantially different from those of the industrial era, while the critics of the economic policy of 2000-02 were used to appeal to the latter. There are two main specifics of modern technologies: a sharp increase of dynamism and variety (up to individualization) of needs, on the one hand, and rapidly possibilities for satisfying them, on the other. This in turn means a sharp narrowing of time horizons for projection regarding priority avenues of technological development of national economies and industrial sectors. Given that under the industrial era one could pinpoint growth-related priorities and, having reached them, join in the group of advanced nations, these days priorities change quickly. Nowadays nation can try to become No.1 in terms of the computers per capita output, or to develop programs to build the best aircraft or telephony – however, by the date of their successful implementation, it will find out that the world will have already gone far ahead in a direction about which no-one could even imagine while designing his comprehensive computerization program.

As the year of 2002 witnessed a political battle around the problem of economic growth, there also were (and will be undertaken in the future) attempts to identify long-term sectoral priorities, on which the state could focus resources. All such attempts failed, for there are no such obvious criteria for singling out sectoral priorities. Further debates on the issue may lead to the situation in which one would single out sectors with maximal lobbyist capacity as priority ones.

The specifics of the post-industrial breakthrough suggests bringing to the forefront the task of ensuring flexibility of an economic system, adaptability of economic agents and their sensitiveness to modern challenges. These qualities substitute for a concentration of resources as a key element of a catching-up policy.

As well, one should not forget that Russia currently faces primarily the need in pursuing a serious structural transformation, rather than (and even not to the same extent) the challenge of ensuring growth. Meanwhile, as the most advanced nations' respective experiences show, it often happens that the period of structural reforms is combined with a slowdown of growth rates or even with stagnation (as it was noted, for instance, in a number of Western economies in the 1970s). This in part can be attributed to the fact that the traditional statistical methodology have a trouble in fixing new sectors (especially services), while partly this can be explained by the need in accumulation of resources for a new technological breakthrough<sup>7</sup>. Naturally, the above should not be perceived as a tribute to stagnation, however, one should take into account the fact that state administrative methods can relatively easy ensure an economic growth without structural shifts (like in Belarus under the reign of A. Lukashenko), but this kind of growth does not make nation more reach or its economy more efficient.

The structural difference between post-industrial and industrial societies lies in the proportion of services in GDP and employment, with this proportion prevailing in the former type of society. Russia has already demonstrated that it has moved along this particular avenue, although one should ensure a greater consistency of this process. A breakthrough (not

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<sup>7</sup> See: Melyantsev V. Informtsionnaya revolyutsia, globalizatsia I paradoxy sovremennogo ekonomicheskogo rosta v razvitykh I razvivayushokhsya stranh. M: ISAA MGU, 2000, p.14

a repetition) strategy must orient the economy towards an accelerated development of the service sector and primarily high-tech services, though here, again, it would be dangerous to try any further sectoral concretization.

As concerns industrial policy, in any case it should not be the center both ‘picking winners’ or appointing ‘national champions’. Both approaches would imply a preservation of the existing proportions. It is the strategy of a constant adjustment of the structure, under which the government is keen to flexibly protect national winners by political (including foreign policy) means in the world competition.

The emphasis on the high-tech does not mean oblivion of other, relatively promising, sectors. In Russia, those could be, for instance, the car- and aircraft- making industries. But with all their importance (from the political, technological and social perspective), these sectors are unlikely to form the ‘points of breakthrough’ into the post-industrial world.

There also is a range of sectors that form priorities in the logic of post-industrial society, but they lie beyond the economic sphere, and the state should focus on them. These sectors are:

- *Education.* Russia enjoys visible comparable advantages in this particular sphere, because the level and quality of education in the country are in excess of the respective parameters noted in the countries with the analogous level of economic development. At the same time it is investment in education that constitutes the critical factor ensuring an economic spurt.
- *Healthcare.* Apart from its humanitarian component, this particular sector is likely to have a considerable multiplying effect. With all the conditionality of the example, it is worthwhile noting that in the current situation the sector’s role can be the same as that of the railway construction in the industrialization of the late 19<sup>th</sup> century.
- *Military reform,* including a prompt transition from the conscription to a contract-based army. In the meantime, the youth is keen to escape the military service, which has a substantial distorting effect on the state of the labor market, as well as on the demand for educational services (including going abroad to study and work).

One can complement the above reform agenda with the judicial system and public administration reforms that made a hot issue for many experts and on which the respective documents were developed in 2002. The actual development of the situation increasingly leads everyone to the conclusion that it is the reform of political institutions that currently forms the bottleneck of economic development. Under imperfect political institutions (the judicial, law enforcement, and public administration systems) the further improvement of economic legislation faces with the effect of ‘diminishing returns’, i. e. providing increasingly less benefits. Economic legislation just provides certain rules of game, whose implementation depends primarily on law enforcement practices, on the efficacy of political institutions.

In addition to the advice to carry out a traditional industrial policy, there exists another set of recommendations on encouraging economic growth by the means of monetary policy – either by resistance to, or by support of the real appreciation of national currency. Proponents of the ‘weak Ruble’ refer to a stronger protection of the domestic producers, while those advocating the ‘strong Ruble’ argue that such a protection inhibits the structural reconstruction of the economy and conserves backwardness. In reality situation appears slightly different.



First, the monetary authorities have very limited capacity to influence the real exchange rate when there is a strong inflow of foreign currency to the domestic market. High prices for Russian exports push the Ruble upwards, while the Central Bank can just restrict its growth to a limited extent and only under some additional conditions. Say, in 2002 the Ruble real exchange rate remained stable, despite favorable prices for Russian exports, because of the Euro appreciation against the USD. Thus, despite a considerable foreign exchange inflow, Ruble did not strengthen against Euro, thus maintaining the competitiveness of Russian producers (as the major part of imported goods arrives to the country from Europe).

Secondly, from the perspective of its impact on an economy, the appreciation of a national currency by itself cannot be judged positively or negatively. Growth is usually coupled with the appreciation of a national currency, but it is the sources of the process that appears extremely important. The positive impact of the Ruble appreciation on growth can be noted only in the case of foreign investment inflow, i. e. when there is a rise in labor productivity and, consequently, in the competitiveness of domestic output. On the contrary, the strengthening of the Ruble as a result of a windfall export revenue inflow is a dangerous phenomenon, which is capable just of undermining the domestic output and giving the rise to the Dutch disease.

Given that post-industrial challenges set strategic contours of a growth policy, the specificity of the post-revolutionary development determines the set of tactical problems that the government has to take into account. The post-revolutionary economy has two important specific features: first, the presence of the so-called renewing growth regularities that manifest themselves practically in any economy that has undergone a severe slump for non-economic reasons (wars, revolutions) and is restoring its pre-crisis level. Secondly, the high level of transaction costs arising due to the impotence of a number of political institutions (primarily judicial, administrative and law enforcement systems), as well as because of the absence of (or the presence of a negative) credit record (credit history) of the majority of economic agents, including the government itself.

As concerns modern Russia, it is the fading nature of growth<sup>8</sup> in which the renewal regularities substantially manifest themselves.

The problem here is that in parallel with the renewal of the pre-crisis level of output, one needs to launch a new growth aimed at a structural renewal of the economy. This requires a very complex set of the above measures, while the lack of coincidence in time of the fading of renewal rates and the start of a new growth may form a source of political crisis related to the elites' reluctance to reconcile to the period of relatively low rates. There may arise a temptation to resort to a number of exotic and extremely dangerous measures as it had already occurred once in the USSR in the late 1920's<sup>9</sup>.

To accelerate economic growth, one also needs a substantial decrease of transaction costs that are high in a post-revolutionary country. This problem is inherent in all the nations abandoning the period of socio-political instability, while it is impossible to predict *a priori* how much time is needed to restore investors' confidence in the functioning of the national institutional system. It is evident that lowering transaction costs necessitates securing a steady

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<sup>8</sup> For a more detailed analysis of these particular processes, see Ye. Gaidar

<sup>9</sup> At the time renewal processes came to their exhaustion thus affecting growth rates and generating their rapid fall, and the government tried a radical change of the course. As a result, high growth rates were ensured by means of a large-scale violence as a key factor of economic life and at the expense of millions of lives, including the extermination of economists who had analyzed regularities of the economic development of the post-revolutionary Russia.

functioning of the aforementioned political and legal institutions — that is, the civil service, juridical and law enforcement systems, etc. It is equally important to ensure the government avoiding decisions that a normal private investor may conceive dubious.

In 2002, the executive power basically was keen to follow this particular logic, i. e. to ensure stability and predictability of its behavior and the refusal of measures that could be viewed as exotic. In this regard the Government's performance was fairly positive, because, despite serious pressures from different sides, it has not resorted to populist measures and continued to pursue a policy aimed at systematic institutional transformations. As well, the monetary policy remained balanced, which allowed avoiding a serious appreciation of the Ruble exchange rate through 2002.

At the same time, in the course of development of reforms and their implementation, which could contribute to overcoming the fading dynamics of the recovery process and to a generation of progressive structural shifts, there appeared a visible deceleration. With a certain progress in implementation of the 2000 Strategic Program was there, its rates were far lower than over the prior period.

Institutional reforms continued to be carried on: specifically, a crucial law on technical regulation was passed, which ensured lowering administrative barriers and opening new opportunities for cooperation with foreign partners. But the government failed to pass another important deregulation bill on self-regulating entities. Despite a vigorous work of the governmental commission on lowering administrative barriers, which considered functions of existing regulatory and control state bodies and ruled on simplification of their structures and regulation of their functions, the pace of de-bureaucratization proved to be lower than desired. That can be attributed to the vitality of excessive administrative regulation practices, rather than to the process of designing laws, and this is connected with the level of efficiency of the law enforcement system as a whole.

As well, in 2002 the government has succeeded in passing important, though compromise, decisions in the area of the land, labor and pension laws.

Tax reform area appears ambiguous: the lowering of taxes has not resulted in lowering the effective rates, but led to the convergence between them and nominal rates. Under the new system, a certain part of loyal taxpayers have already seen a tax burden relief, but a significant part of producers that had practiced tax dodging have not experienced real relief. This causes businesses' dissatisfaction, which forces the Government to continue to lower taxes as a prerequisite of the rise in growth rates.

There also is a range of negative phenomena in implementation of institutional and tasks aimed at stimulating economic growth: more specifically, there appeared a slowdown in the areas that are of critical importance for investment and entrepreneurial activity, such as the natural monopolies (especially the gas and electricity sectors) reform, the reform of social sub-sectors, the budget expenditures reform, the banking sector, and the military reforms. Should there be no vigorous attempts to reform these particular sectors, the current economic growth would remain unsteady and structural reforms would be unlikely.

From the tactical point of view, another pressing problem is the Government's ability to make decisions that entrepreneurs (investors) would conceive as fair and not requiring any further justification. Since 2000, practically all the Government's actions have remained clear and acceptable to the business community. However, right in the end of 2002 there appeared a dangerous precedent that can undermine the country's reputation: the auction on the sale of the control stake of Slavneft oil company raised questions about the ability of the Government



to maintain its neutrality towards big businesses and to create equal conditions and transparent procedures with regard to economico-political decisions. The problem does not lie with the fairness of the price Sibneft paid for the Slavneft and even not with the amount of losses the federal budget suffered because of debarring some large economic agents from participation in the auction. Rather, the main problem is that public opinion (and especially entrepreneurs' opinion) recognized the results of this particular deal as unfair, which has blackened modern Russia's business reputation.

The suspension of the progress in reforms in combination with low rates of economic growth has formed a reason for an exacerbation of the polemics on economic growth issues that had started as early as in the late 2002 already within the government. The polemics took place in the frame of the logic of institutional reforms. While concluding results of the prior year and the first three years of Mr. Putin in office, the RF Ministry of Economic Development and Trade made a series of statements on an insufficiently intense liberalization of the national economy: that implied the maintenance of a high level of tax burden (some 35 % of GDP), a slow and inefficient deregulation (lowering administrative barriers), failures to undertake special measures aimed at attraction of foreign investment (more specifically, the laws on special economic zones), the suspended natural monopolies reform, among others. It is the above that was recognized as a source of the slowdown in growth rates and the failure to fully capitalize on advantages Russia enjoyed resulting from political stabilization.

It was the RF Ministry of Finance supported by the RF Ministry of Taxes and Levies that opposed the former views. The financial agencies advocated a more conservative approach to the institutional and tax reforms. They proposed to suspend (or decelerate) the rate of changes in the tax system for a year or two, not to exploit special privileges (primarily various economic zones) to encourage investment activity, and to take a very conservative stand towards the further liberalization of the currency regime and any decisions that may resemble tax amnesty (for instance, Minfin was against the abolition of control over incomes in the case of investing into housing). In other words, to grant both businesses and the state with an opportunity to adapt to a new system, these agencies proposed maintenance of *status quo* for some time.

The thesis of some decline in the implementation of institutional reforms appears fair, but one cannot draw absolutely unambiguous conclusions on the impact of such a slowdown on economic growth rates. As it was discussed above, the currently emerging challenges have a far more complex nature.

## **Foreign economic factors of consolidation of economic growth: WTO and EU**

There are important factors of the strategy of acceleration of growth rates, which ensure its sustainability, that lie in the foreign trade sphere. That suggests an increase of efficiency of tariff policy (including the promulgation of a new Customs Code), completion of the process of WTO accession, and the progress in shaping the Common European economic zone (CEEZ).

Current level of Russian economic development does not require any 'international guarantors' of adequacy of its economic policy. Rather, it raises a question about competitiveness of Russian economic policy and its ability to be more attractive than the developed market economies' policies. The comprehension of this fact makes it clear that a direct and full copying of foreign institutions will not be able to help the country overcome its backwardness from the leading economies.



The year 2002 witnessed the crucial stage of the process of Russia's joining WTO. The negotiations intensified notably and became focused primarily on technical aspects, while the Government concentrated on completion of the legislation whose adoption constitutes a prerequisite of membership in WTO. Finally, the US and EU made important political decisions regarding recognition of Russia as a market economy. This also forms a substantial step on the way to accession to WTO.

Single nations' positions posed some additional obstacles to the process. Thus, having recently joined WTO, China now seeks Russia's consent with regard to simplification of its citizens' business operations in the Russian territory. There also are some attempts to tie up the membership in WTO with political problems Russia experiences in its relationship with single countries (for instance, Georgia). However, all these problems do not form serious constraints to the said process.

The problem of accession to WTO also has an important domestic political dimension – that is, a clear comprehension of objectives in this regard. There are four such objectives:

First, the accession for accession, for the purpose of having the possibility to participate in international institutions. This requires protection of domestic producers from foreign competition. In this case one should uphold maximal protection measures without any acceleration of joining WTO, as the latter can last as long as needed.

Second, support to Russian exporters, who, thanks to WTO, will receive new instruments to protect their interests, including the possibility of fighting against antidumping procedures. This concerns specifically the domestic metallurgical sector, chemicals, and some others.

Third, encouragement of development of new sectors (primarily those for highly technological services) that are of crucial importance to the nation's breakthrough into the post-industrial world. This logic is based upon recognition of the fact that the key to a successful accomplishment of the post-industrial breakthrough lies only with the orientation towards export, along with the development of new sectors in cooperation and competition with foreign producers.

Fourth, fostering competition and restricting the influence of domestic financial and industrial groups keen to broaden their economic and political control.

It is only with account of building the noted priority hierarchy that one can develop a further strategy of negotiations with the WTO members, as well as the relationship with main groups of influence within the Organization. It appears that it is the accomplishment of the third and fourth objectives that is critically important to Russia now. Indeed, the country sees the rise and strengthening of financial and industrial groups capable of solving certain strategic tasks – thus, they cannot form an object of a primitive fight. Though it has not been in the center of attention as yet, the major task is to establish favorable conditions for emergence and expansion of new sectors of the economy.

It is the post-industrial breakthrough, rather than a primitive protection of 'domestic producers', at which negotiations on accession to WTO and, consequently, on the matters of shaping the Common European economic zone should be aimed. The government policy in this regard should be focused on ensuring the penetration of perspective production and high-tech services to the world markets, rather than on protection of inefficient sectors. Such an approach suggests a fundamentally different, than the current concept of the accession to WTO.

As the membership in WTO forms an urgent issue, it has greatly intensified the domestic political discussion on the issue, which involved representatives of practically all business groups. It was heads of the biggest national industrial groups, who had joined the Russian Un-



Russian Union of Industrialists and Entrepreneurs a year ago, who sounded especially aggressive. Though the discussion would sometimes be not quite businesslike (including publicizing letters about a danger in joining WTO), the aforementioned stabilization allowed streamlining and institutionalization of the debates: Russian Union of Industrialists and Entrepreneurs established a special group to form a forum for big businesses to discuss the issue.

It is worth noting that there emerged a broad public consensus regarding joining WTO and the basic need of opening the economy. Disagreements in this regard mostly concern the pace of such a liberalization and protection of priority sectors (with each business group advocating different sectors), rather than the vector of liberalization of the foreign trade regime.

Diminishing custom duties and WTO accession do not appear unambiguously mutually related matters. Given that the purpose of the former in all likelihood should become the Russian consumers' well being, the latter proves to be the most effective means of assistance to Russian producers designed to protect them from other nations' attempts to restrict the freedom of trade.

Building relations with the EU forms a special task. Upon its expansion, roughly as much as a half of the Russian foreign trade turnover would fall on EU, and this should be taken into account while developing strategic matters of the socio-economic development.

The last 2-3 years witnessed further development of the national political and economic elites in recognizing prospects for the Russia-EU relationship. The Russia-EU dialogue has been reactivated after 2000, and the process of a real convergence has begun. The latter is based upon the concept of the Common European economic zone originally officially formulated by V. Putin and R. Prody in May 2001. Last year showed that the process is not easy walk, and there are numerous obstacles in this particular area.

Meanwhile, there are some groups of visible challenges, the solution of which would predetermine the nature of Russia-EU relationship in the foreseeable future. Those are, first, the principles of political and economic interaction, second, the prospects for the EU expansion and its will to consider Russia's interests, and, third, the contours of the Common European economic zone.

Recent discussions revealed the lack of readiness on both sides to promote Russia's political integration into Europe. For the EU, it would pose a serious problem due to the size of Russia and its geopolitical position. As long as Russia's development is concerned, its national interests dictate the inappropriateness of such an integration. There are both political and economic grounds underlying the latter.

From the political perspective, Russia remains a large and mostly national state, i. e. the state of the modern world which is keen to ensure an ultimately clear geopolitical position, with clearly set borders and domestic political structure. At this point, Russia appears close to the US, while being further from Europe whose states undergo an increasing transformation towards a 'post-modern' state<sup>10</sup>. The distinctive characteristics of the latter are a vague national sovereignty and transparent borders. The above helps understand why recently Russia's political dialogue with the US has been far simpler than with EU.

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<sup>10</sup> See: Emerson M. Slon i Medved: *Evropeysky Soyuz, Rossia i ikh blizhayshee zarubezhye*. M: Institut Evropy RAN, 2001. P. 8-9

From the economic perspective, Russia cannot adapt as the basis of national legislation European *acquis communitaire*, which constitutes a mandatory condition of a full membership in EU. *Acquis* impose on member states and candidate states financial obligations that appear incompatible to the present level of Russia's economic development and the need to address the aforementioned challenge of post-industrial breakthrough, though the country can use them as a landmark for building its new institutional system, though to a very limited extent and following only those parameters that encourage, rather than inhibit, economic growth<sup>11</sup>. For instance, should the EU social, labor, environmental and especially agricultural law standards be introduced to Russia, that would just create additional obstacles to economic growth. At the same time, it may become fairly appropriate to use the EU legal procedures in such areas as bankruptcy and banking law, standardization system, and technical regulation.

The effective Russian law undergoes a gradual adaptation along this particular avenue. In 2002, the law on technical regulation was promulgated, which should contribute to a substantial facilitation of cooperation between the domestic and European companies. The same can be said about the Code of Corporate Behavior designed and adopted last year by the Federal Securities Commission and professional operators on the securities market.

So, instead of a full-fledged Russia's integration into EU in the foreseeable future, it is intended to pursue a convergence policy, apparently along with the shaping of CEEZ as its core element. Meanwhile, there are three major avenues on which the progress will be seen: first, the convergence of the legal systems (the Europeans believe Russia should adopt the EU one); second, shaping conditions of free trade with goods and services; third, solving some problems in which the common European cooperation appears urgent or appropriate.

As noted above, it is just a limited circle of matters to which the EU legislation may be applicable, while Russia would benefit greatly from the creation of conditions of expansion of the free trade sphere. Despite the existing doubts about competitiveness of a considerable part of Russian products, the mutual opening of markets would be quite beneficial, considering strategic interests of Russia and the need to attain a new level of technological development. On the one hand, that would allow to limit monopolistic trends that have recently strengthened in the economy, while on the other hand, it would help overcome the domination of oil and gas in Russian exports, for private companies (those outside the monopolistic sectors) would find their niche both in terms of sales of their products and development of production cooperation. At any rate, that was the scenario according to which the situation in the Central and Eastern European economies evolved in the early 90's: at the time, they found EU markets to a significant extent open to them, which formed a major factor to contribute to their growth at the first stage of post-communist development.

Recent practices have shown that EU is reluctant to open its markets to Russian competitors, which became visible both in the course of negotiations on CEEZ and even with regard to accession to WTO, when the EU nations decided to grant Russia with the market economy status as a specific condition of the latter. As concerns Russia's accession to WTO, the respective rulings were passed by the US (in spring 2002) and EU (in autumn 2002), but

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<sup>11</sup> This problems is considered in a greater detail in: Aslund A., Warner A. EU enlargement: Consequences for the CIS countries. A paper presented to the conference 'beyond Transition: Development Perspectives and Dilemma' (CASE, Warsaw, 2002). Mimeo; Mau V., Novikov V. Otnoshenia Rossii i ES: prostranstvo vybora ili vybor prostranstva?// Vorposy ekonomiki, 2002. #6



the negotiations themselves and the nature of these decisions testify to serious concerns the EU had about the rise of Russian rivals. That in turn makes the prospects of liberalization of trade and economic relations and development of CEEZ fairly vague.

Having crossed out Russia from its documents on non-market practices, European Commission raised a number of claims in the area of market procedures, thus making them aimed against Russian exports. More specifically, this concerns the practices of using non-national (surrogate and even world) prices in anti-dumping investigations against countries with market economies. As well, the adjusted procedures allow imposition of sanctions both on single producers and the country as a whole, even if its economy is recognized as a market one. Thus a whole range of sanctions applied to non-market countries has been introduced in regulations that concern market economies. That was made fairly intentionally after making the political decision on granting Russia with the market economy status.

Nonetheless, the year of 2002 saw a continuation of the work on developing the concept for CEEZ and studying into factors and mechanisms of its functioning. Under the auspices of the 'High level commission' established specifically for this purpose and co-chaired by V. Khristenko and C. Patten, there started a work on developing conceptual and economic reports, including reviews on the state of single sectors and prospects for their functioning in the common European market (more specifically, the reports covered the ferrous and non-ferrous metallurgy, car-making industry, among others). The European Union ruled to extend the European Investment Bank's mandate towards Russia, and contacts and cooperation in energy and environmental problems were underway, though without serious effect.

In 2002, the prospects for Russia-EU dialogue were also challenged by the problem of Kaliningrad Oblast: after the EU expansion, the Oblast is to become an exclave Russian territory within EU. Last year, the predominant problem was visa regime for those commuting between the Oblast and 'mainland'; however, it is economic development of the region that would move to the forefront soon. Some experts proposed occasionally to consider the Oblast a 'pilot' region for furthering the relationship between Russian and EU. So far the realization of this concept has failed due to both political and economic reasons. However, both sides will have to consider their willingness to ensure a more intense integration in this regard, which can create the basis for further convergence of Russia's and European economic systems. So far, both sides have demonstrated a certain mistrust and circumspection towards each other. However, providing no formal membership of Russia's in EU, should a political decision in favor of economic integration be distinctly made, Russia will no longer be able to consider the integration of the Oblast's economy into the European one as a step towards separation of the Oblast, while EU will no longer view such an integration as a way for Russian rivals to illegally penetrate to European markets.

## **Challenges and priorities of the economic policy in 2003**

It is the upcoming parliamentary (scheduled for December 2003) and presidential (March 2004) elections that form a key political factor that will affect Russia's economic policy in 2003. While Western experiences in this regard allowed a detailed study into problems of a politico-business cycle, they still appear rather new for modern Russia and do not allow to draw theoretically significant conclusions. On the one hand, the past decade has not yet provided statistically significant data for a serious quantitative evaluation. On the other hand,

other hand, the phase of intense systemic reforms in principle provides insufficient fundamentals to identify steady regularities. The coming elections will form a crucial factor of an economic policy over the upcoming period, but so far the impact of elections on an economic policy at best can form a subject for speculative analyses.

With account of high chances for Mr. Putin's victory, any strengthening of populist tendencies in the macroeconomic policy in 2003 appears unlikely. So far the future institutional policy, i. e. reforms aimed at encouraging modernization and economic growth, leaves more questions than answers. The specificity of the current politico-business cycle in Russia lies with the deceleration of institutional and structural reforms, rather than a deterioration of macroeconomic parameters prior to the elections.

First, these reforms require the support of the Parliament. In the upcoming period, prior to the elections, the Duma members will be extremely cautious to take any decisions that may even remotely have a negative effect. The presidential Administration, with their current mission to ensure a formal parliamentary majority («the ruling party») as a result of the elections, will unlikely to insist on adopting unpopular (or not popular enough) laws. On the contrary, it is quite likely that the year of 2003 would see the rise in law-making populism – at least, in the institutional area, if not in the macroeconomic one.

Secondly, following its bureaucratic, rather than ideological, grounds, the power currently emerges in such a structural model that can pose an obstacle to institutional reforms. The political groups that form a 'protonucleus' of the 'ruling party' have no clear ideology and reform strategy, which in this particular case appears as if 'implanted' by the President or the Government. Should such political groups acquire power (or have guarantees of their coming to power), their interest in conducting serious transformations (even those promoting economic growth<sup>12</sup>) would fall sharply. Should a 'one-and-half-party' political regime emerge, this problem would become especially aggravated.

Third, it was already in 2002 that the government showed the first signs of a natural tiredness and the tendency to having a break after the two-year period of intense institutional reforms.

It is the President who could reverse the trend to slowdown in the institutional reform pace, because, first, a high personal popularity allows him to avoid populism in the pre-election period, and, second, the group of the most pressing decisions practically lack those that may cause negative social and political effects. On the contrary, the delay with long-awaited and much-needed reforms by itself can affect the economic situation. That is why, to postpone the reforms until the next electoral cycle can worsen the socio-political climate in the country. The problem is that institutional reforms usually require a long period of time to have their positive effects visible. That is why ensuring significant outcomes of the President's second term, including an accomplishment of the key mission – consolidation of economic growth – requires a timely implementation of the respective program of institutional reforms.

In one year before the elections the Government will have to carry out a very neat policy of encouraging economic growth under progressive structural shifts. The Cabinet will

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<sup>12</sup> Under certain circumstances, such a stance can prove to be even useful, particularly when an economy has already gained a certain momentum and any excessive interference of the power would be undesirable. However, so far Russia's economy has not reached such a state, that is why it is yet premature to speak about preservation of institutional reforms.



have to balance between encouragement of demand for domestic products and an increasingly growing importation of technological equipment, between maintenance of the present level of mineral export revenues and increase in exportation of machine-engineering (and in the future — new high-tech) goods. These tasks will require addressing a number of serious economic-political challenges.

In 2003, the government economic policy will allow to single out two groups of challenges that is, working out conceptual decisions on some strategic matters of national development, on the one hand, and implementing recently developed economical and political measures, on the other.

The former group of problems comprises a critically important concept of overcoming the economy's dependence on mineral exports, among others. This mission was assigned to the RF Ministry of Economic Development and Trade yet in 2002, however, it involves a huge volume of work on formulation of the respective complex of measures.

Another critical challenge is identification of a strategy in the budgetary policy area after passing the peak of foreign debt repayment in 2003. Since the problem of the Russian debt no longer forms the political issue, and it becomes primarily technical one, the debt management would not unambiguously demand pursuing a budget surplus policy. The Government will be confronted with an alternative: to proceed with forging a surplus budget, thus accumulating a reserve (stabilization fund), or to refuse this idea and lower the tax burden.

These conceptual options appear closely interrelated. The need in stabilization fund is determined by a significant role mineral export revenues play in the federal budget. That is why lessening the national economy's dependence on mineral exports would be accompanied by a less significant part played by the financial reserve and an extension of the room for the budgetary maneuver aimed at lowering the tax burden.

The government should show their commitment to the concept for the budgetary expenditures reform. This particular challenge has two aspects, and they both appear important: first, the structural reform of the budget sector and increase in the efficiency of budgetary resources; second, reduction in the budget pressure on the economy, which also demands rationalizing budget expenditures. The reform in this particular area should have been launched yet in the wake of the tax reform, however there was no progress in it. With the account of the upcoming elections, the start of the reform yet in 2003 is unlikely, however the elections may not preclude the Government from developing the reform concept.

The Government will have to develop a clear formula to begin realizing the concept for administrative reform, including reforming the civil service. The year of 2002 witnessed an intense preliminary work on evaluation of departmental and ministerial functions and development of an optimal system of their structure and interaction. The completion of the conceptual and organizational work in these areas would allow the new presidential term to start with a new operational structure of the civil service.

Finally, a substantial progress should be ensured in the military reform area, primarily in the change of recruitment principles. This is important both from the political, military, and economic perspective, for the task of post-industrial challenges is hardly compatible with a long distraction of young people from a vigorous creative activity. The discussions held in 2002, in pair with the growing openness of the defense expenditures in the 2003 budget, form the basis for making more resolute steps than before towards a professional army. Further-

Furthermore, an action plan to change the conscription procedures could form an attractive component of the incumbent President's pre-election program.

The list of practical tasks that should be addressed in 2003 comprises the following priorities:

- The completion of the negotiations on joining WTO and passing the necessary legal acts. A further procrastination of the negotiations is pregnant with the postponement of the accomplishment of the task for an uncertain period of time, due to the prospects of reforming the Organization itself;
- The infrastructural monopolies reform, that is, the continuation of reforming the Ministry of Railway transportation, adoption of a legal base of the RAO 'UES Russia' reform;
- Development and promulgation of laws regulating local self-governance and especially those securing its financial fundamentals;
- The continuation of implementation of the deregulation programme, including the adoption of a law on self-regulating organizations and streamlining the regulatory and control instances' functions. On the conceptual level, this mission is closely related to the administrative reform;
- Development of the legal base and enhancement of the financial institutions' operational efficiency; the continuation of the banking sector reform, to increase its reliability.

There will be much more to accomplish in 2003, however, the above is what we believe should form the list of priorities of the reform agenda. At this point, it should be emphasized that 2003 is the year of making decisions on a considerable number of conceptual problems, which can also be attributed to the specificity of the economico-political cycle in modern Russia: with the account of high chances for re-election of the incumbent President, in the pre-election year the emphasis may be made on developing the agenda for next presidential period.

## Section 3. The Real Sector

### 3.1. Production Macrostructure

#### 3.1.1. GDP Production: Dynamics and Structure

##### Production and Services

In the 1999-2002 period, a high rate of growth was observed in Russia's national economy. The economic upturn occurred in conditions of a favorable situation on the international markets and socioeconomic stability on the domestic scene. In 2002, growth in the GDP amounted to 4.3 percent, growth in investment in fixed capital, to 2.6 percent and growth in gross industrial output, to 3.7 percent. With the performance being continuously high, as compared to the international dynamics, there are grounds to estimate the showing as satisfactory.

In the 1999-2002 period, there was a change in proportions between different branches of the economy. While the total growth in output amounted to 35.8 percent in that period, the volume of market services grew by 21.0 percent; freight turnover with commercial carriage increased by 19.0 percent on the 1998 figure, commodity turnover with wholesale trade, by 60 percent, and the volume of communications services, by fifty percent. In the post-crisis period, retail trade has been among the fastest-growing branches of the economy. The 1998-1999 period saw an over ten percent reduction in the volume of retail trade on the 1997 figure, however, as households' effective demand was gradually restored in the following three years thanks to policy aimed at increasing households' real incomes, the volume of retail trade grew faster than the GDP. In 2002, the commodity turnover index was 131.6 percent as compared to the 1999 figure, while the GDP only grew by 19.2 percent in that period.

The dynamics of the GDP have been positive since the second quarter of the Year 1999 thanks to growth in output in the industrial sector, building industry and agriculture. In 2002, industrial output was 45.7 percent higher than in 1998, agricultural output, 22.6 percent higher and the volume of construction work, 33.1 percent higher. In the industrial sector, a thirty-year high in the average annual growth rate (6.4 percent) was registered in the 1999-2002 period. During that period, investment in fixed capital grew faster than the GDP for the first time in ten years.

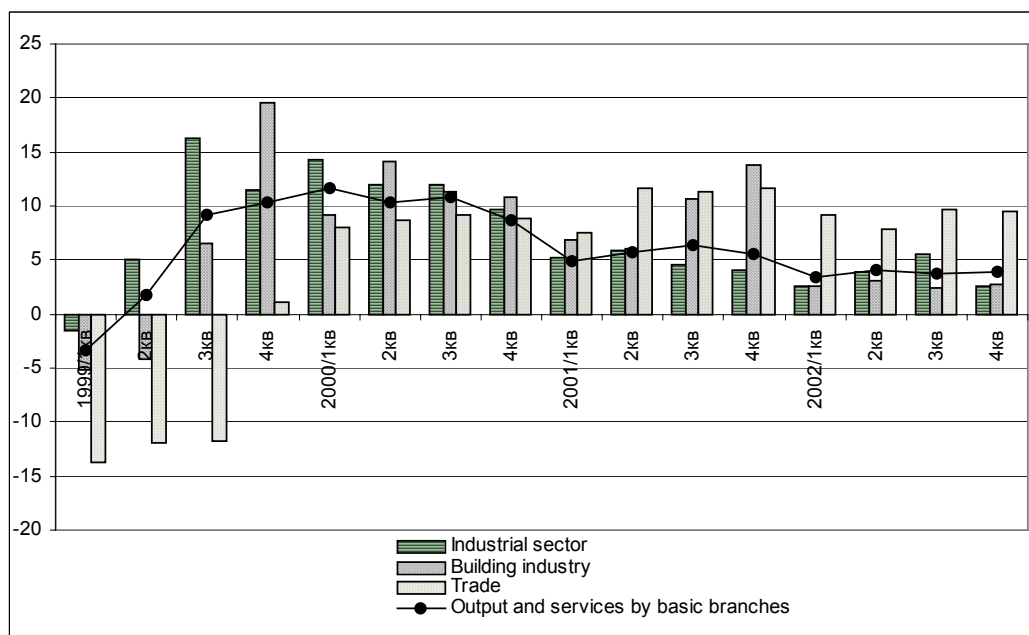
At the same time, comparative analysis of the macroeconomic performance observed in each year in that period reveals gradual slowing down of the growth rate. While in 1999-2000 annual growth rate of the GDP amounted to 8.5 percent, in 2001-2002 it amounted to 4.3 percent.

In economic growth in the 1999-2002 period, several distinct stages were observed, which were characterized by predominant influence on growth of different sets of factors:

- Late in 1998 and in the first half of 1999 there were extensive launches of products serving as substitutes for imported goods (these were stimulated by devaluation of the ruble); during that period, imports were sharply reduced and the growth in wages and salaries was comparatively slow; prices of natural monopolies' products were comparatively low;



- Starting from the second half of 1999, growth in external demand was registered thanks to favorable change on the world fuel, energy and primary goods markets;
- Starting from the third quarter of 1999, growth in domestic investment demand was observed thanks to growth in enterprises' incomes;
- Starting from the second half of 2000, growth in consumer demand was registered thanks to growth in households' incomes;
- Starting from the fourth quarter of 2000, the rate of industrial growth started slowing down due to fast growth of costs (which was caused by a rise in rates and fees charged by the natural monopolies) and gradual restoration of the former import rate;
- Starting from the beginning of 2001, decline in investment activity was observed due to change in the relative domestic and international prices;
- Starting from the beginning of 2002, slowing down of the growth rate in the industrial sector was observed due to factors that had taken shape in the above period.



Source: State Committee of the Russian Federation for Statistics

*Fig. 1. Dynamics of output and services by basic branches of the national economy in 1999-2002, percent of the figure of the corresponding quarter of the previous year.*

The extensive growth in output observed in the 1999-2000 period can be explained by an extremely favorable combination of external and domestic factors. The dynamics and proportions of production and ultimate consumption were greatly influenced by increased efficiency of domestic businesses caused by devaluation of the ruble and by favorable change on international fuel and primary goods markets. In the 1999-2000 period, average annual rates of growth in industrial output amounted to 11.1 percent. That period saw both expansion of the domestic market thanks to extensive development of manufacturing industries and growth in demand in investment goods on the part of the export-oriented sector.



At first, the situation favored manufacturers of consumer goods who are traditionally mostly active on the domestic market. In 1999-2000, growth in output of consumer goods amounted to 13.1 percent, which was a higher rate than that observed with the industrial sector as a whole and with growth in retail trade. Growth in the extractive sector was slower. In the 1999-2000 period, the average annual growth in output of fuel industry amounted to 3.5 percent. In that period, output of metallurgical industry was influenced by growth in domestic and international demand in structural materials.

The dynamics and proportions of production and ultimate consumption in 1999-2000 were greatly influenced by extensive growth in incomes of the national economy. In conditions of highly favorable international prices of hydrocarbon primary goods and metals, sharp growth in income from foreign economic activities and profitability of production, the exporting sector initiated expansion of demand in capital goods. Manufacturing industry's demand in domestically made equipment and intermediate goods also grew as the process of modernization and restructuring of production was stepped up. In the 1999-2002 period, growth in output in engineering amounted to over 46 percent on the 1998 figure. Growth in domestic demand had a favorable effect on growth in metallurgical, chemical, timber and building materials industries. In 2002, the volume of output of structural materials was nearly 33 percent bigger than in 1998.

However, the growth in investment demand that was observed late in 1999 and in the first six months of 2000 subsequently dwindled. Starting from the fourth quarter of 2000, the economy's incomes began to go down; simultaneously, there was a reduction in investment activity. In 2001, the rate of growth in investment in fixed capital went down by over 50 percent, to 8.7 percent, as against 17.4 percent in 2000; in 2002, it shrank to 2.6 percent.

In 2002, services growth rate exceeded commodity output growth rate for the first time since the 1998 default: with services branches, the growth rate amounted to 5.1 percent, as against 3.7 percent in the previous year. The dynamics of the volume of market services were particularly strongly influenced by growth in the volume of communication services and growth in commodity turnover in retail trade. With commodity branches, slowing down of growth was observed in 2002. Commodity output grew by 3.1 percent in 2002, as against 6.5 percent in the previous year. While in 2001 overall growth in commodity output was primarily attained through increased output in agriculture and building industry, in 2002 the industrial sector made the greatest contribution to that growth. In 2002, growth in the volume of construction work amounted to 2.8 percent, as against 8.7 percent in 2001. Starting from the third quarter of 2002, the amount of value added in agriculture went down, though, on the whole, the value of that parameter remained positive. The index of growth in agricultural output in 2002 amounted to 101.7 percent, as against 107.5 percent in the previous year. Starting from the second quarter, value added in the industrial sector grew faster than in agriculture and building industry, and that compensated for reduced growth rates in other commodity branches.

In 2001-2002, as the situation on international markets changed, economic policy priorities gradually shifted towards expansion of domestic end demand. When economic growth began in Russia, opportunities were created for raising of the living standards. While in 1999-2000 ultimate consumption by households was limited due to a low level of their effective demand, in 2001-2002 the situation changed. In the past two years, the ultimate consumer demand grew thanks to a 40-percent increase in real wages and real pensions on the 2000 figure and gradual abatement of inflation. With growth in households' incomes, retail trade became the fastest growing economic branch leaving building industry and the

came the fastest growing economic branch leaving building industry and the industrial sector behind.

*Table 1*

**Dynamics of the principal macroeconomic parameters in the 1997–2002 period,  
percent of the previous year's figure**

	1997	1998	1999	2000	2001	2002
Gross domestic product	100.9	95.1	105.4	109.0	105.0	104.3
Commodities output and services by basic branches отраслей	-	94.2	104.6	108	105.7	103.9
Industrial output	102.0	95.1	111.0	111.9	104.9	103.7
Investment in fixed capital	95.0	93.3	104.1	117.4	108.7	102.6
Agricultural output	101.3	86.8	104.1	105.0	106.8	101.7
Freight turnover	96.6	96.6	105.8	104.8	103.1	105.6
Commodity turnover with retail trade	104.7	96.7	93.9	108.8	110.7	109.1
Foreign trade turnover	101.7	84.7	86.7	129.7	105.4	107.8
Real available cash incomes	106.3	83.8	86.4	109.5	105.8	108.8
Consumer prices index	111.0	184.4	136.5	120.2	118.4	115.1

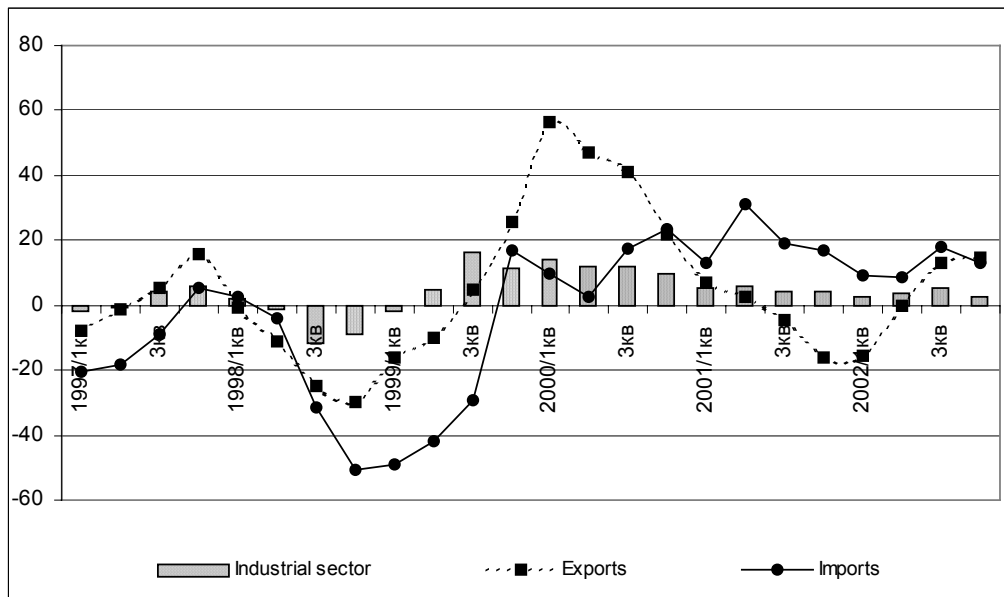
*Source:* The State Committee for Statistics of the Russian Federation

In 2001-2002, in a situation where consumer demand increased and growth in the industrial sector slowed down, imports of consumer goods grew faster than domestic production. Starting from mid-2000, the share of imports in overall consumer commodity resources has been growing. Strengthening of the ruble also contributed to expansion of imports. While reduction of the rate of exports in the 2001-2002 period can be explained by change of the situation on international primary goods markets, extensive growth in exports in the past two years has been caused by purely domestic problems.

Slowing down of industrial growth in the past two years shows that domestic businesses have not undergone such restructuring as would help create new competitive markets of domestic produce. As soon as the protection afforded to domestic markets by an artificially low exchange rate of the ruble began to slacken, it became obvious that Russian-made goods had not become more competitive than before. In fact, the proportion between domestic output and imports is the same as before the 1998 crisis. Due to orientation towards the traditional positions on international primary goods and fuel markets and lack of a long-term strategy for development of manufacturing branches of industry, financial and credit institutions have taken but a cautious stance on the issue of participation in financing of the real sector of the national economy.

Due to the primary goods exporting model, the rates of economic growth and the dynamic of foreign-trade turnover tend to level. Throughout 2002, the dynamics of output and structure of Russia's national economy were influenced by a favorable situation on international markets, which stimulated exports. In the second half of 2002, exports came to play an even more important role than before. In that period, unlike 2001, output in the export-oriented sector grew faster than output in the industrial sector as a whole. While the overall industrial sector output grew by 3.7 percent, output of the traditional exporting branches grew by 4.3 percent. While in 2001 expansion in extracting branches accounted for around one third of output growth in the industrial sector, in 2002, contribution by fuel industry and metallurgical industry accounted for nearly 50 percent of the growth in output in the industrial sector as a whole. As a result, manufacturing industries' influence on the general dynamics

became less pronounced. With influence of consumer branches remaining on the same level as in 2001 and contribution by investment branches reduced nearly by half as compared to the previous year, the nature of manufacturing industries' development was influenced by competing imports. Manufacturing industries' output went up by 3.4 percent; imports grew by 12.5 percent. In the structure of retail market resources, material and technical resources market and investment goods market, the share of imported goods grew continuously throughout the Year 2002.



Source: The State Committee for Statistics of the Russian Federation

Fig. 2. Dynamics of growth in exports, imports and output in 1995-2002, percent of the figure of the corresponding quarter of the previous year.

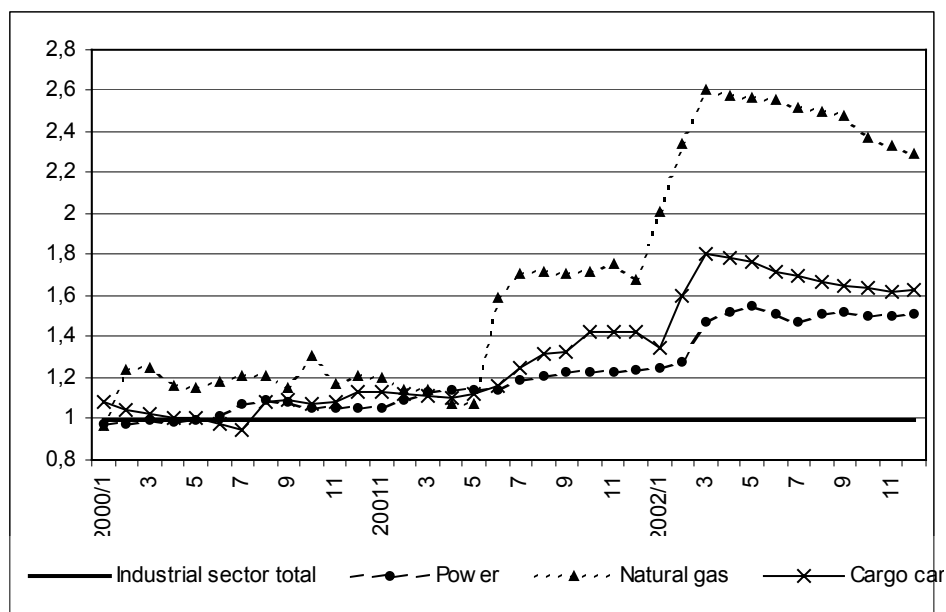
In 2001-2002, dynamics of economic growth were also influenced by changes in price proportions. While in 1999 and up till mid-2000, the dynamics of prices and tariffs charged by natural monopolies were but moderate, in the second half of the Year 2000 the situation changed. In 2000, natural gas prices were increased by 60 percent on the 1999 figure, cargo carriage tariffs, by 50 percent and prices charged by manufacturers in the industrial sector, by 31.6 percent. At the same time, growth in power rates exceeded growth rate of producer prices in the industrial sector by a mere 8.3 percent.

The Year 2001 saw widening of the gap in growth rates of prices of industrial manufacturers' produce and those of rates and prices charged by natural monopolies. The aggregate growth in manufactured goods prices amounted in 2001 to 10.7 percent, while the rates charged for power grew by 30.2 percent, prices charged for natural gas, by 41.5 percent and carriage charges by 38.2 percent. At the same time, growth in prices of intermediate goods and end products slowed down. With iron and steel industry, growth in prices amounted to 3.5 percent; in engineering, to 16.5 percent; in light industry, to 10.9 percent; and in food industry, to 15.0 percent; in nonferrous industry, prices went down by 10.6 percent.

April 2002 saw a sharp rise in producer prices in the industrial sector. That was a natural reaction to the rise in rates and prices charged by natural monopolies. In January-February 2002, gas prices went up by nearly 40 percent; in February, carriage tariffs were raised by 18.9 per-

cent. In April, growth in producer prices in the industrial sector amounted to 2.2 percent; from that time on, producer prices grew faster than consumer prices. Another reason behind that change in proportions of prices was last May's 8-percent rise in fuel prices, which, on the one hand, was aimed at leveling of domestic and international prices in conditions of change on international markets and on the other hand, stimulated by growth in domestic demand for gasoline. It is also to be noted that in May 2002 a 20-percent price rise on the FOREM wholesale power market was effected (it had been postponed since March 1, 2002). The above had a particularly adverse effect on fuel-consuming and power-consuming branches and industries. In the year in question, the total growth in prices of natural gas amounted to 30.2 percent; growth in power rates, to 27.3 percent; and growth in carriage tariffs, to 38.6 percent. After the sharp rise in industrial producers' prices in the second quarter, in the remaining months of 2002 gradual slowdown of growth in such prices was observed. Seeking to preserve their markets, end demand branches pursued cautious pricing policies. Growth of prices in engineering industry amounted to 10.6 percent, in light industry, to 5.3 percent and in food industry, to 5.8 percent.

In 2002, growth rates of manufacturers' prices (17.1 percent) were higher than those of consumer prices (15.1 percent). However, looking at a longer period, one can see that growth in consumer prices after the 1998 crisis was still greater than that in industrial producers' prices. In four years (August 1998-August 2002), producer prices grew by 240 percent, while consumer prices, by 280 percent. So, increased growth rates of manufacturers' prices can be seen as a mere closing of the gap.



Source: The State Committee for Statistics of the Russian Federation

Fig. 3. Dynamics of growth in natural monopolies' prices in 2000-2002, compared to industrial manufacturers' prices, percent of the December 1999 figure, industrial sector = 1

It is to be noted that in spite of increased growth rates of industrial producers' prices, the process of normalization of the structure of payments, growth of the share of cash payments for industries' produce and reduction in the volume of legal entities' arrears continued in 2002.



## Manufacturing Sector

Structural change in production was determined by changes on the domestic and international markets. During the 1999-2001 economic upsurge, the rates of growth in manufacturing industries were higher than those in extracting industries. Analysis of changes in the structure of the industrial sector shows that overall growth in output was almost totally attained through fast growth in branches oriented towards the domestic market. Structural changes in the industrial sector in that period were accompanied by faster than the average growth in the investment complex. Upturn in investment activity, which began in 1999, stimulated faster growth in engineering industry and building materials industry and higher demand in construction work. Growth in investment demand also stimulated development of branches producing intermediate goods.

However, starting from the second half of 2000, factors slowing down development of manufacturing industries came to prevail. Faster than the average growth in prices of primary energy carriers, growth in the real exchange rate of the ruble and a rise in wages and salaries brought about changes in the competitive situation on the domestic market. As a result, starting from the fourth quarter of 2000 reduction in the growth rate of profit and investment in end demand branches was observed.

In addition to market fluctuations, deeper-going limitations showed up. Opportunities for further increase of output are but limited due to the obtaining technical and economic parameters of industries' fixed capital and lack of equipment. In such a situation, level of business activity depends on the extent of utilization of competitive production facilities and efficiency of storekeeping.

Analysis of utilization of production capacities shows that a considerable portion of production facilities cannot be used in production due to their physical wear or functional depreciation. The rate of utilization of production capacities considerably differs with different branches of industry. With primary industries, where the share of value added is low, the rate of utilization of equipment is much higher than with manufacturing industries. There can be considerable differentiation even within the same branch of industry, depending on the type of prices. Extensive utilization in production of reserve capacities permitted resumption of economic activity, yet, it is to be remembered that there are certain limitations to utilization of equipment.

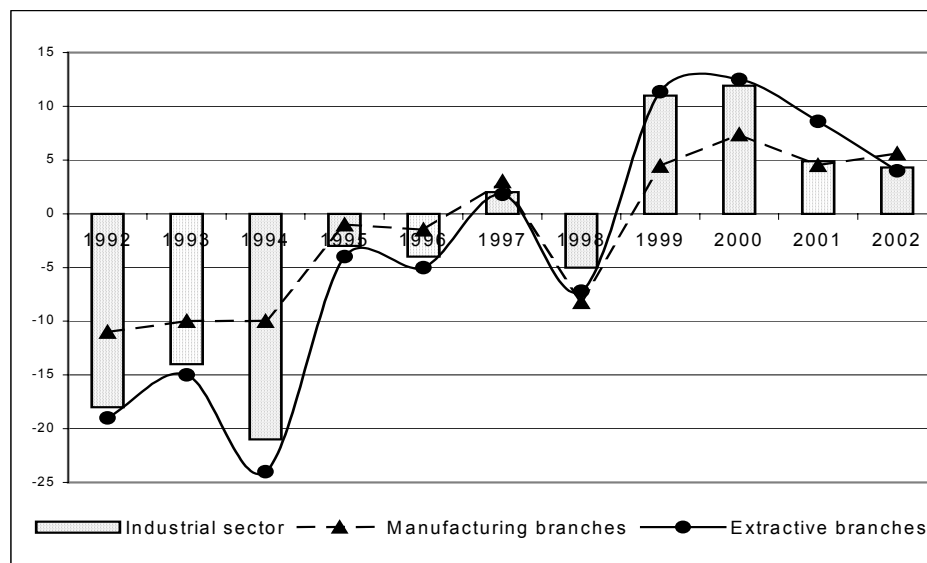
In extractive industries, growing demand can in most cases be met through use of the existing capacities, since quality of primary materials depends on the nature of the deposit, rather than on the method of extraction. In such industries, use of new technologies mostly helps reduce costs, raise labor productivity, increase output of co-products and the like. In extractive industries the ratio between the rate of wear and rate of utilization of production capacities is such that the loads on equipment can be seen as critical.

In manufacturing industry, especially in advanced technology production, potential for increasing output depends on quality of the equipment and technologies used. Due to a high rate of wear of fixed capital in manufacturing branches, the rate of utilization of equipment is the lowest there, that is also a factor limiting potential for further growth in output.

The relationship between the wear rate and age structure parameters evidences urgent need for speeding up of modernization. Engineering still ranks among the branches of industry with the lowest levels of utilization of production capacities. The long investment pause caused conservation of the structure of engineering; in conditions of switchover to an invest-

ment-based economic growth model, lack of machinery and equipment has become a factor hampering expansion of production. The situation has been made even worse by the fact that quality of engineering products is below the market standards and for that reason engineering industry cannot assure such sales volumes as would yield sufficient funds for large-scale investment in modernization of its production capacities.

Change in the dynamics and structure of domestic demand was accompanied by intensification of competition between domestic manufacturers and between domestically produced and imported substitute goods. The situation has been complicated by the fact that with growth in households' incomes and reduction in price-related competitive advantages formerly enjoyed by domestically produced goods imports of both consumer and investment goods tend to grow. The above circumstances have brought about slowdown in growth in manufacturing branches of industry, which branches have been ever more dependent on the dynamics of investment demand and innovation development strategy. The obsolete fleet of equipment and technologies and low labor productivity have put significant limitations on expansion of the aggregate supply and change in its structure. Considering the above and with the market capacity being high and effective demand being gradually restored, it is hardly surprising that foreign manufacturers have expanded their presence on the market. Abatement in domestic manufacturers' investment activity has resulted in loss of much of the ground previously gained and change in the competitive environment.



*Fig. 4.* Change in the dynamics of extractive and manufacturing branches of industry in 1992-2002, percent of the previous year's figure.

In 2002, considerable slowdown was observed in branches of the investment complex. In engineering industry, growth in output amounted in 2002 to 2.0 percent, as against 7.0 percent in 2001 and 20.0 percent in 2000. The state of investment engineering branches is such that it poses limitations to potential for urgently needed modernization and restructuring of production on a new technological basis; the obsolete structure currently observed in engineering can only reproduce obsolete forms of reproduction.



*Table 2*

**Dynamics of gross industrial output in 1998-2002, breakdown by the production complex, percent of the previous year's volume**

	1998	1999	2000	2001	2002
Industrial sector	95.4	111.0	111.9	104.9	103.7
Fuel and energy complex	97.5	100.9	103.9	104.6	104.3
Metallurgical complex	93.5	113.4	115.5	102.4	104.5
Chemical and timber complex	94.3	121.4	113.0	105.3	101.9
Investment complex	92.8	116.0	119.0	106.9	102.1
Consumer complex	97.1	104.8	114.7	107.7	105.5

*Source:* Calculated using data of the State Committee for Statistics of the Russian Federation

Performance by engineering industry was affected by change in the structure of demand in machinery. While in 1992-1998 the dynamics of growth in engineering industry primarily depended on automotive industry's dynamics, in the past four years the situation changed. That period saw fast development of instrument-making industry, communication industry and heavy engineering producing investment goods for transport, agriculture and oil industry. As domestic engineering industries gained an edge on their foreign competitors in prices, growth was observed in output of equipment for the consumer complex. Continuing their work on optimization of capacities, restructuring of assets and certification and introduction of new types of machinery, engineering industries managed to increase output of import substitutes.

*Table 3*

**Dynamic of output with different engineering branches, percent of the previous year's level**

	1998	1999	2000	2001	2002
Industrial sector, total	94.8	108.1	109.0	104.9	103.7
Engineering industry,	92.5	115.9	115.5	107.2	102.0
Including:					
Railway machine-building	87	108.9	107.4	126.0	121.7
Metallurgical machine-building	70.6	91.8	130.2	86.1	82.6
Electrical industry	85.7	127.0	130.1	112.6	93.8
Machine-building for chemical industry and oil industry	96.1	120.7	119.5	121.6	96
Machine-tool building and tool engineering	82.3	99.6	111.5	99.4	81.7
Instrument-making industry	103.4	140.8	118.4	98.0	90.9
Automotive industry	88.5	114.7	103.3	101.7	97.8
Communication industry	93.7	95.7	330.0	90.0	174.6
Production of tractors and other agricultural machinery	70.7	159.3	148.4	129.1	77.6
Machine-building for light industry and food industry and production of household appliances	90.6	115.8	109.5	107.1	115.9

*Source:* The State Committee for Statistics of the Russian Federation

However, in spite of the above positive trends, engineering industry's contribution to overall growth in industrial output is still much less than that of extractive industries. The two reasons behind this are the nature of this country's economic development since the 1960s and the specifics of the market situation in the past few years.

Thanks to growth in consumer demand, business activity in the consumer sector was maintained at the former level. Even though the growth rate slightly went down in 2002, consumer industries' contribution remained on the same level as before. The slowdown in



output of consumer goods can be explained by a 3.4-percent recession in light industry (on the previous year). While in foods turnover domestic manufacturers' positions remain stable, the situation on the non-foods market has been characterized by fast growth in imports. Light-industry output only grew faster than textiles imports and nonfoods turnover for a brief period of time; it was over by the third quarter of 1999. With change in the competitive environment and growth in imports' efficiency, the tendency towards ousting of domestically produced goods gained momentum. As can be seen from experience, sheer devaluation with no purposeful restructuring policy pursued did not improve domestic manufacturers' competitive ability, and that has caused instability in light industry's output dynamics.

The high rate of consumer branches' influence on the overall dynamics of output has been maintained through their faster growth, as compared to the primary goods complex and the investment complex. The consumer complex's output index amounted to 105.5 percent in 2002. As can be seen, the proportions of domestic industrial output were particularly strongly influenced in 2002 by reduction in the investment complex's share. It is to be noted that the change in the structure of production in the past few years has been mostly caused by change in the market situation and did not concern the material and technical basis of production. So, it can be concluded that the possible limits to development of the manufacturing sector have been determined by the accumulated potential.

### Oil and Gas Sector

In 2002, the situation of Russia's oil sector was greatly influenced by the situation on the global oil market. Since over 60 percent of oil produced in Russia has been exported, either in the raw state or refined, and on the domestic market oil is sold at prices considerably lower than the international prices, the international level of prices is the principal factor determining the income and financial situation of Russia's oil industry.

The landslide of international oil prices in the fourth quarter of 2001 (when the average price of OPEC basket oil went down to 18.3 USD a barrel) induced OPEC countries to pass on November 14, 2001 a decision on additional reduction in oil production by 1.5 million barrels per day for six months starting from January 1, 2002. However, unwilling to have its share of the international markets reduced, OPEC made implementation of that decision conditional on non-OPEC oil producers' readiness to effect aggregate reduction in oil production by 500 thousand barrels per day. In response, Russia declared its intention to reduce its international sales by 150 thousand barrels per day for the first quarter of 2002, Norway declared reduction of production by 150 thousand barrels per day for the first half of 2002, Mexico declared reduction in exports by 100 thousand barrels per day also for the first half of 2002, Oman and Angola also declared reductions in output, though on a lesser scale (in Oman oil production was reduced by 40 thousand barrels per day, while in Angola, by 22.5 thousand barrels per day). As can be seen, in 2002, OPEC chose to focus on stabilization of prices and securing of short-term income rather than launch a price war (as some experts had predicted), that is, dumping for the purpose of expanding of OPEC's share of the global market.

Thanks to the reduction starting from January I, 2002 in production and export of oil by OPEC countries and some non-OPEC oil producers and also a slight upturn in major industrialized countries' national economies, growth in international oil prices was observed in the first quarter of 2002. In March, oil prices on the international markets reached the level of



24-25 dollars a barrel. In April-July, OPEC countries' oil stabilized at the level of 24-25 dollars a barrel, that is, were in the middle of the price range (22-28 dollars a barrel) maintained by OPEC (see *Table 4* and *Fig. 5*). In August, as a result of global reduction in oil production (which primarily occurred due to slump in production in Iraq and in the North Sea region) oil prices began to grow reaching the level of 27-28 dollars a barrel. On September 19, 2002, a regular OPEC conference passed a decision on maintenance till the end of the year of the oil production quotas introduced on January 1, 2002.

However, as oil production in Venezuela and oil exports from that country dropped dramatically as a result of a nation-wide strike (according to the US Department of Energy, oil production went down from 2.9 million barrels per day early in December to 0.6 million barrels per day by the end of that month), oil prices on the international markets went up and the OPEC basket oil prices exceeded the ceiling of the price range set by that organization. In December 2002, Brent oil sold at 28.67 dollars per barrel, while OPEC basket oils, at 28.21 dollars a barrel. The high level of international oil prices in the closing months of 2002 can to a certain extent be explained by the expected US invasion of Iraq.

*Table 4***International oil prices in 1997–2002, dollars a barrel**

	1997	1998	1999	2000	2001	2002 1 <sup>st</sup> quarter	2002 2 <sup>nd</sup> quarter	2002 3 <sup>rd</sup> quarter	2002 4 <sup>th</sup> quarter	2002
Prices of Brent oil, the UK	19.12	12.72	17.97	28.50	24.44	21.09	25.07	26.91	26.81	25.02
Prices of Urals oil, Russia	18.33	11.83	17.30	26.63	22.97	19.72	23.60	25.81	25.55	23.73
Prices of OPEC oil basket	18.68	12.28	17.47	27.60	23.12	19.92	24.42	26.15	26.63	24.34
Average price of oil imported in the US	18.50	12.08	17.22	27.72	22.01	19.33	23.84	25.88	25.74	23.77

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

The two principal reasons behind international oil prices remaining rather high for a better part of the Year 2002 were the policy pursued by the OPEC and a certain upturn in global economy. In the US (which accounts for over 25 percent of the world consumption of oil), GDP growth rate went up from 0.3 percent in 2001 to 2.4 percent in 2002. Overall growth in the global economy was, however, held back by low growth rates in Europe and recession in Japan. As a result, according to the OECD International Energy Agency, the rate of growth in global demand in oil amounted to 0.5 percent in 2002, being only slightly higher than in the previous year (see *Table 5*). With OECD countries, a 0.2-percent reduction in demand in oil was observed in 2002. The most significant increase in demand in oil was observed in China (5.7 percent). In Europe, demand in oil went down by 0.7 percent in 2002. Of industrialized countries, Japan had the greatest reduction in demand (2.2 percent on the previous year's figure). According to the US Department of Energy, in the US demand in oil went up by 0.5 percent (in 2001, there was a 0.3-percent reduction in such demand in that country).

Unlike 2001, in 2002 growth in global demand in oil was accompanied by a considerable reduction in global oil production. While OPEC countries dramatically reduced oil production for the purpose of assuring the desired level of oil prices, in some other countries oil production was considerably increased. According to the International Energy Agency, oil production in OPEC countries was reduced from 30.11 million barrels per day in 2001 to

28.54 million barrels per day in 2002, that is, by 1,57 million barrels per day. Outside OPEC, significant increase in oil production was observed, especially in Russia where it was the largest. Oil production was also considerably increased in Canada, China, Brazil and Angola. In 2002, aggregate oil production by non-OPEC countries went up by 1.38 million barrels per day on the 2001 figure. So, reduction in oil production in OPEC countries was largely neutralized by increased deliveries from non-OPEC countries (see *Table 6*). As a result, OPEC countries' share in world oil production went down from 40.1 percent in 2000 to 39.2 percent in 2001 and to 37.3 percent in 2002.

*Table 5*

**Structure and dynamics of global demand in oil in 2001–2002**

	Demand, mil. barrels per day		Annual change, mil. barrels per day		Annual change, %
	2002	2001	2002	2001	2002
World, total	76.87	0.28	0.39	0.4	0.5
North America	23.95	-0.18	0.09	-0.8	0.4
Europe	15.88	0.20	-0.11	1.3	-0.7
OECD countries in the Asian Pacific Region	8.50	-0.08	-0.05	-0.9	-0.6
China	5.15	0.09	0.28	1.8	5.7
Countries in the former USSR territory	3.76	0.07	0.07	1.8	1.9
Middle East	4.96	0.14	0.12	3.0	2.5
Other Asian countries	7.47	0.02	0.09	0.7	1.2
Africa	2.51	0.03	0.03	1.4	1.2
South America	4.70	-0.03	-0.13	-0.7	-2.6
For reference: OECD countries	47.60	-0.07	-0.08	-0.1	-0.2

Source: OECD International Energy Agency.

*Table 6*

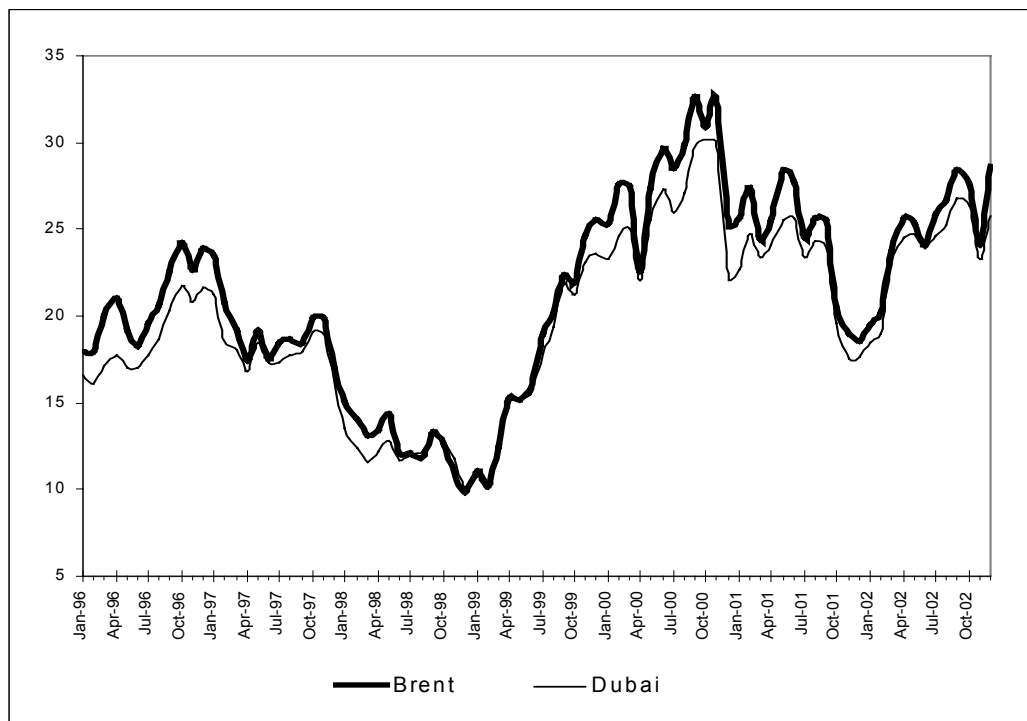
**Structure and dynamics of global oil production in 1999–2002, million barrels per day**

	1999	2000	2001	2002
World, total	74.20	76.72	76.78	76.58
Growth/reduction on the previous year's figure	-1.40	2.52	0.06	-0.20
OPEC countries	29.40	30.80	30.11	28.54
Growth/reduction on the previous year's figure	-1.40	1.40	-0.69	-1.57
Non-OPEC countries	44.80	45.92	46.66	48.04
Growth/reduction on the previous year's figure	0.00	1.12	0.74	1.38

Source: OECD International Energy Agency.

In 2002, development of Russia's oil and gas sector was largely determined by continuation of the processes that had begun in 2000-2001. In 2000-2001, both oil industry and Russia's national economy as a whole greatly benefited by the extremely high international oil prices, which situation afforded extremely favorable opportunities to Russia's oil sector. That period saw considerable growth in oil industry's output and profit, as well as in investment in oil industry. While in 2000 growth in production of oil and gas condensate on the previous year's volume amounted to 6 percent, in 2001, to 7.7 percent. It is to be noted that in 2001, unlike 2000, growth in oil output was mostly attained through commissioning of new oil wells, built thanks to investment made in the 2000-2001 period. While in 2000, oil extraction from formerly idle oil wells whose operation had been resumed amounted to 12.0 million

tons, or 68.3 percent of that year's growth in oil production, in 2001 that figure was 5.7 million tons, or 23.5 percent of that year's growth in oil production. The share of idle oil wells in the fleet of production oil wells went down from 24.3 percent in 1999 to 22.5 percent in 2000 and to 21.5 percent in 2001. A sharp upturn in investment activity was observed; volumes of production petroleum drilling and exploration petroleum drilling went up (on the previous year's figure) by 67.5 percent and 27.8 percent, respectively, in 2000 and by 8.4 percent and 15.6 percent, respectively, in 2001. The number of new oil wells made operational went up by 53.7 percent in 2000 and by 18.6 percent in 2001. The aggregate growth in oil and gas condensate output in the 2000-2001 period amounted to 14.1 percent, while growth in the volume of production petroleum drilling, to 96.1 percent, growth in the volume of exploration drilling, to 33.1 percent and growth in the number of new oil wells put into operation, to 84.6 percent.



Source: OECD International Energy Agency

Fig. 5. International oil prices in 1996-2002, USD per barrel

There was also an improvement in qualitative and quantitative performance of oil refining industry, which can largely be explained by modernization of oil-refining facilities. In 2000, new primary oil refining facilities with an aggregate capacity of 0.35 million tons were made operational, while in 2001, facilities with an aggregate capacity of 6.5 million tons. Fineness of oil refinement was increased to reach 71 percent, the share of lead-free motor gasoline in total output of motor gasoline went up to 97.9 percent, while the share of high-octane gasoline, to 46.7 percent.

In 2002, the same tendency for growth in output of oil and petroleum products as had taken shape in the 2000-2001 period dominated development of the oil and gas sector (see *Table 6*). According to the Ministry of Energy of the Russian Federation, total oil and gas condensate output amounted to 379.6 million tons in 2002, having grown by 9.0 percent on the previous

year's figure (that was the highest growth rate in the entire post-reform period). Largest oil outputs were achieved by the following oil companies: LukOil (77.5 million tons), YUKOS (69.9 million tons), Surgutneftegaz (49.2 million tons), Tyumen Oil Company (37.5 million tons), Sibneft (26.3 million tons) and Tatneft (24.6 million tons). Operators of projects based on output-sharing agreements only produced 2.0 million tons in 2002, or 0.5 percent of the total oil output in Russia. The volume of primary oil refining was increased by 3.3 percent, output of motor spirit, by 4.9 percent, output of diesel oil, by 4.7 percent and output of residual fuel oil, by 7.1 percent. For the first time in years, growth in output of natural gas was observed (by 1.9 percent). At the same time, due to limited export opportunities, saturation of the domestic market and drop in international oil prices late in 2001 and early in 2002 (in the fourth quarter of 2001 and in January-February of 2002, average prices of Russian oil on international markets amounted to 18-19 USD per barrel), a slump in investment activity was observed: the volume of production petroleum drilling went down by 16.8 percent in 2002 on the previous year; the volume of exploration drilling, by 40.2 percent, while the number of new oil wells put into operation, by 21.9 percent. The share of idle oil wells in the fleet of production oil wells, which had been reduced to 21.5 percent late in 2001, went up to make 23.1 percent by the end of 2002.

In oil refining industry, new primary oil refining facilities with an aggregate capacity of 1.5 million tons were made operational in 2002 (in 2001, facilities with an aggregate capacity of 6.5 million tons), and catalytic cracking facilities with an aggregate capacity of 2.5 million tons (in 2001, facilities with an aggregate capacity of 0.5 million tons). At the same time, fineness of refining of raw oil went down from 70.7 percent in 2001 to 69.7 percent in 2002. Output of petroleum products with the use of deepening technologies went up by 0.4 percent, while output of high octane motor gasoline was increased by 9.9 percent (its share in total production of motor spirit going up from 47.1 in 2001 to 49.3 in 2002).

*Table 7*

**Output of oil, petroleum products and natural gas, percent of the previous year's figure**

	1999	2000	2001	2002
Oil and gas condensate	100.5	106.0	107.7	109.0
Primary refining	102.9	102.7	103.2	102.0
Motor spirit	102.2	103.6	100.6	103.1
Diesel oil	104.2	104.9	102.0	103.5
Fuel oil	94.8	98.3	104.2	104.8
Natural gas, billion cubic meters	99.7	98.5	99.2	102.8
Oil gas, billion cubic meters	103.2	102.5	105.0	107.1

*Source:* The State Committee for Statistics of the Russian Federation, Ministry of Energy of the Russian Federation

*Table 8*

**Proportions of output, consumption and export of energy carriers in 1997–2002**

	1997	1998	1999	2000	2001	2002 (estimate)
<b>Oil, million tons</b>						
Output	305.6	303.4	305.0	3232	348.1	379.6
Export, total	126.9	137.1	134.5	144.5	159.7	180.0
Export to non-CIS countries	109.8	117.9	115.7	127.6	137.1	148.6
Export to CIS countries	17.1	19.2	18.8	16.9	22.7	31.4



	1997	1998	1999	2000	2001	2002 (estimate)
Net export	119.0	129.2	128.5	138.7	154.7	173.8
Domestic consumption	132.2	125.1	120.5	123.0	122.9	122.3
Net export, % of output	38.8	42.4	42.1	42.9	44.4	45.8
<b>Petroleum products, million tons</b>						
Export, total	60.6	53.8	56.9	61.9	70.8	83.7
Export to non-CIS countries	58.4	51.2	53.9	58.4	68.3	81.2
Export to CIS countries	2.2	2.6	3.0	3.5	2.5	2.5
Net export	56.6	51.0	50.3	61.5	70.5	83.5
<b>Oil and petroleum products, million tons</b>						
Net export of oil and petroleum products	173.4	178.3	184.5	200.2	225.2	257.3
Net export of oil and petroleum products, percent of oil output	56.7	58.8	60.5	61.9	64.7	67.8
<b>Natural gas, billion cubic meters</b>						
Output	571.1	591.0	590.7	584.2	581.5	594.5
Export, total	200.9	200.6	205.4	193.8	180.9	187.0
Export to non-CIS countries	120.9	125.0	131.1	133.8	131.9	134.8
Export to CIS countries	80.0	75.6	74.3	60.0	48.9	52.2
Net export	196.4	197.6	201.3	189.7	176.9	183.0
Domestic consumption	374.7	393.4	389.4	394.5	404.6	411.5
Net export, percent of output	34.4	33.4	34.1	32.5	30.4	30.8
<b>Overall</b>						
Output of oil and natural gas, million tons of oil equivalent	819.6	835.3	836.6	849.0	871.5	914.7
Net export of oil, petroleum products and natural gas, million tons of oil equivalent	350.2	356.1	365.7	370.9	384.4	422.0
Domestic consumption of oil and natural gas, million tons of oil equivalent	469.4	479.2	470.9	478.1	487.1	492.7
Net export of oil, petroleum products and natural gas, million tons of oil equivalent, percent of output of oil and natural gas	42.7	42.6	43.7	43.7	44.1	46.1

Source: The State Committee for Statistics of the Russian Federation, Ministry of Energy of the Russian Federation, State Committee of the Russian Federation for Taxation, our own calculations

Analysis of data on production and exports of oil and petroleum products (see *Table 8*) shows that practically all the oil produced in 2002 was exported, either as crude oil or as petroleum products produced from it. According to preliminary estimates, net oil and petroleum products exports amounted in 2002 to 257.3 million tons, growing by 32.1 million tons on the previous year's figure (in that growth, increase in exports of oil accounted for 19.1 million tons, while increase in exports of petroleum products, for the remaining 13.0 million tons). Just like in the 2000-2001 period, growth in exports stimulated a considerable increase in output in 2002. As a result, the share of net exports of oil and petroleum products went up to 67.8 percent of oil production. As a result of increased demand in natural gas, both on domestic and international markets, output of natural gas was increased in 2002, for the first time in years, and the share of net export in the total natural gas output went up to 30.8 percent. There was also a considerable growth in investment activity in the gas sector. In 2002, the volume of production natural gas drilling grew by 60.9 percent on the previous year's figure.

While in 2000 domestic oil prices in USD equivalent tended to grow nearly reaching the pre-devaluation level, in 2001 fast growth in oil output in conditions of limited domestic demand resulted in overproduction and hence in drop in domestic oil prices, both in real and in nominal terms. Domestic oil price in dollar equivalent went down from 56-58 USD per ton early in 2001 to 49.9 USD per ton in December. Gasoline prices, which had hit the high (200 USD per ton) in the fourth quarter of 2000, went down throughout 2001 reaching the 151.5 USD per ton level by the end of the year. The domestic gasoline price thus went below the pre-devaluation level (see *Table 9*). After the above period of reduction of domestic oil and petroleum product prices, which continued into the opening months of the Year 2002, in spring of 2002 the tide changed due to increased costs and rise in international prices. Beginning from April 2002, continuous growth in oil prices was observed (both in rubles and in USD equivalent); beginning from May, gasoline prices started growing, too. Towards the end of the year, oil and petroleum product prices stabilized. At the same time, there was still a considerable gap between domestic and international oil prices; in 2002, the difference was in the area of 35-40 percent. Natural gas prices nearly reached the pre-devaluation level in 2002.

*Table 9*

**Domestic oil, petroleum product and natural gas prices,  
USD equivalent, in 1997–2002 (enterprises' average wholesale prices, USD per ton)**

Year	Month	Oil	Motor spirit	Diesel fuel	Fuel oil	Natural gas, USD/ thousand cubic meters
1997	December	63.1	169.6	170	73.8	6.6
1998	December	16.4	63.4	52.9	22	2.1
1999	December	37	171.9	125	46.1	2.2
2000	December	54.9	199.3	185	79.7	3.1
2001	December	49.9	151.5	158.5	47.1	4.8
2002	March	39.4	113.2	119.3	33.8	6.3
2002	June	49.4	166.7	171.4	75.9	6.3
2002	September	59.5	184.2	154.3	77	6.2
2002.	December	60.7	168.8	153.8	66.1	5.9

*Source:* Calculated using data of the State Committee for Statistics of the Russian Federation

Despite the limitations on export of oil imposed in the 1<sup>st</sup> quarter of 2002 (which limitations were imposed in conformity with Russia's obligations to reduce supplies of oil to the international market in support of the OPEC's effort to bring international oil prices back to the level which would be acceptable to oil-producing countries), in January-November 2002 export of oil and petroleum products was larger than the volume of the corresponding period in 2001 by 12.7 percent and 18.2 percent, respectively (*Table 10*). In January-November 2002, the share of export in production of fuel oil, diesel fuel and motor spirit amounted to 66.6 percent, 54.4 percent and 11.7 percent, respectively (It is to be noted for the sake of comparison that in 1999 the share of export in production of motor spirit amounted to a mere 7.2 percent.) In January-November 2002, export of oil in value terms amounted to 110.2 percent of the level of the corresponding period in 2002. In January-November 2002, the total value of export of oil and main types of petroleum products amounted to 34.9 billion USD, which was 11.6 percent more than the figure of the corresponding period in 2002.

*Table 10***Export of oil, petroleum products and natural gas from Russia,  
% of the volume of the corresponding period of the previous year**

	<b>2001 January-November</b>	<b>2002 January-November</b>
Oil export, total	111.0	112.7
including:		
Export to non-CIS countries	108.0	108.4
Export to CIS countries	133.9	138.7
Export of petroleum products, total	111.5	118.2
including:		
Export to non-CIS countries	113.7	119.0
Export to CIS countries	72.5	100.7
Gas export, total	92.5	103.4

*Source:* The State Committee for Statistics of the Russian Federation

The total volume of export of oil and petroleum products increased from 230.5 mil tons in 2001 to 236.7 mil tons (preliminary estimate) in 2002, that is, by 14.4 percent. Export of crude oil still accounted for a larger portion (70%) of the total volume of export of oil and petroleum products, while diesel oil and fuel oil accounted for most of the export of petroleum products. Export of natural gas grew by 3.4 percent. The greater portion of energy carriers (83% of oil, 97% of petroleum products and 72% of gas) was exported to non-CIS countries. In January-November 2002, the share of export of oil and petroleum products in Russia's volume of export amounted to 36.4 percent.

Reduction in import of petroleum products which had begun late in 1998 as a result of devaluation of the ruble and due to high prices on oil on the international market continued. In January-November 2002, import of petroleum products decreased by 49 percent on the volume of the corresponding period in 2001, in particular, import of motor spirit went down by 65 percent on the 2001 volume, while the share of import in gasoline supply fell from 0.4 percent in 2001 to 0.1 percent in 2002 (it is to be noted for the sake of comparison that in the first half of 1998 (that is, prior to the devaluation of the ruble) the share of import in gasoline supply amounted to 8.7 percent).

Analysis of dynamics of Russia's oil export for a long period of time reveals that in 2002 the total net export of oil and petroleum products exceeded (according to preliminary estimates) the 1990 level (246.3 mil tons) for the first time in the past few years. However, it is still below the 1988 level when the record-high volumes of export of oil (291.6 mil tons) were registered. In oil exports, absolute reduction in the volume of export of crude oil and increase in the volume of export of petroleum products (which volume had been continuously growing since 1996) was observed. The share of petroleum products in oil export grew from 18.2 percent in 1990 to 32.5 percent in 2002 (Table 11). Due to a drop in domestic consumption of oil (according to our calculations it went down from 269.9 mil tons in 1990 to 122.3 mil tons in 2002, that is, by more than 50 percent) the share of export of oil and petroleum products in oil production increased from 47.7 percent to 67.8 percent in that period. Unlike export of oil and petroleum products, net export of natural gas did not exceed in the past few years the volume of the second half of 1990s, though the share of net export in natural gas output is still somewhat higher than the pre-reform level (30.8 percent in 2002, as against 28 percent in 1990).



*Table 11*

**Structure of net export of oil and petroleum products**

	1990		2002 (estimate)	
	Mil tons	%	Mil tons	%
Oil and petroleum products	246.3	100.0	257.3	100.0
Oil	201.5	81.8	173.8	67.5
Petroleum products	44.8	18.2	83.5	32.5

*Source:* The State Committee for Statistics of the Russian Federation, the State Customs Committee of the Russian Federation, the OECD International Energy Agency and our own calculations.

In 2002, the aggregate net export of oil, petroleum products and natural gas reached the 1990 level (while still remaining below the 1988 level). In our estimate, it rose from 407.6 mil tons of oil equivalent in 1990 to 422.0 mil tons of oil equivalent in 2002 (that is, there was a 3.5 percent increase). The share of net export in the aggregate production of oil and natural gas rose from 37.3 percent to 46.1 percent. This shows that in a way the oil and gas sector became more export oriented than it was in the pre-reform period, however, it is to be remembered that such growth in the share of export can mostly be explained by drop in production of hydrocarbons due to decrease in the rate of their domestic consumption and the volume of such supplies to CIS countries and Baltic states and worsening of conditions of production, rather than by growth in export volumes in real terms (which growth was rather insignificant).

Thanks to oil prices on the international market being high for the better part of the Year 2002 the oil sector received high revenues. In January-November 2002, aggregate revenues from export of oil and petroleum products amounted to 34.9 billion USD. In January-October 2002, the total profit (balance financial result) of oil industry, including oil production industry and oil refining industry, amounted to 3.49 billion USD. It is to be noted that oil industry accounted for 31.3 percent of the total profit of the industrial sector and 13.2 percent of the overall profit of Russia' national economy (in 2001, those figures were 39.4 percent and 20.7 percent, respectively). Reduction in the volume of profit of oil industry was largely caused by introduction (from January 2002) of a mining tax in respect of oil, which tax is charged at a higher rate than the three types of charges which were levied earlier (charge for use of mineral wealth, deductions for reproduction of mineral and other natural resources and oil excises), high export duties and growing production costs.

Revenues of the oil sector as a whole helped secure high budget revenues and permitted oil companies to stabilize the situation with accounts payable to suppliers and reduce their arrears to the budget. By the end of October 2002, arrears (US dollar equivalent) of oil industry to budgets of all levels amounted to 0.1 billion USD which was a many-year low (*Table 12*). By the end of October 2002, overdue debts of oil industry in respect of bank loans and credits went down to 78.8 mil USD, which was a considerable reduction. The share of oil industry in the total volume of overdue debts of branches of the economy in respect of bank loans and credits decreased from 7.6 percent in October 2001 to 2.0 percent in October 2002.

*Table 12*

**Oil industry's financial performance in the 1997-2002 period, billion USD**

	1997	1998	1999	2000	2001	2002*
Revenues form export of oil and main types of petroleum products	21.09	13.96	18.82	34.89	33.43	34,90.

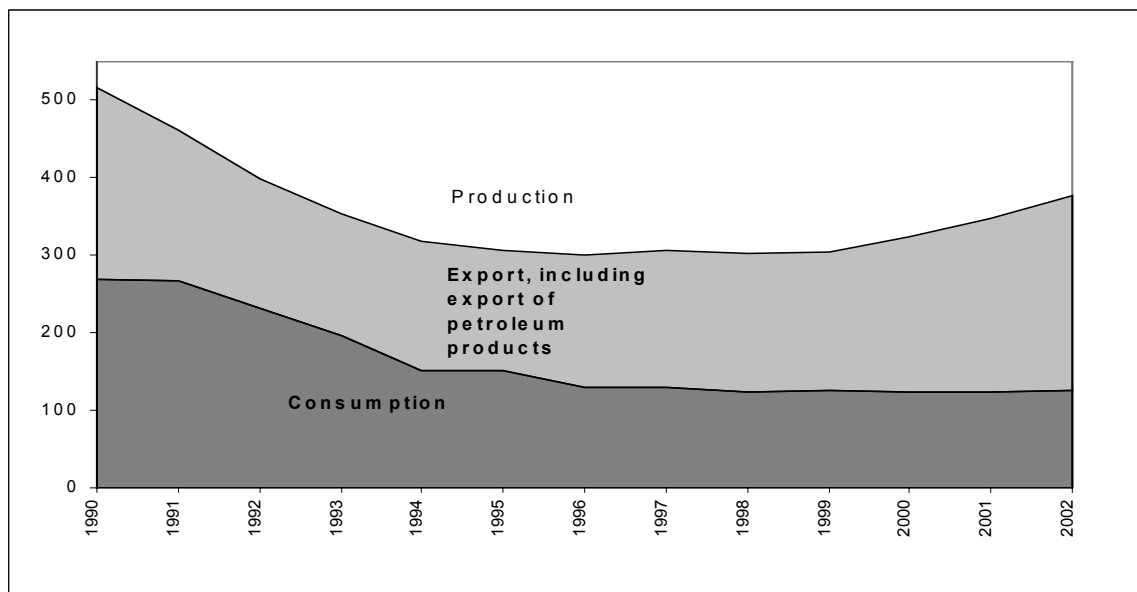


Profit (balance financial result)	3.52	0.60	6.32	10.42	8.14	3.49
Overdue accounts payable (as of the end of the year)	6.79	2.41	1.61	1.35	1.01	1.01
including:						
debts to suppliers	2.38	0.94	0.7.2	0.55	0.52	0.53
debts to budget	2.53	0.66	0.43	0.27	0.15	0.10

\*Data for the Year 2002: revenues from export of oil and petroleum products in January –November, profit in January –November and overdue accounts payable as of the end of October.

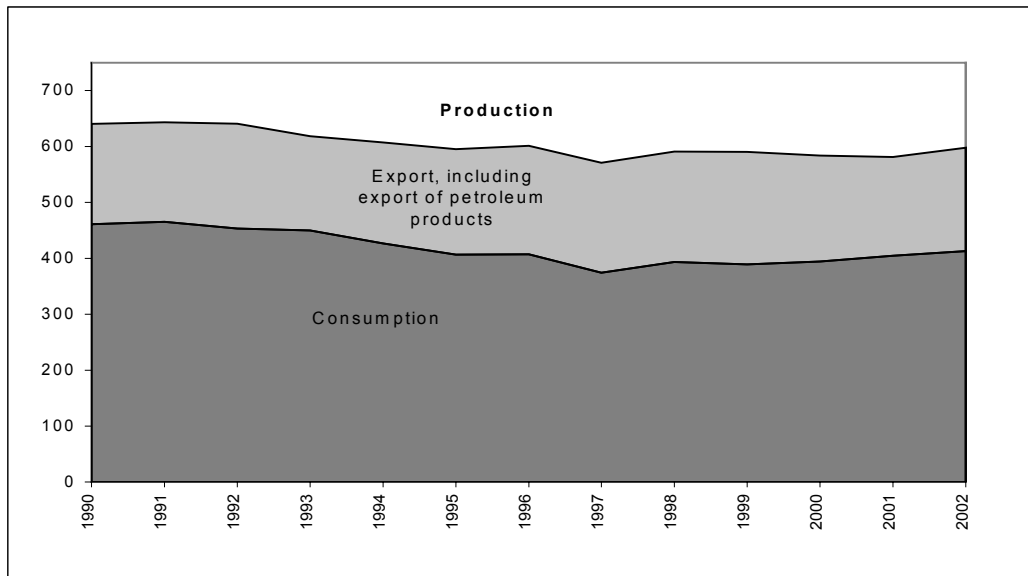
Source: Calculated using data of the State Committee for Statistics of the Russian Federation.

Change in such principal parameters of development of the oil sector as characterize the volume of production and sales on the domestic and international markets, pricing, investment activity and the situation with payments and settlements is illustrated in Fig. 6-14.



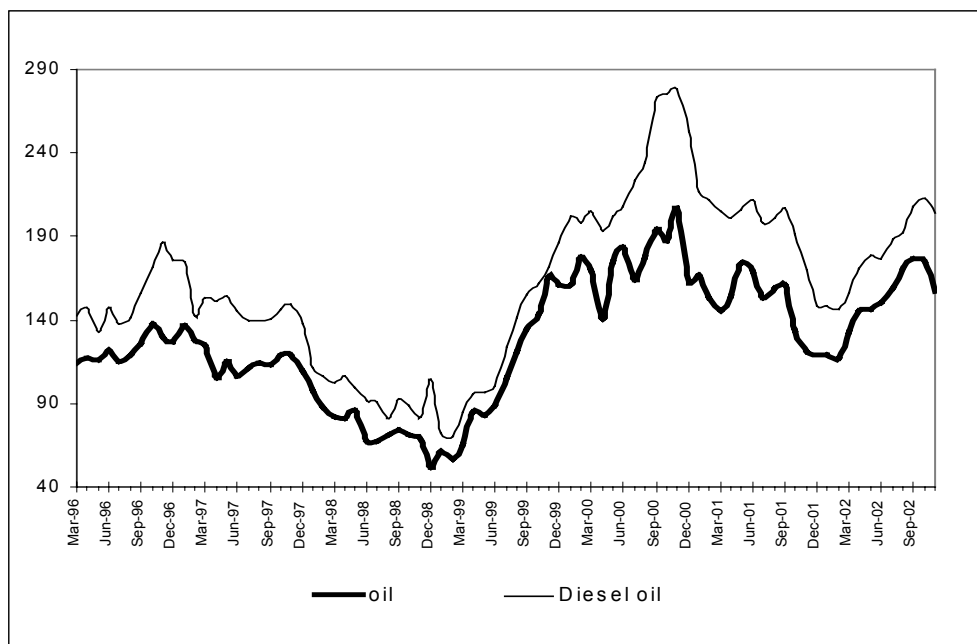
Source: The State Committee for Statistics of the Russian Federation, the State Customs Committee, the International Energy Agency and our own calculations.

Fig. 6. Production, consumption and export of oil in the 1990-2002 period, mil tons.



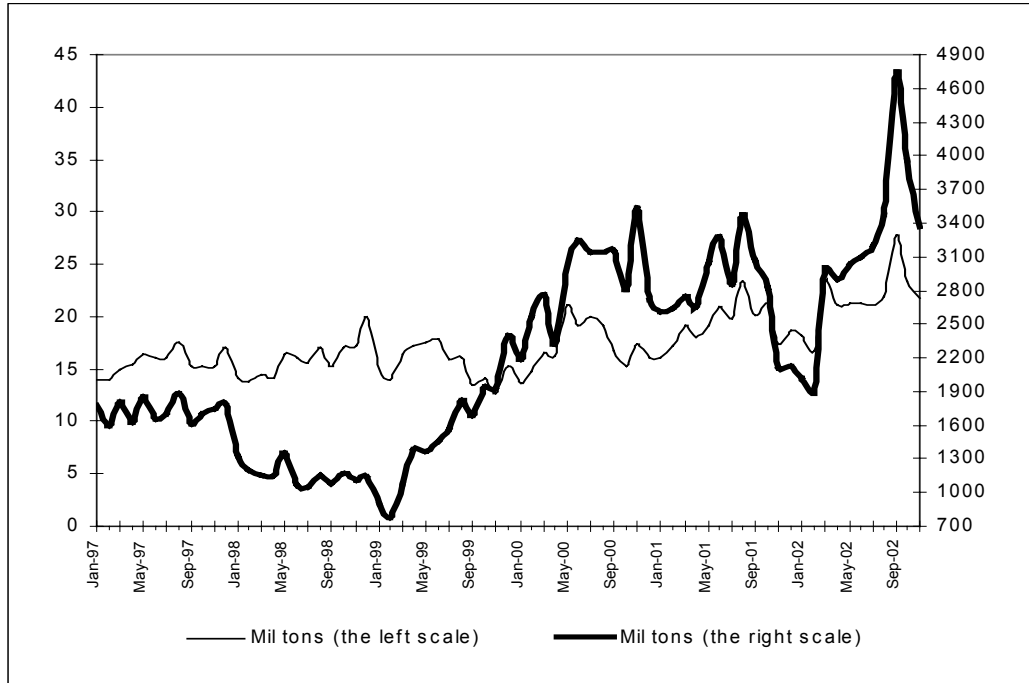
Source: The State Committee for Statistics of the Russian Federation, the Ministry of Power Industry, the State Customs Committee, the International Energy Agency and our own calculations.

*Fig. 7.* Production consumption and export of natural gas in the 1990-2002 period, billion cubic meters.



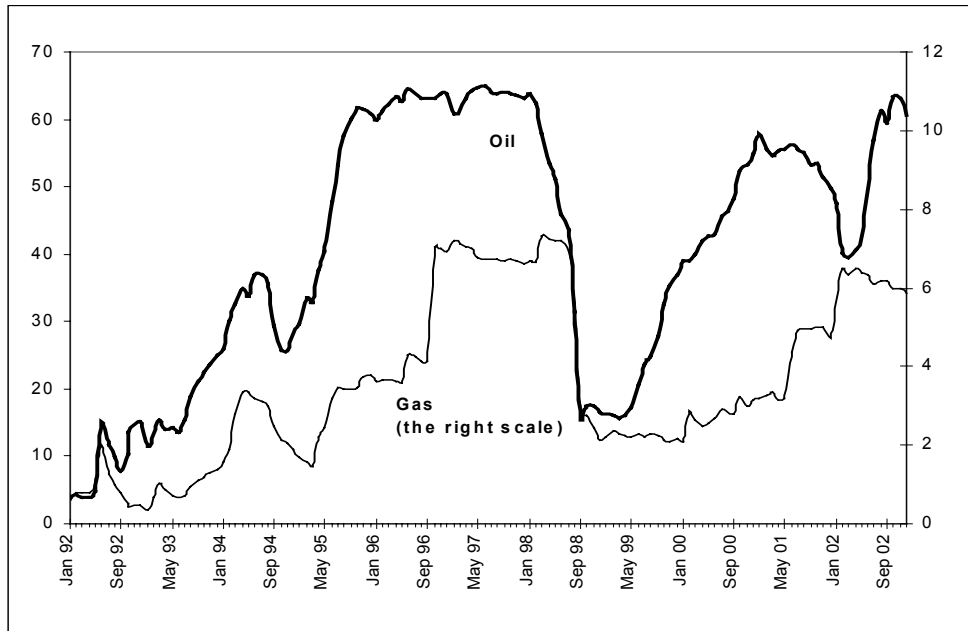
Source: Calculated using data of the State Committee for Statistics of the Russian Federation.

*Fig. 8.* Average export prices of oil and diesel oil in the 1996-2002 period, USD/tons



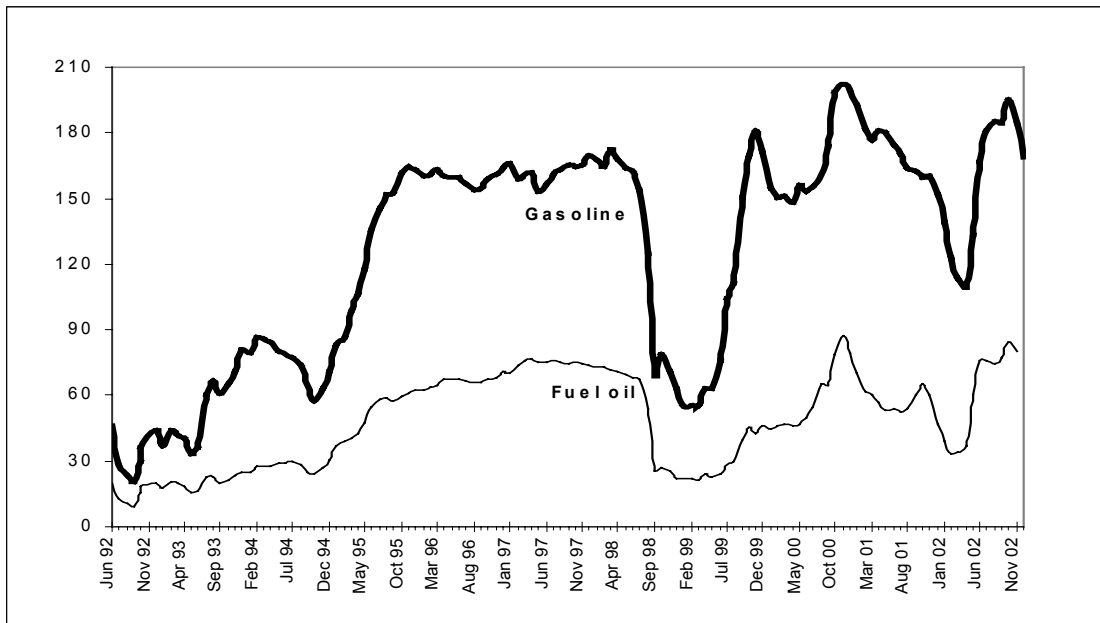
Source: Calculated using data of the State Committee for Statistics of the Russian Federation.

Fig. 9. Export of oil and petroleum products in the 1997-2002 period, physical and in value terms (mil tons, mil USD)



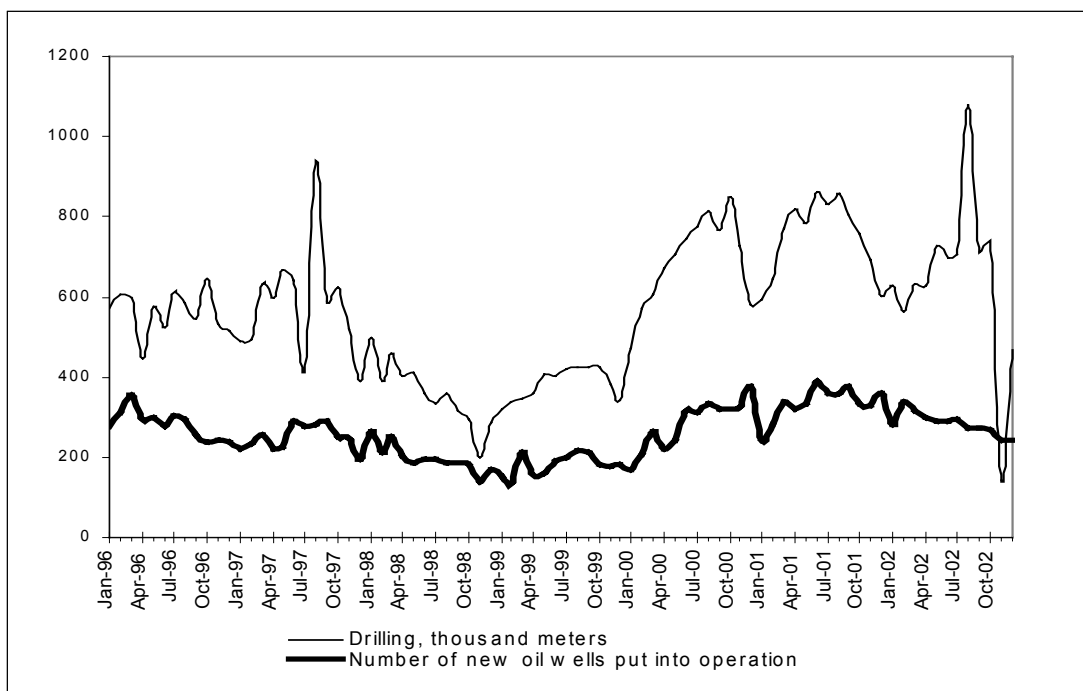
Source: Calculated using data of the State Committee for Statistics of the Russian Federation.

Fig. 10. Industries' average wholesale prices on oil and gas (USD equivalent) in the 1992-2002 period, USD per tons, USD per thousand cubic meters



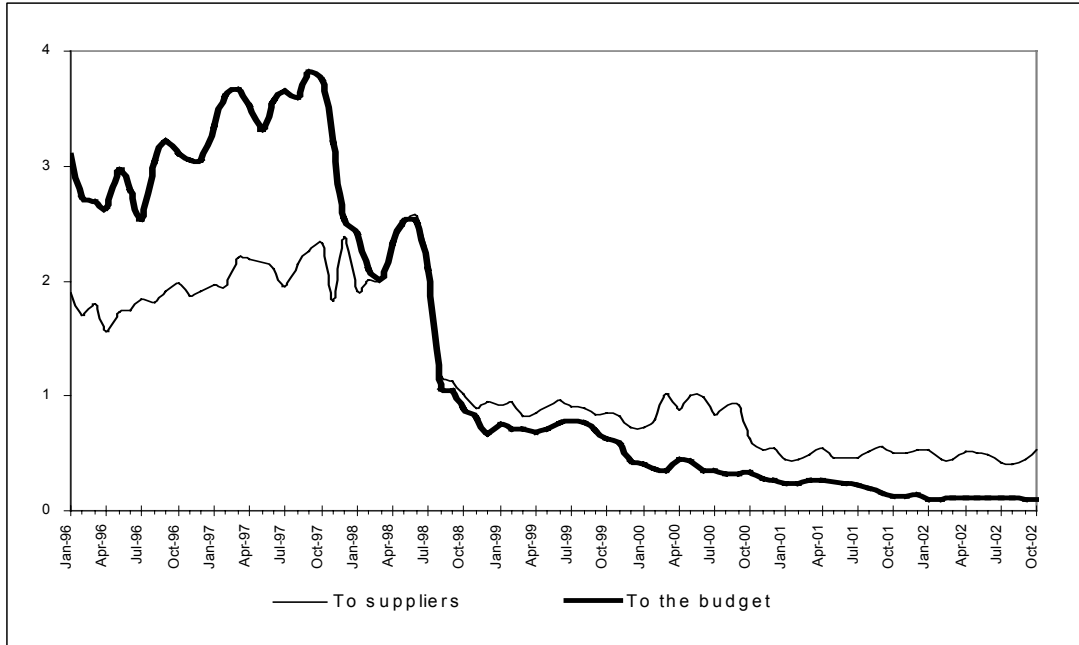
Source: Calculated using data of the State Committee for Statistics of the Russian Federation.

*Fig. 11. Industries' average wholesale prices (the USD equivalent) on gasoline and fuel oil in the 1992-2002 period, USD per tons*



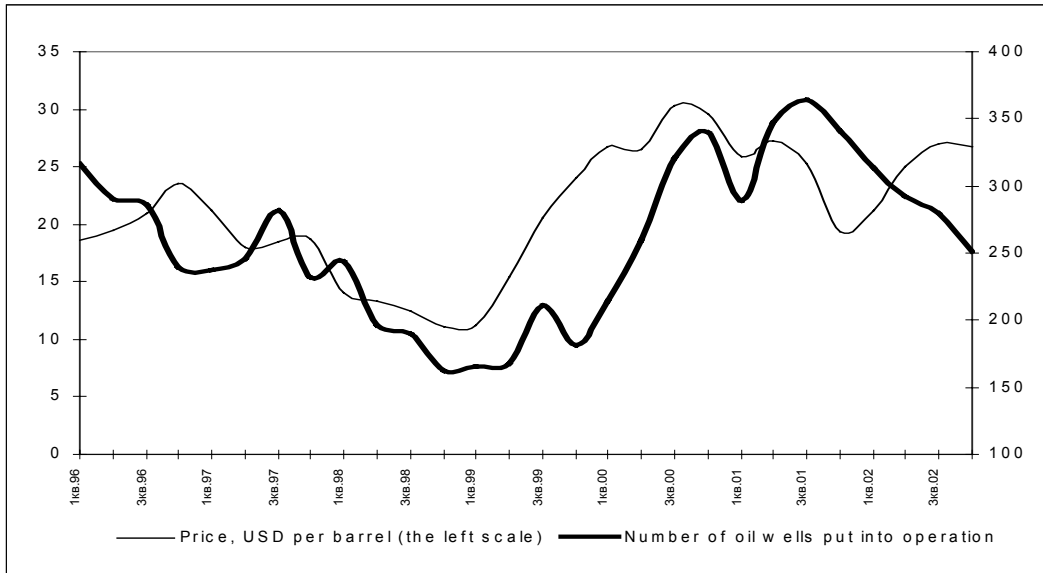
Source: the State Committee for Statistics of the Russian Federation.

*Fig. 12. Production drilling and numbers of oil wells put into operation in the 1996-2002 period*



Source: Calculated using data of the State Committee for Statistics of the Russian Federation.

*Fig. 13.* Oil industry's arrears to suppliers and to budgets of all levels in the 1996-2002 period, billion USD.



Source: the State Committee for Statistics of the Russian Federation and the International Monetary Fund.

*Fig. 14.* International prices on oil and number of new oil wells put into operation in the 1996-2002 period.

### 3.1.2. Use of the GDP: Dynamics and Structure

Analysis of the economic situation in Russia reveals that the share of ultimate consumption in the GDP was largely influenced by growth in income. In the 2000-2002 period, one of the specific features of development of the Russian national economy consisted in domestic demand growing faster than foreign demand. In 2002, the share of domestic demand in the GDP increased to 90.0 percent, as against 87.1 percent and 79.9 percent in 2001 and 2000, respectively.

*Table 13*

#### **Structure of use of the Gross Domestic Product in the 2000-2002 period, breakdown by the quarter, % of the total**

	2000				2001				2002			
	quarters											
	I	II	III	IV	I	II	III	IV	I	II	III	IV*
Used GDP	100	100	100	100	100	100	100	100	100	100	100	100
Expenses on ultimate consumption	63.6	60.8	56.0	66.3	64.8	66.8	60.1	69.0	69.8	70.6	71.0	69.2
Households	48.2	44.7	42.3	47.3	51.2	49.6	46.2	51.9	54.8	51.4	54.0	50.9
Public institutions	13.2	15.0	12.7	17.7	12.6	15.9	12.8	15.7	13.7	17.7	15.8	16.8
Gross accumulation	12.2	17.8	25.4	17.2	16.9	19.0	28.5	21.8	19.4	18.4	18.9	20.8
Gross accumulation of fixed capital	10.6	13.8	16.3	20.2	12.9	16.2	17.2	23.0	13.2	16.0	14.7	21.6
Net export	25.5	21.4	18.6	16.5	18.3	14.2	11.4	9.2	10.8	11.0	10.1	10.0

\* Preliminary data.

*Source:* The Ministry of Economic Development of the Russian Federation, the State Committee for Statistics of the Russian Federation.

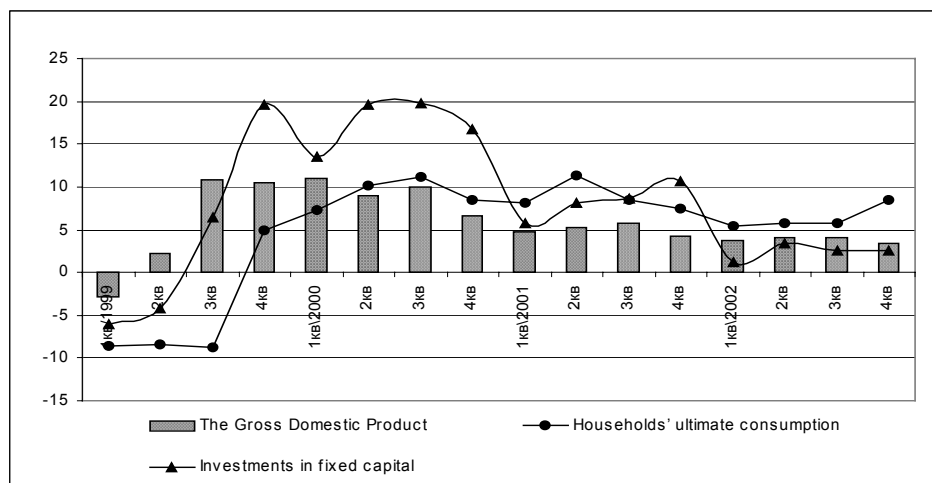
With expansion of business activity in Russia's national economy, growth in investment demand brought about nearly a 20 percent increase in the physical volume of the GDP. However, with shift in redistribution of GDP resources towards the investment component and the rest of the world in the 1999-2000 period, reduction in the share of expenses on ultimate consumption of material wealth and services was observed. The existing level of effective demand on the consumer market limited further growth in output of foods and volumes of services. As a result, the share of aggregate expenses on ultimate consumption in the GDP decreased by 6.9 points in 2000. In that situation, the government's policy aimed at raising wages and pensions had a favorable effect on economic development. In 2001, with a stable growth in wages and pensions, households' real income grew by 5.8 percent. The share of expenses on ultimate consumption increased by 3.8 percent on the 2000 figure; it is to be noted that such an increase was initiated by a faster than the average growth in households' expenses.

In 2002, shift in proportions of use of the GDP took place in a situation where consumer demand was growing faster than demand in investment. Growth in consumer demand can be regarded as a factor compensating for slowdown of growth in investment demand. Expansion of retail trade turnover and growth in output of domestic consumer goods point clearly to a positive change in households' living standard. In 2002, growth in households' expenses on ultimate consumption was estimated at the level of 8.5 percent. Retail trade turnover increased by 9.1 percent on the 2001 figure. Unlike 2001, the volume of foods purchased by households grew faster than that of non-foods. In 2002, turnover of retail trade in foods increased by 9.7 percent and that in non-foods, by 8.5 percent, as against 7.2 percent and 12.7

percent in 2001, respectively. Change in consumer behavior can be explained by change in proportions of prices of the principal commodity groups. In 2002, consumer prices increased by 15.1 percent, as against 18.6 percent in 2001. From the beginning of 2002, prices on foods grew at a higher rate than those on non-foods.

With the existing level of households' income, change in proportions of prices of commodity groups ceased formation of pent-up demand in durables and, as a result, the existing level and dynamics of households' savings were preserved. In the 2000-2002 period, the share of consumer expenses in the volume of households' cash expenses decreased; in 2002, it amounted to 72.8 percent, as against 74.4 percent in 2001 and 78.4 percent in 1999. At the same time, the share of savings in the total volume of households' cash expenses increased by 2.0 points in the past two years and amounted to 16 percent in 2002. The volume of individuals' savings in rubles and foreign currency deposited with credit institutions increased by 38.8 percent and 26.2 percent, respectively. It is to be noted that such a growth in the volume of savings takes place in a situation where ever greater differentiation of households by the level of their income is observed and concentration of income with the high-income population group. At the same time, it needs to be pointed out that in the past few years reduction in the number of households with income below the subsistence level has been observed. In 2002, persons with income below the subsistence wage level numbered 35.8 million (25.0 percent of the total population), as against 39.4 million (27.3 percent) in 2001 and 41.9 million (28 percent) in 2000.

Reproduction conditions which took shape by the end of 2001 had a decisive effect on the dynamics of economic growth in the first half of 2002. In the 1<sup>st</sup> quarter of 2002, the volume of investment in fixed capital was less than 50 percent of the volume of such investment in the 4<sup>th</sup> quarter of 2001. According to preliminary data, in 2002 the volume of investment in fixed capital increased by 2.6 percent, while households' ultimate consumption, by 6.9 percent.



*Fig. 15.* Change in dynamics of use of the GDP, breakdown by the component in the 1999-2002 period, % of the level of the corresponding quarter in the previous year.

Change in dynamics and structure of formation of the GDP in relation to income in the 2001-2002 period was caused by the fact that wages grew faster than labor productivity and profitability of production decreased due to change in domestic price proportions.



Undoubtedly, in 2001 amendment of tax legislation and de-bureaucratization had a positive effect on the rates of economic growth. However, one can hardly expect large-scale institutional reforms to pay off soon in terms of higher efficiency in utilization of resources. This is illustrated, in particular, by the widening gap between the rates of growth in wages and those in labor productivity. In 2002, there was particularly no growth in labor productivity. Whereas in the 2000-2001 period, the above gap could be explained by 'legitimization' of wages and salaries, in 2002 it was largely caused by shortage of skilled workers at industries. That factor is likely to have an ever more important role to play in the near future and the issue of raising of labor productivity will be of great importance.

In 2002, the share of hired workers' wages and salaries increased by 2.0 points on the figure of the corresponding period in 2001 and its share in the GDP amounted to 47.1 percent. Extensive growth in the level of wages and salaries which account for over 80 percent of households' cash income has had a favorable effect on the sociopolitical situation. Such a growth in the share of wages and salaries in the volume of households' cash income was a result of growth of the proportion of workers' pay in the real sector of the economy. In 2002, the share of social transfers amounted to 14.9 percent, increasing by 1.7 points on the 1999 figure. At the same time, general growth in income was hindered by a relative decrease in the rates of growth in income from private enterprise. With growth in the volume of income from private enterprise observed in absolute terms, by the beginning of 2002 its share in the total volume of cash income decreased by 0.3 points on the 1999 figure and amounted to 12.1 percent.

With expansion of production and growth in demand in labor, the situation on the labor market is improving; workers can be confident that they can get a job. The above growth in demand in labor was initiated by creation of a large number of jobs in the services sector.

In 1999, growth in the number of workers employed in the national economy amounted to 0.2 million, while in the 2000-2002 period, to 0.4 million. The number of unemployed (calculated using ILO methods) fell to 5.7 million (8.0 percent of the able-bodied population), as against 7.5 million on the average in 2000 (10.5 percent) and 9.3 million on the average in 1999 (13.0 percent).

Reduction in the number of registered unemployed from 1.3 million in 1999 to 1.1 million in 2001 can be explained by growth in demand in labor force. In 2002, the number of registered unemployed grew to 1,3 million, which growth was related to an increase in the amount of the minimum unemployment benefit calculated on the basis of the subsistence wage and official registration of a certain number of formerly unregistered unemployed persons seeking entitlement to the increased unemployment benefit. In addition to that, the number of registered unemployed is growing because only registered unemployed persons are entitled to specific social aid, such as subsidization of housing rents and utilities rates and also because enterprises get rid of redundant labor force (workers working reduced hours or being on unpaid leaves).

*Table 14*

**Formation of the gross domestic product, breakdown  
by the source of income, % of the total**

	2001				2002			
	Quarters				Quarters			
	I	II	III	IV	I	II	III	IV



Total GDP,	100	100	100	100	100	100	100	100
including:								
Hired workers' pay (including hidden pay)	44.1	45.5	42.4	47.9	46.4	47.1	47.0	48,9
Net taxes on production and import	13.7	17.4	13.7	16.8	12.9	15.2	14.9	16,8
Gross profit of the economy and gross income from mixed sources	42.2	37.1	43.9	35.3	40.7	37.7	38.1	34,3

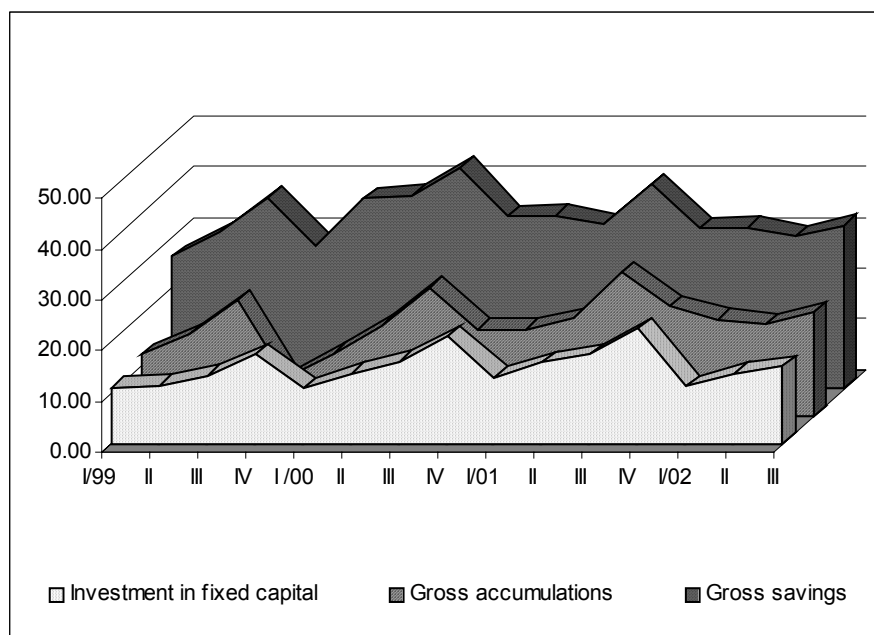
*Source:* The State Committee for Statistics of the Russian Federation and the Ministry of Economic Development of the Russian Federation.

At the same time, the widening gap between the level of wages and the level of labor productivity caused growth in production costs and reduction in the rate of profitability. Reduction in the profit rate was also caused by growth in the volume of material expenditure due to an increase in wholesale prices and tariffs on consumable material resources, in a situation where growth in industrial producers' prices was less dramatic. In addition to that, the profit rate was affected by the situation on international markets, which was rather unfavorable for certain Russian exporters. As a result, the share of gross profit and gross income from mixed sources in the GDP decreased by nearly 2 points on the 2001 figure.

In a situation where the rates of development of infrastructure branches are faster than dynamics of production output, the share of the industrial sector in the total volume of profit of branches of the economy fell to 40 percent, as against 54.6 percent in 2001. Dynamics of formation of gross profit in the industrial sector were characterized by continued growth in the share of branches of the fuel and energy complex and primary industries at the expense of manufacturing industries. According to calculations, the share of extractive industries and primary processing of raw materials accounted for two-thirds of the total volume of profit in the industrial sector.

As the situation on international markets improved, starting from the beginning of 2002 the rate of decrease in balance profit slowed down with each new quarter, as compared to the figures of the corresponding periods in the previous year. In 2002, the share of gross profit in the GDP fell from 40.7 percent in the 1<sup>st</sup> quarter to 37.7 percent in the 2<sup>nd</sup> quarter and 34.3 percent in the 4<sup>th</sup> quarter, while the profit rate in the industrial sector went down from 18.0 percent in 2000 and 14.7 percent in 2001 to 8.9 percent in January-September 2002.

With profitability of production and export going down, in 2002 the share of gross savings and accumulations in the GDP tended to decrease again. In 2002, the share of savings in the GDP amounted to around 32 percent, as against 34.9 percent in 2001, while the share of gross accumulations in capital assets in the GDP stabilized at the 2001 level. In 2002, with the existing level of income all obligations in respect of financing of budget expenditure and servicing of the public debt were met in a timely manner.



*Fig. 16.* Shares of gross savings, gross accumulations and investment in fixed capital in the GDP in the 1999-2002 period, % of the level of the corresponding quarter

Investment in fixed capital ceased to have a dominating effect on the rates of economic growth. Though positive dynamics of growth in investment were preserved, with the obtaining technological, reproduction and age structure of fixed capital such investment was insufficient for implementation of an active industrial policy. Considering high concentration of capital in the export-oriented sector and lack of mechanisms of inter-sectorial capital mobility, one can hardly expect radical changes in reproduction of fixed capital. The investment situation is complicated by the fact that apart from needing large-scale investment the economy is also in need of a clear strategy in attraction of investment resources. In conditions of a slowdown of the rates of growth in income, enterprises reproduce the existing proportions.

Taking into account the fact that investment activity was low in the past, the amount of investment in fixed capital in the past three years was insufficient for the required modernization of production facilities, which adversely affected economic efficiency. The much-needed investment maneuver in favor of high value added branches (branches that would be able to contribute to higher competitive ability of the Russian national economy) was not carried out.

With high volumes of savings accumulated in the economy, the issue of transformation of accumulated resources into investments has become even more topical. Due to slow pace of restructuring of the financial sector, banks do not lend much to real-sector industries. Industries' own funds remain the principal source of investment, since mechanisms of inter-sectorial capital mobility and accumulation of gross savings for development of competitive segments of the economy do not work. In conditions of economic growth, it has become clear that investment management is not properly adopted to dynamic restructuring processes in Russia's national economy. However, it is to be noted that sociopolitical stability in Russia had a positive effect on the investment climate, which became more attractive to Russian and foreign private investors.



Growing appeal to foreign investors of Russia's vast and promising market has facilitated Russia's effort to build an open market-oriented economy and integrate it into the international economy. In the 2001-2002 period, foreign investment grew at a higher rate than domestic investment into fixed capital. Foreign investors expanded their presence on the Russian market. However, the volume of direct investment in Russia was modest. As regards the volume of direct investments accumulated in the 1993-2002 period, Russia ranks 21<sup>st</sup> among the 25 countries of Central and Eastern Europe.

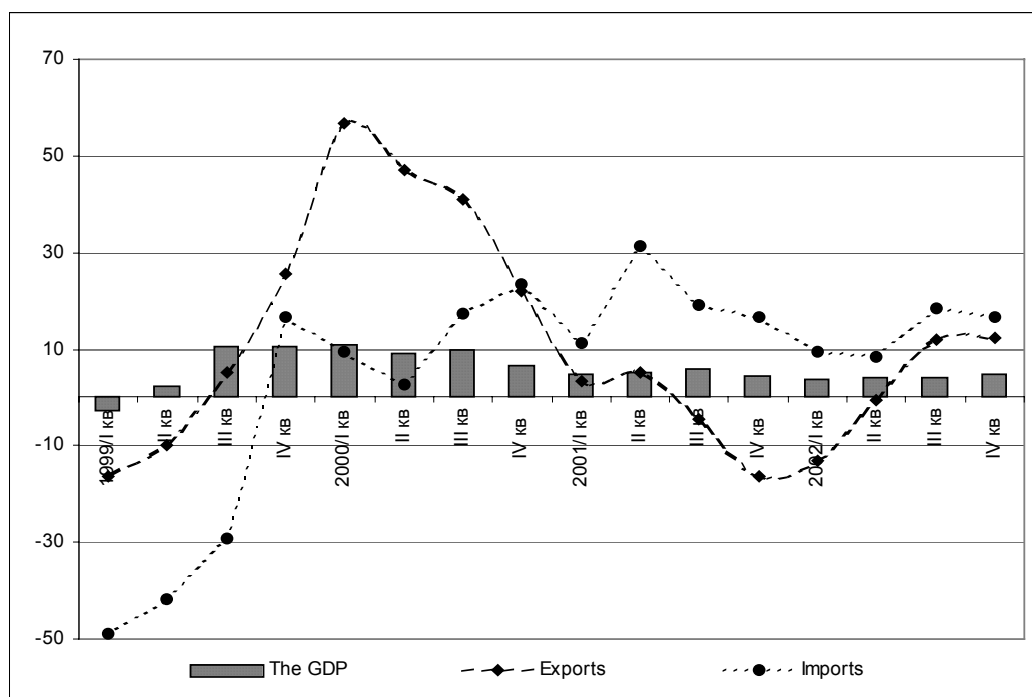
In 2002, new factors stimulating reduction in net flight of capital emerged. Growth in inflow of foreign capital (mostly in form of credits and loans) was also observed. According to the data of the State Committee for Statistics, in January-November 2002 the total volume of foreign investment amounted to 12.9 billion USD, which was an increase of 3.2 mil USD on the figure of the corresponding period in 2001.

Reduction in the rate of flight of capital was another factor stimulating demand in investment on the domestic market. It is important to estimate the volume of flight of capital from Russia as an alternative source of investment in the domestic economy. According to the Central Bank of the Russian Federation, in 2001 the flight of capital from Russia amounted to around 16.2 billion USD, decreasing by 7.4 billion USD on the 2000 figure. In relation to the foreign trade turnover, the net flight of capital decreased from 16.2 percent in 2000 to 10.9 percent in 2001, while in relation to the GDP, from 10.2 percent to 4.5 percent, respectively. In 2002, that trend persisted. According to calculations, in 2002 the flight of capital went down to 11.7 billion USD, which roughly amounted to 3.3 percent of the GDP.

Raising of the sovereign credit rating and/or revision of the forecast by prominent rating agencies contributed to development of that trend. Consistent amendment of the investment legislation, formation of financial institutions and development of the stock market also had a positive effect on it.

Cumulative effect of external factors grows with formation of an open market-oriented economy. It is to be noted that the past four years saw change in proportions between internal and external factors, which change had an effect on growth in output. In 1999, imports were nearly halved, which created favorable opportunities for expansion of domestic production. Growth in prices on energy resources and ferrous metals on international markets was a major factor contributing to growth in production in 2000. Growth in export revenues had a considerable effect on the structure and dynamics of ultimate demand. Starting from 2001, rates of growth in the physical volume of imports were faster than those of exports and the GDP.

Analysis of external and internal factors and conditions of economic development in 2002 reveals that the favorable situation observed on the international markets of fuel and primary goods was one of the factors which accelerated growth. Starting from the 2<sup>nd</sup> quarter of 2002, dynamics of exports became positive again and simultaneous growth in internal and external demand was observed, which was a key factor behind acceleration of rates of growth in the GDP and the industrial sector as a whole in the second half of 2002. Acceleration of rates of growth in the industrial sector was initiated both by growth in output of export-oriented branches and maintenance of high rates of growth in branches of the consumer complex, which is oriented mainly towards the domestic market.



*Fig. 17. Change in dynamics of the GDP, exports and imports in the 1999-2002 period, % of the level of the corresponding quarter of the previous year*

Analysis of development of the trade sector suggests that Russian-made goods did not win any new niches, either on domestic, or on international markets. Expansion of the domestic demand in the past few years which was initiated by export-oriented branches of the economy, was based on the inertial growth in output of a rather limited segment of branches producing construction materials and investment products. Branches oriented towards the domestic market failed to receive sufficient investment support and lost much of their competitive abilities at the change in the exchange rate.

One of the reasons behind low competitiveness of domestic produce was that economic growth was primarily oriented towards higher utilization and involvement in production of reserve production capacities. Lack of radical change in commissioning of new production facilities prevented purposeful implementation of a policy aimed at import substitution and diversification of export flows. The share of imports in the volume of commodity supply on the consumer market and the market of material and technical produce tended to grow. In addition to that, strengthening of the ruble also contributed to the growth in imports.

Growth in competing imports had a considerable effect on dynamics of branches oriented towards the domestic market. Extensive expansion of imports had a particularly strong effect on dynamics of the investment complex and output in light industry. According to estimates, the share of imports in the volume of non-food commodity supply has increased by 3.3 points since the beginning of the year. It is to be noted that while in foods retail trade turnover imports are mostly non-competing, in non-foods turnover imports have been ousting domestically produced goods. The share of imported machinery and equipment in the volume of investment supply has also been growing since 2001. Further development of those trends would make expansion of domestic production of consumer and capital goods rather compli-

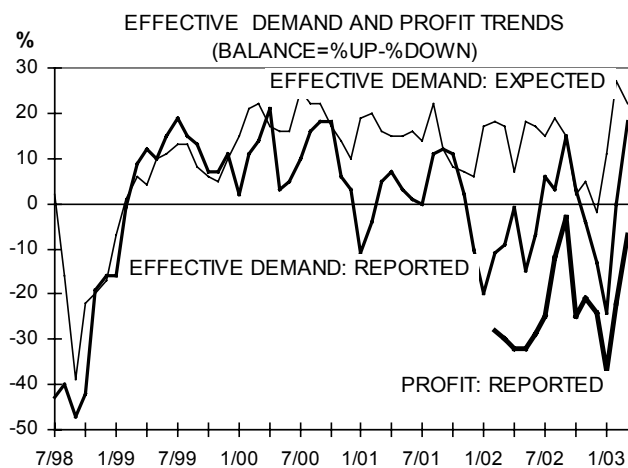


cated. In that situation, decision on reduction in import duties on certain types of technological equipment was a important factor stimulating modernization of production and higher competitive abilities of Russian-made goods.

### 3.2. Situation in the Industrial Sector<sup>1</sup>

#### 3.2.1. Dynamics of the Principal Types of Demand in Industrial Products in 2002

Late in 2001, Russian industries encountered the most serious and long-lasting sales problems ever. After three months (August through October) of stable and relatively high growth of sales for cash, a sharp nosedive of effective demand was observed with the low registered in January 2002. The rate of sales for cash stopped to grow in November (the balance was +2 percent, as against +11 percent in October). In December, surveys revealed a sharp drop in sales (balance of -10 percent), for the first time for that month since the default. In January 2002, the balance of estimations of change in monetary demand went down to -20 percent. Such a sharp nosedive in sales had not been observed since the beginning of post-default growth in effective demand, nor was one like it ever registered since that time up till the time of preparation of the present paper. The volumes of sales of industrial produce for cash kept going down throughout the first six months of the Year 2002, with only the slant of the curve varying. In February, the average industrial sector balance grew by nine points, in March-April, by another eight points. As a result, the demand nearly stopped dropping by the beginning of the second quarter. However, the May holidays pushed the sales down again; the balance dropped to -15 percent. June did not see any significant change in the dynamics of demand. It was only in July that surveys revealed a growth of sales for cash (see *Fig. 18*).



*Fig. 18*

<sup>1</sup> The present section has been prepared on the basis of polls of industrial enterprises' CEOs. Such surveys have been carried out by the IET on a monthly basis since September 1992 throughout the territory of the Russian Federation. The panel comprises 1,400 enterprises, which account for over 20 percent of those employed in the industrial sector. The panel has been shifted towards major enterprises in each of the 61 sub-branches identified. Return of questionnaires, around 70 percent.

The above situation was observed in every branch of industry but production of building materials. Only with food industry and power generation drop in sales continued at the beginning of the second six months of the year. By September, the rate of growth in effective demand went up by several more points to reach the same level as had been observed in the autumn of 2001 when the two-year high in the growth of that parameter was registered. So, the third quarter was the most favorable period for Russia's industrial sector in the Year 2002. By September, growth of sales for money was resumed in every branch but light industry. The drop in sales for cash, which was observed in building industry, was due to the nearing end of the building season. In October, the growth in sales of industrial products for cash ceased. The balance of estimations (growth-reduction) immediately dropped by 11 points, but it remained positive; the growth in effective demand continued. Negative balances (absolute drop in sales) were observed in October in iron-and-steel industry, engineering industry and building industry. So, the sales growth in September was the high of the past 24 months (+15 percent, after 3 percent in August). The slowdown of the growth in sales did not cause any concern with industries, though. Moreover, while in August-September 38 percent of respondents referred effective demand as 'normal', later that figure grew to make 43 percent. The highest values of that parameter were observed with nonferrous industry (86 percent), power generation (74 percent) and timber industry (69 percent).

In November 2002, just like in November 2001, growth in effective demand came to a halt. In December, the rate of drop in sales grew from -4 percent to -15 percent (according to the balance), exceeding the December 2001 figure (-10 percent). According to IET surveys, the fastest drop in sales in the 1999-2002 period was observed in January 2002 (-20 percent). At the close of 2002, growth in effective demand was only observed in power generation and food industry. The negative trends in sales dynamics finally brought about a change in estimation by industries of the volume of sales. The proportion of respondents seeing the volume of sales as 'normal' dropped in December by six points amounting on average in the industrial sector to 32 percent, which was the low of the closing six months of the Year 2002.

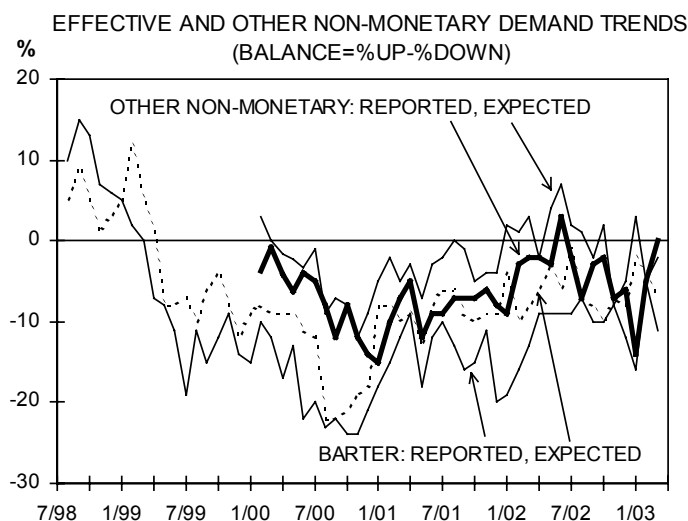
The sharp drop in sales for cash (which was also the most prolonged one in the post-default period) resulted in change in the dynamics of non-monetary forms of demand and enterprises' attitude to such forms of demand. While in 2001 industries preferred to reduce volumes of non-monetary deals, in 2002 polls revealed absolute growth in volumes of bill and setoff operations. In 2002, the most acute and prolonged lack of barter, bills and setoffs was also observed.

The rate of reduction of volumes of all forms of non-monetary deals started to go down at the beginning of the Year 2002. In the first four months, the balance in respect of change in the volumes of barter deals grew from -20 percent to -9 percent. In the next four months, the rate of decline in the use of barter remained practically unchanged. However, in August, that parameter grew to make -7 percent. Such a slow decline in volumes of barter deals had not been observed since the April of 1999 when the post-default growth of effective demand and production began. By the end of the year, the rate of decline in the volume of barter grew by several points, yet, it remained among the more moderate since 1999. (See *Fig. 19.*) In the January of 2003, the traditional seasonal drop in all kinds of demand was observed which brought the balance of barter fluctuations down to -15 percent. Responses revealing a reduction in the volume of barter deals prevailed in all the branches of industry, especially in the building industry, chemical industry, petrochemical industry and engineering industry.



The dynamic of realization of produce for bills and on the basis of setoffs in the first six months of the year was similar to the above. At first, the rate of reduction dropped from -9 percent to -2 percent, then, in June, polls revealed absolute growth in volumes of such deals with Russia's industrial sector. That happened for the first time since monitoring was started in February 2000. It is to be noted that the scope of sales for bills and on the basis of setoffs came to exceed all the other types of demand, including normal, cash demand. After that, growth in volumes of cash sales was observed, which permitted industries to resume their former policy of reduction of volumes of non-monetary deals. The balance became negative again and remained such till the end of the year. For the first time in 2002, according IET surveys, the balance of forecasts in respect of dynamics of the volumes of bill and setoff deals remained positive for a comparatively long time. Just for four months out of twelve Russian industrial enterprises did not plan any increases in the volumes of bill and setoff deals. The greatest hopes for growth in volumes of such operations were in May and June of 2002.

Estimation by enterprises of those three kinds of demand as above normal/normal/below normal also revealed serious sales problems encountered by the Russian industrial sector. Firstly, after October 2001 (when polls revealed the best balances of effective demand since the end of 1993) that parameter went down by 16 to 18 points. It was only by September 2002 that the growth in sales made estimations of the volumes of effective demand more optimistic. The share of 'normal' responses grew to 39 percent, which was the 11-month high. The slowing down in October of growth in effective demand did not cause much concern with industrial enterprises. Moreover, the share of estimation of effective demand as 'normal' grew to make 43 percent. The highest values of that parameter were observed in nonferrous industry (86 percent), power generation (74 percent) and timber industry (69 percent). It was only the drop in the volumes of sales observed in December that changed enterprises' estimations of such volumes. In December, the share of 'normal' estimations went down by six points, to 32 percent (industrial sector average), which was the low of the closing six months of the Year 2002. The lowest values of that parameter were observed in engineering industry (22 percent), chemical industry and petrochemical industry (26 percent).



*Fig. 19*



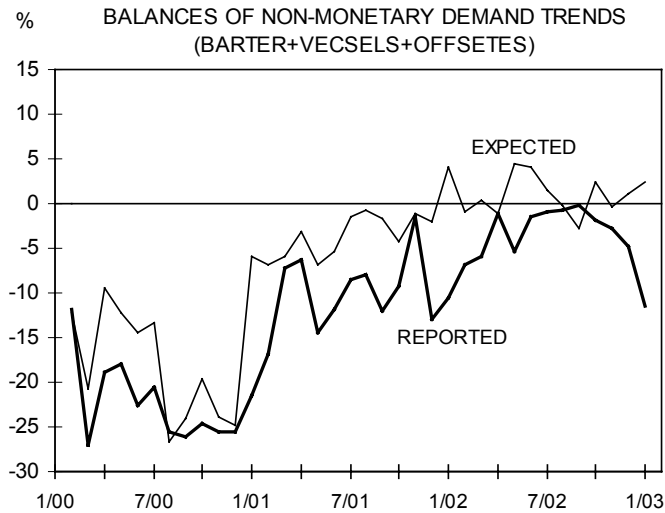
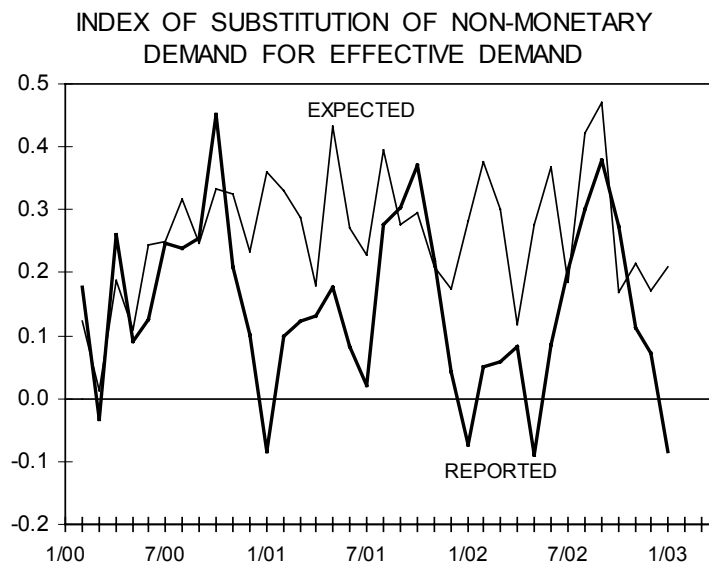
The Year 2002 saw the acutest and most prolonged lack of non-monetary deals. For three quarters of the year, most of the enterprises in the Russian industrial sector believed that their volumes of barter, bill and setoff deals were 'below normal'. The absolute minimum of such estimations for barter deals was observed in the second quarter (-7 percent), while for bill and setoff deals, in the third quarter (-8 percent). It is to be noted that in the fourth quarter the balance of estimations of non-monetary deals grew from -4 percent to -2 percent for barter and from -8 percent to -3 percent for bill and setoff deals. At the end of the year, the prevalent belief in Russia's industrial sector was that the volume of such deals was insufficient, but during the quarter that insufficiency was reduced by two points and five points, respectively. However, early in 2003 it reached an all-time high. The balance of estimations of barter deals (above normal/below normal) went down to -8 percent, while of bill and setoff deals, to -10 percent. In other words, the highest ever proportion of Russian industries believed that the volumes of their non-monetary deals were insufficient. The greatest insufficiency of such volumes was observed in building industry, metallurgical industry, chemical industry and petrochemical industry.

Dynamics of all non-monetary operations in realization of produce can be assessed with the use of matrices of conjugation of issues of the dynamics of barter deals and the dynamics of bill and setoff deals.<sup>2</sup> According to estimates, the rates of decline in the volumes of non-monetary deals in 2002 were among the more moderate in the past three-year period. (See Fig. 3.) It is to be noted that the beginning of the year was quite promising for enterprises. The sales and production boom that occurred in the autumn of 2001 permitted enterprises to considerably reduce the volumes of barter, bill and setoff deals. In December 2001, the aggregate balance of non-monetary demand amounted to -13 percent. However, after that the rate of reduction of the volumes of such deals started slowing down continuously. In September, the balance amounted to -0.5 percent. That was the lowest rate of reduction in the volumes of non-monetary deals in the 2001-2002 period. Moreover, in 2002, balances of forecasts in respect of aggregate non-monetary demand of Russian enterprises became positive for the first time. The overall statistic was that Russian industrial enterprises only planned reduction of volumes of non-monetary deals at realization of their produce in four months out of twelve in 2002. By the end of the Year 2002, the volumes of total non-monetary demand started to decline (in line with the general decline in volumes of sales). The balance in January 2003 (-11.4 percent) was similar to the balance which had been observed in January 2002 (-10.6 percent).

The outputs of surveys permit assessment of interrelation between the two types of demand in industrial products, effective demand and non-monetary demand. For that purpose, a matrix needs to be made of conjugation of actual (or forecasted) change in effective demand and such change in non-monetary demand. The substitution index (which may have values ranging between -1 and +1) is calculated as a ratio between the difference between the supra-diagonal and sub-diagonal elements and the sum of those elements. Positive values of that index indicate displacement of non-monetary demand by effective demand, while negative, the opposite process. The higher are the absolute values of that coefficient, the more extensive the displacement process (see *Fig. 21*).

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<sup>2</sup> That method is described in greater detail in the "Situation in the Industrial Sector" section of the previous IET survey.

*Fig. 20**Fig. 21*

The dynamics of the substitution index show that on the whole Russian industries more often succeed in increasing sales for cash in conditions of reduction of the volumes of non-monetary deals. It is to be noted that each year (of the three affording full calculations) had one pronounced high and two lows. In 2002, the high was observed in September, which was one of the best months in respect of the rate of growth in effective demand. It was also in September that the highest substitution index was observed in forecasts. However, on two occasions negative values of that index were observed in the same year (in January and May). Seasonal drops in sales were so strong in those months that displacement of effective demand with non-monetary demand was, in fact, observed in the industrial sector. Between those two lows, the index had positive values, in spite of a drop in effective demand (the balances of

estimations in respect of the dynamics of effective demand were negative). That shows that a majority of industrial enterprises still increased sales for money and reduced volumes of non-monetary deals. They exceeded industries with the opposite tendency insignificantly, though (the values of the index were lower than any ever observed for the February-April period). After the May holidays, fast growth in the substitution index was observed. In four months, its value grew from -0.09 to +0.38 nearly equaling the all-time high (+0.45 in October 2000). The substitution index based on forecasts in respect of dynamics of the two types of demand never had a negative value. Industries never planned expansion of their non-monetary deals even when a drop in sales for money was expected.

Let us discuss specifics of sectoral substitution indices by the example of engineering industry and food industry (see Fig. 22). In engineering industry, the values of that index remained positive nearly all the time. This means that most of the time a decline in volumes of non-monetary deals accompanied by growth of cash deals rather than the opposite was observed there. In food industry, the opposite trend prevailed. There were more cases of drops in the volumes of sales for cash with simultaneous growth in volumes of non-monetary deals, especially in 2000 and the opening months of 2001. Only in 2002 the substitution index for the food industry sometimes had positive values comparable with those of engineering industry. And even then such occurrences were rare.

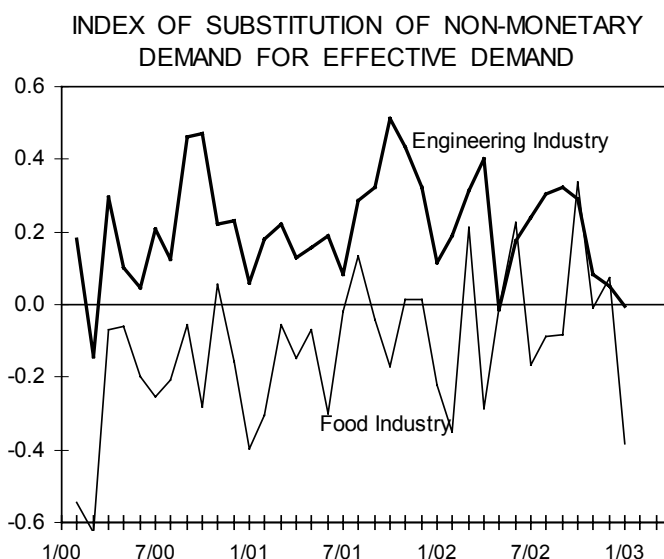
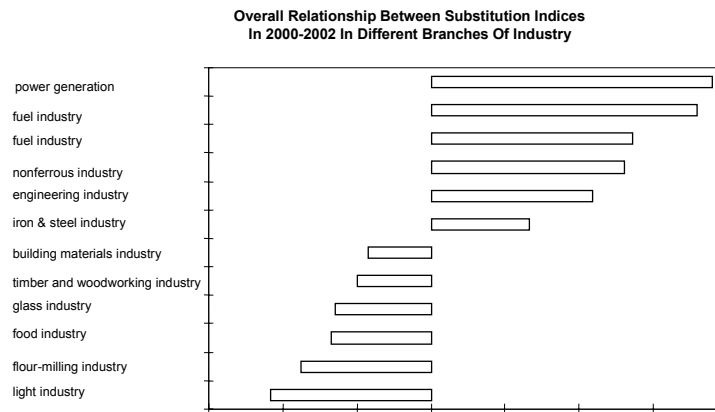


Fig. 22

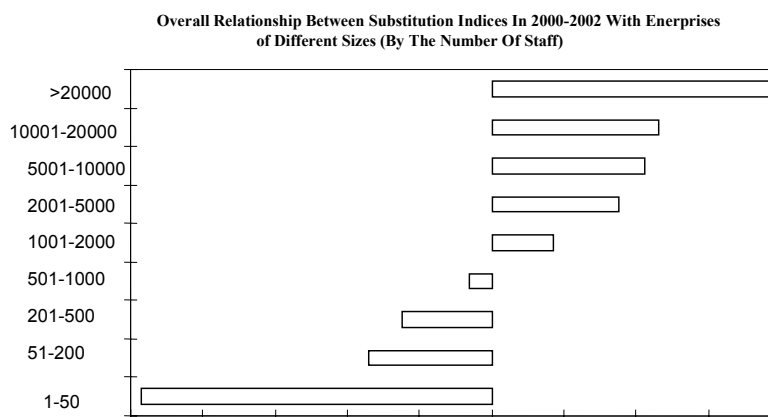
Calculation of the aggregate sectoral substitution indices for the entire 2000-2002 period permits classification of branches of industry by the extent of displacement of non-monetary deals with sales for cash (see Fig. 23). The top line in that rating is occupied by power generation. Efforts by management of enterprises in that branch of industry have resulted in an increase in volumes of cash deals with simultaneous reduction of the volumes of such other types of settlements as were quite widespread in that branch a few years ago. It seems that similar success achieved by fuel industry and nonferrous industry can primarily be explained by their export orientation. The high values of that parameter with engineering industry are another matter: they signify a more important success of post-default growth and “debarterization” of Russia’s national economy. The branches which had positive values of the index could afford not only to increase sales for cash, but also to reduce volumes of non-

monetary deals without detriment to production. The situation in branches with negative values of the index was quite different. Enterprises in those branches had to resort to increases in volumes of barter, bill and setoff deals at the expense of cash deals. Particularly difficult in this respect was the situation of enterprises in light industry.



*Fig. 23*

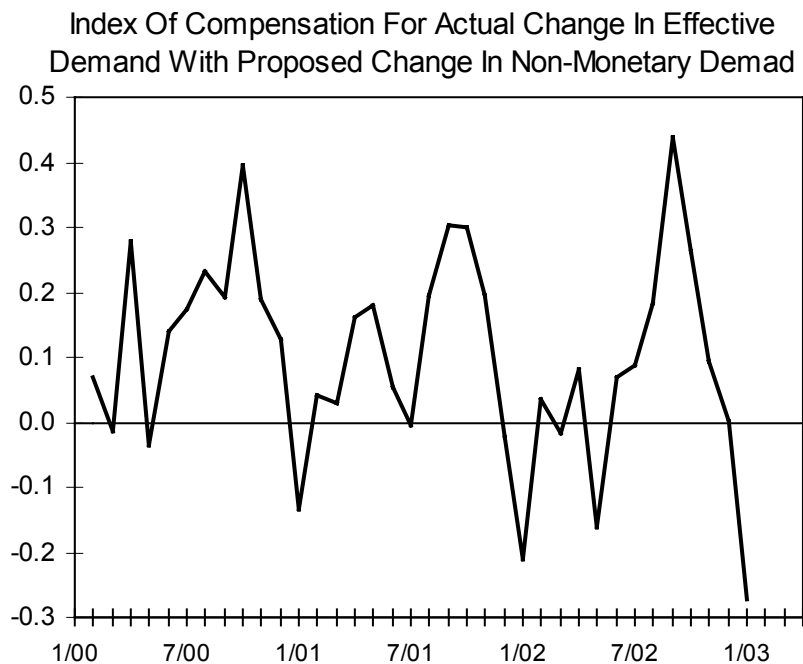
Calculations of the substitution index for enterprises of different sizes revealed a pronounced pattern (see *Fig. 24*): the smaller the enterprise was, the more difficult it was for it to increase the share of cash deals at the expense of non-monetary settlements. Small enterprises have but insignificant financial and material resources, so they cannot afford to stockpile their produce while waiting till a buyer with money turns up. Another factor making small manufacturers consent to non-monetary deals is a high rate of competition. The situation of major enterprises is very different. Not only can they afford to stockpile finished products, but they also have a certain degree of monopoly, which permits them to “squeeze” cash out of the buyers.



*Fig. 24*

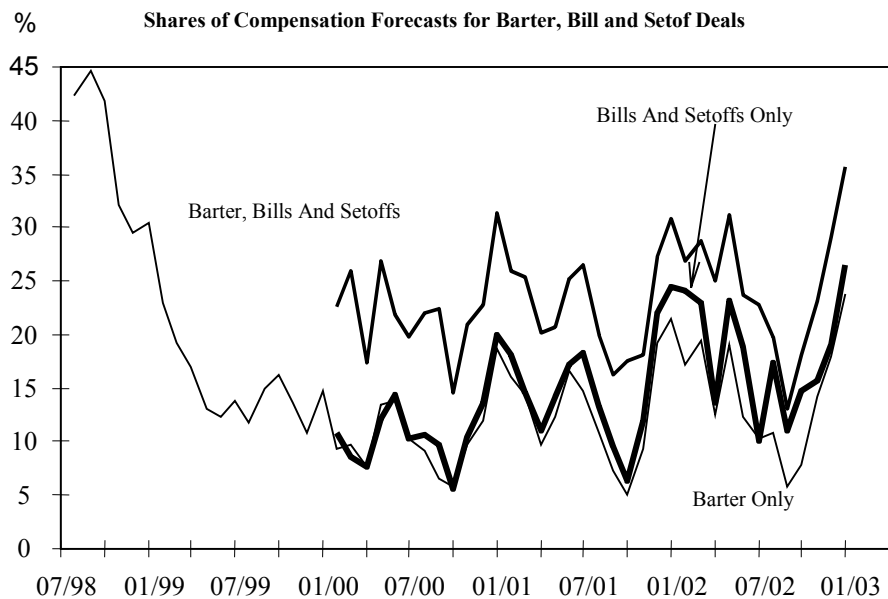
The substitution index can be calculated on the basis of a matrix of conjugation of the actual change in effective demand and planned change in non-monetary demand. In such a

case, estimation is made of enterprises' readiness to use in future non-monetary deals for compensation for the current drop in cash sales or of enterprises' readiness to reduce the volumes of barter, bill and setoff deals in response to current rise in cash sales. The dynamic of that 'cross-index' is similar to the dynamic of the conventional index based on the actual change in demand. As the difference between the two indices consists in use of actual change in non-monetary demand in the latter case and use of expected change in non-monetary demand in the former case, it is to be concluded that formation of forecasts of change in non-monetary demand is of an extrapolation nature



*Fig. 25*

For simpler characterization of enterprises' preparedness to use non-monetary settlements for compensation for drops in effective demand, the mere share of enterprises prepared to increase the volumes of non-monetary deals at actual drop in cash sales can be used. That share is also calculated with the use of a matrix of conjugation of the actual change in effective demand and the expected change in volumes of barter, bill and setoff deals. However, unlike the above-described substitution (compensation) index which uses both supra-diagonal and sub-diagonal sums, in this case only the sub-diagonal sum is used, or rather share of that sum in the totality of all the elements of the conjugation matrix. As we have at our disposal separate sets of data on barter deals on the one hand and bill and setoff deals on the other hand, and also forecasts in respect of the total non-monetary demand, the share of compensation forecasts for all the above types of demand can be calculated (see *Fig. 26*).



*Fig. 26*

The longest chain of observations in respect of barter (since August 1998) offers a wealth of material for analysis. As effective demand started growing after the 1998 default, the share of barter-related compensation forecasts started declining. By mid-1999 that index dropped from 45 percent to 12 percent, which can be explained by unprecedented change in the dynamics of effective demand. By October 2000, that index dropped to 6 percent, after which the compensation effect of barter forecasts started growing due to an absolute drop in sales for cash (the first one in the post-default period). In January 2001, 19 percent of enterprises planned to use barter for compensation for the drop in effective demand. In April, resumed growth in volumes of sales reduced the demand for barter deals to 10 percent, however, the seasonal recession in May pushed that index up to 17 percent. The absolute minimum was observed in October 2001. At that time, just five percent of enterprises proposed to use barter for compensation for reduction of the volumes of sales for cash. However, the subsequent prolonged slump in normal cash demand increased the need in barter to 22 percent. Such a high value of that index had not been observed since February 1999. The absolute decrease of demand which persisted throughout the first six months of the Year 2002, made enterprises keep the share of barter compensation forecasts high (over 10 percent). After that, a growth in demand was observed which reduced the barter-related expectations to 6 percent. The reduction in the rate of growth of cash sales at the end of the year, which was followed by an absolute decrease in the volume of cash sales, pushed that index up again. The high was observed in January 2003 when 24 percent of enterprises expressed readiness to use barter for compensation for the slump in cash sales.

The Year 2002 was different in that there was a divergence in compensation forecasts in respect of barter and compensation forecasts in respect of bill and setoff deals. In the previous years, Russian industrial enterprises rated all the types of non-monetary demand similarly. Starting from January 2002, “stratification” began. Enterprises preferred to use bill and setoff

deals as compensation for lack of sales for cash. The difference came to amount to seven percent, while in the previous years it was 3 to 3.5 percent at most.

### **3.2.2. Development of Competition in Russian Industry in the Post-Default Period**

The issue of competition on Russian industrial enterprises' markets, as well as its effect on domestic manufacturers is still in the focus of attention of analysts, government officials and the general public. In 2002, debates on that issue entered a new phase as calls for protection of domestic manufacturers sounded again (for the first time since the 1998 default) following publication of customs statistic, according to which the volumes of imports reached the 1998 level in 2002. However, there are two factors that make one question such depressing estimations. Firstly, the customs statistics is probably one of the most unreliable sources of economic information in modern Russia. Secondly, in 2002 the dynamics of demand and output, as well as monetary settlements in the Russian industrial sector were fundamentally different from those which were observed in the first half of 1998. So, projection of conclusions and forecasts based on the analysis of the pre-default situation to 2002 seems to be unjustified.

True, traditional methods of research of the issue of competition fail to produce such reliable data as is needed for regular and prompt monitoring of that phenomenon which is very important for the Russian national economy. However, competition monitoring started by the IET as early as 1995 offers ample material for analysis of development of the competitive environment in the Russian industrial sector in recent years. Such monitoring is based on regular surveys of CEOs of enterprises on competition related issues. It is to be noted that such an approach has a number of advantages<sup>3</sup>. Firstly, those surveys help collect data on a wide range of such competition-related indices as are not quantified. Secondly, there is no need to gather and analyze large volumes of detailed technical and economic information; that task is handled by each of the surveyed enterprises themselves. Thirdly, only such an approach permits aggregate assessment of the level of competition on actual markets where enterprises sell their produce. Fourthly, that is the only way to make comparative assessments of domestic competition and competition from imported goods.

Of particular interest are the six-monthly aggregate panel assessments of the competition level. The CEO (or deputy director or head of the economic department of the enterprise) makes an assessment of the competition level on the market where his/her enterprise sells produce by the following scale: "strong", "moderate", "none" and "difficult to assess". All respondents are asked to assess the following three types of competition: competition from other Russian manufacturers, competition from foreign manufacturers and competition from manufacturers from the CIS countries and Baltic states. Simple and obvious as they are, such questionnaires offer ample opportunities for analysis of various competition levels.

#### **Competitive Markets in Russian Industry**

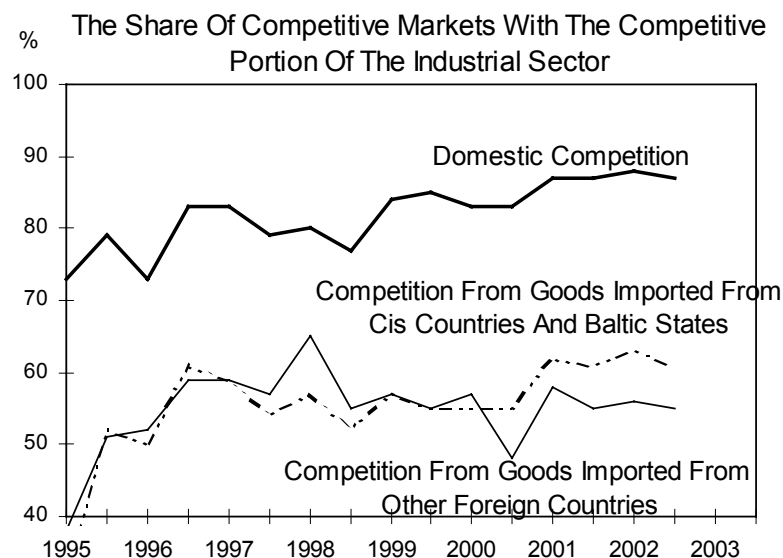
A survey approach permits us to isolate competitive markets and assessed markets in the totality of markets where Russian enterprises sell their produce. The share of competitive

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<sup>3</sup> S.V. Tsukhlo. Assessment of Competition in Russian Industry. Potentialities of Surveys of CEOs of Enterprises. //Voprosy Statistiki, 2000 №11

markets is determined as the share of enterprises which used in their assessment of competition one of the following three types of estimations: “strong”, “moderate” and “weak” (which means that such answers as “none” and “difficult to assess” were excluded from the analysis). If the enterprise gave one of the two latter types of answers, it is likely that the level of competition on the market where that enterprise sold its produce was so insignificant that the enterprise was either aware of its being insignificant or had never given thought to that issue. The share of assessed markets is determined as the share of enterprises which used the following four types of estimations: “strong”, “moderate”, “weak” and “none”. In that case, the “difficult to assess” answer is excluded from the analysis and the aggregate assessments are solely based on definite assessments of the level of competition.

Particularly promising is analysis of the dynamics of the share of competitive markets where Russian industrial enterprises sell their merchandise (See *Fig. 27*). It is to be noted beforehand that the data shown in the chart illustrates the share of markets where competition is observed, rather than the level of such competition.



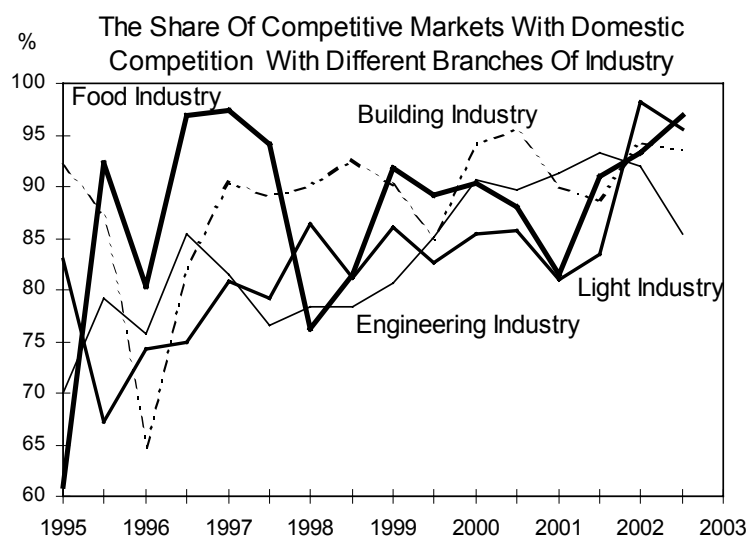
*Fig. 27*

What conclusions can be drawn from the analysis of the dynamics of shares of competitive markets in the 1995-2002 period? Firstly, the share of competitive markets in all cases (that is, on all lines of competition) was always less than 100 percent. In other words, there have always been markets free from significant competition (competition felt by enterprises). Speaking about domestic competition, the smallest shares of non-competitive markets were observed with the building materials industry (11%), food industry (12%) and chemical industry and petrochemical industry (14%). As regards competition with imported goods, the minimum share of noncompetitive markets was observed with chemical industry and petrochemical industry (33%), engineering industry (41%) and light industry (42%).

Secondly, domestic competition was observed on a greater share of competitive markets. On the average, in the past eight years of monitoring, 82% of enterprises regarded their markets as competitive. That index tends to grow; its highest values (87% to 88%) were observed in 2001 and early in 2002. The share of competitive markets with the Russian indus-



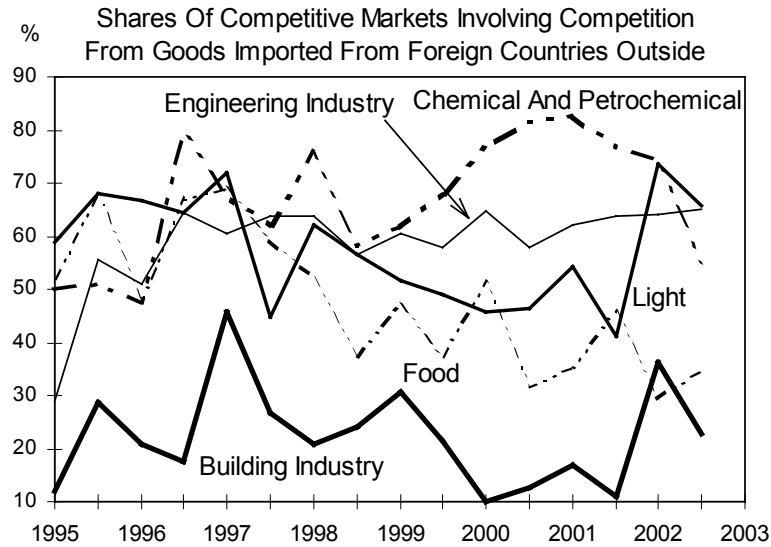
trial sector as a whole amounts to 84 percent. In 2002, the maximum shares of competitive markets (see *Fig. 28*) were observed with light industry (97%), food industry (95%) and building industry (94%).



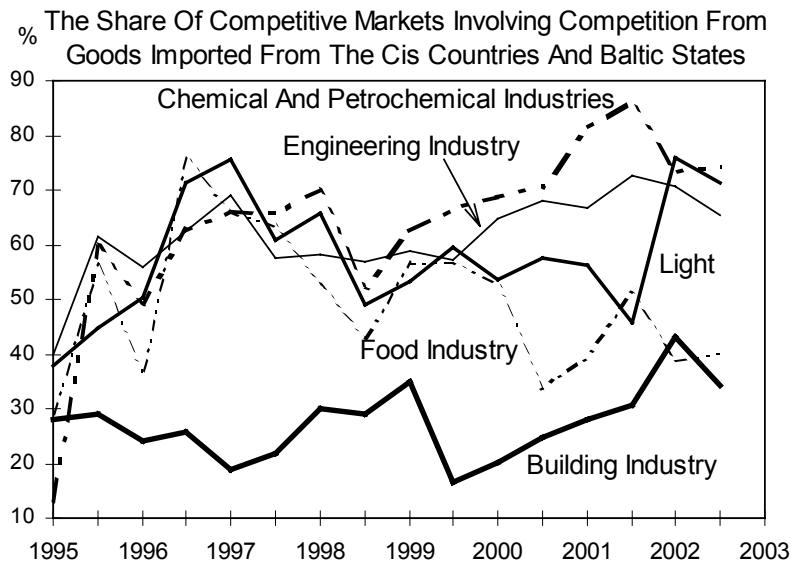
*Fig. 28*

Thirdly, competition from merchandise imported from CIS countries, Baltic states and other foreign states was only observed, on average, on 55 percent of the markets. Speaking about competition from goods imported from foreign states, the maximum share of competitive markets (65%) was observed in the first half of 1998. That index later fell to 55 - 58 percent and remained at that level throughout the post-default period (but for the ‘nosedive’ observed late in 2000). So, in 2002, the share of markets where Russian enterprises competed with manufacturers from foreign countries was similar to that observed in the 1996-1998 period and in the early post-default years. In other words, competition from imported goods did not increase on the markets where Russian industrial enterprises sold their produce. So, assertions to the effect that imported goods are “pressuring” domestic manufacturers again seem ungrounded. Moreover, according to estimations made by enterprises themselves, the level of competition from imported goods on markets where enterprises from most of the branches of industry sold their merchandise remained low and/or decreased in the second half of 2002 (See *Fig. 12*). In 2002, the largest share of competitive markets with foreign competition was observed with light industry (70%), chemical industry and petrochemical industry (65%) and engineering industry (65%).

Fourthly, the share of competitive markets involving competition from goods imported from the CIS countries and Baltic states increased after the default of 1998 and amounted to 62% in 2002. Starting from the Year 2000, that index was invariably higher than that of the share of competitive markets involving competition from goods imported from foreign countries outside the CIS and Baltic States region. In 2002, the greatest number of competitive markets involving competition from goods imported from the CIS countries and Baltic states (see *Fig. 13*) was observed with chemical industry and petrochemical industry (74%), light industry (74%) and engineering industry (68%).



*Fig. 29*

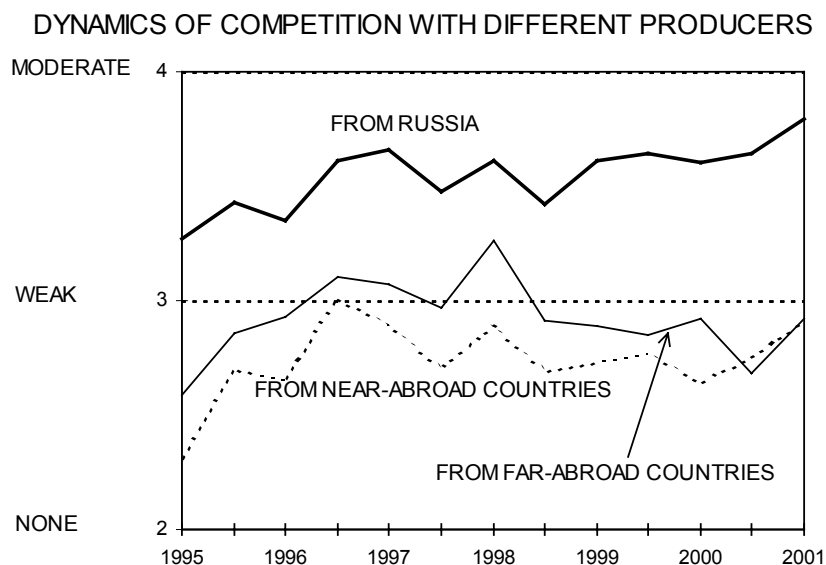


*Fig. 30*

### Dynamics of Competition Levels on All Markets

The toughest competition experienced by Russian industrial enterprises on all markets has always been and remains competition from other Russian enterprises. It is to be noted that domestic competition on all markets has never been weaker than that with imported goods. It is also to be noted that those two types of competition were very different. Aggregate estimations of competition from foreign manufacturers have always been slightly below the “weak”

level, while those of domestic competition tend ever more distinctly towards the “moderate” level.



*Fig. 31*

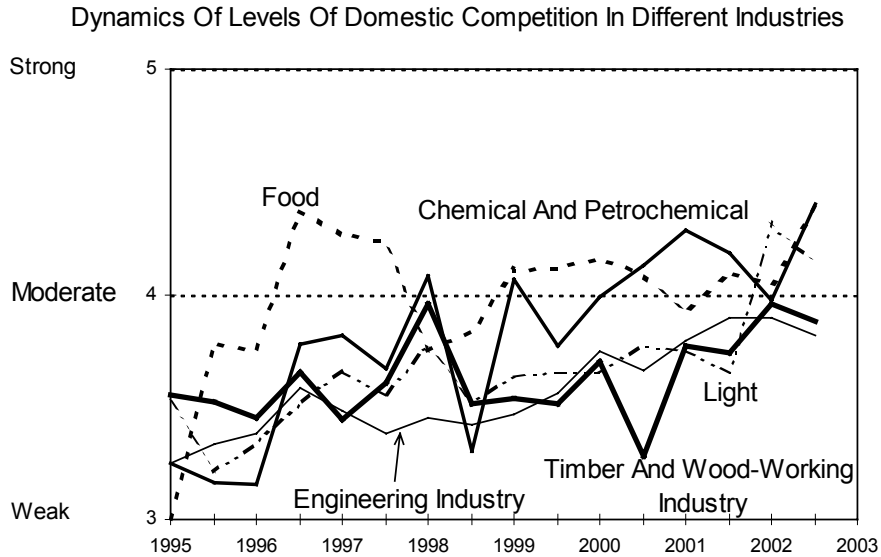
The greatest spread of assessments was observed late in 2000 (it amounted to 0.96 points). In 2002, domestic competition exceeded that from foreign manufacturers by 0.89 points.<sup>4</sup> The absolute maximum of domestic competition was observed early in 2002, while that of competition from imported merchandise, early in 1998. In the post-default period, competition from imported merchandise fluctuated within a narrow band of 2.68 points to 2.98 points.<sup>5</sup> If the ‘nosedive’ observed late in 2000 is not to be taken into account, the band shrinks to 0.13 points. At the same time, domestic competition underwent considerable changes within the post-default period; its estimations increased from 3.42 points to 3.91 points. So, the growth in import had practically no effect on the overall level of competition from imported merchandise on the markets where Russian industrial enterprises sell their produce.

A similar situation can be observed with all branches of industry. Firstly, all surveys revealed growth in domestic competition in the post-default period. The maximum values were observed late in 2002 with the chemical industry and petrochemical industry (4.40) and the food industry (4.38). Secondly, in the post-default period, the level of domestic competition in a great number of branches of industry was slightly below the “moderate” level (see *Fig. 32*). Such a situation can hardly be seen as satisfactory by the Ministry of Antimonopoly Policy and Promotion of Entrepreneurship of the Russian Federation. Thirdly, the weakest competition was always observed with engineering industry. Domestic competition in that industry was rated as the lowest throughout the entire period of monitoring (1995-2002) and

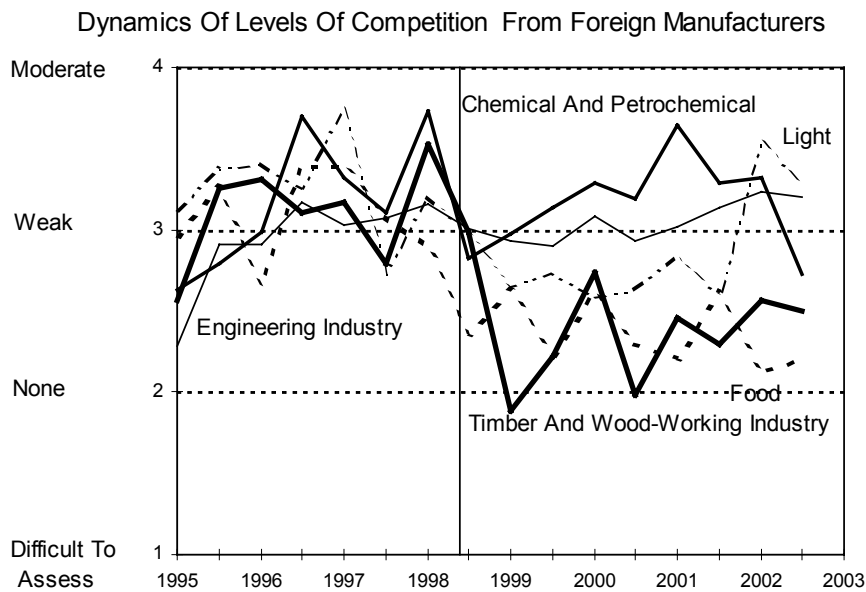
<sup>4</sup> One point used in that calculation is equal to the difference between two grades (“strong”, “moderate”, “weak”, “none” or “difficult to assess”) of the scale used for assessment of competition

<sup>5</sup> Value 2 corresponds to “none”, value 3, to “weak”, while value 4, to “moderate”.

in 2002 taken separately. The high degree of monopoly which was typical of the Soviet era has been preserved in that industry to a great extent.



*Fig. 32*

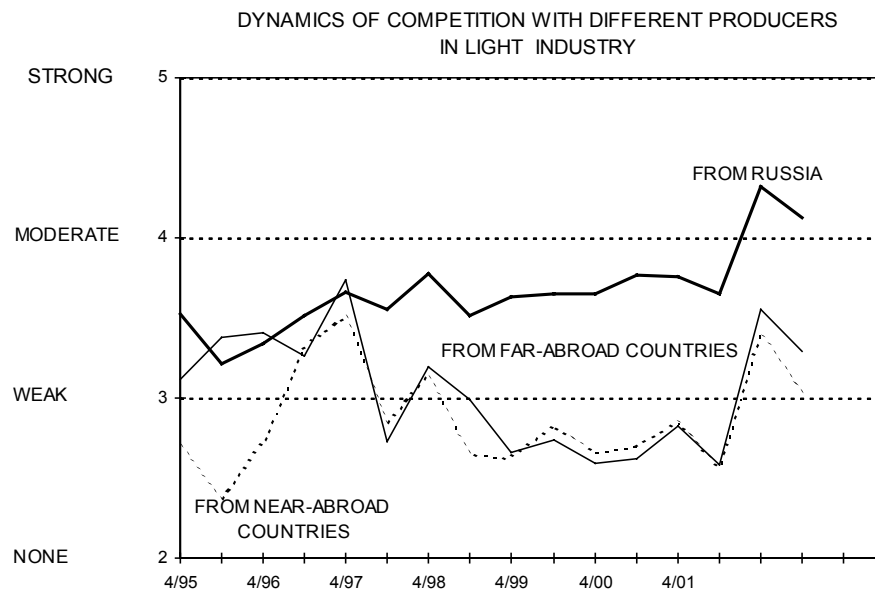


*Fig. 33*

Estimations of competition from foreign manufacturers with different branches of industry show that the advantages received by different branches of industry after the default of 1998 varied both in extent and duration. The advantage estimations by the food industry was the greatest and of the longest duration. Prior to the default, the average level of competition in that industry amounted to 3.09 points, while after the default, to 2.36 points; so the differ-

ence in average figures amounted to 0.73 points. The second biggest difference was observed with timber industry, wood-working industry and pulp-and-paper industry (0.70). The smallest positive difference (that is, reduction of aggregate post-default estimations) was observed with chemical and petrochemical industry (0.03). In engineering industry, however, “the difference” (that is, the advantage gained from the default) was negative; that is, average estimations of post-default competition from imported goods exceeded those of the pre-default period by 0.11 points. Moreover, in 2002 the level of competition in the engineering industry amounted to 3.23 points and 3.20 points. Such a high level of competition from imported goods had never been observed with that industry since 1995.

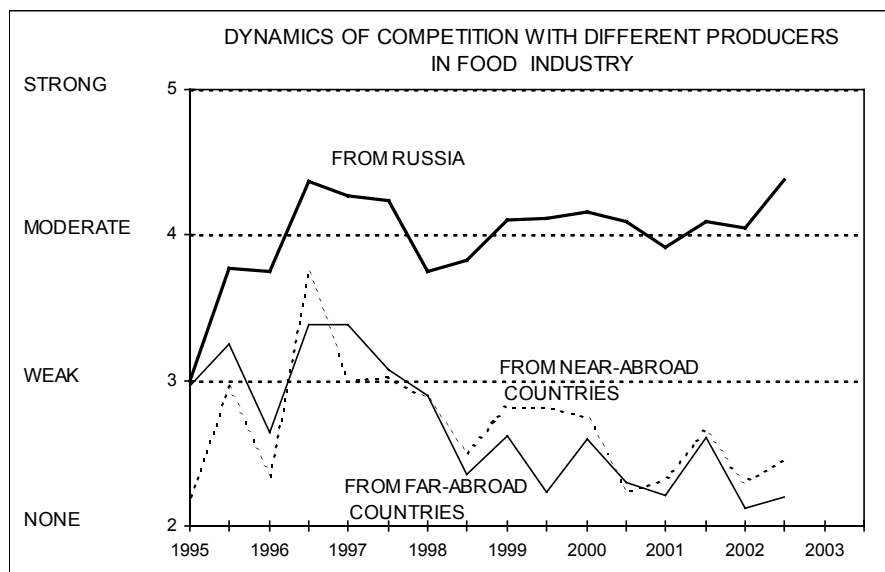
The competitive environment in light industry needs to be discussed separately. With all markets taken into account, that branch of industry was the only one where estimations of competition from foreign manufacturers were comparable to those of domestic competition. However, such a situation only observed in the 1995-1997 period. Later, the level of competition from imported goods fell below the “weak” level and remained at that level up till the beginning of 2002, while the level of domestic competition was somewhere in the middle between the “weak” level and the “moderate” level. In 2002, light industry enterprises experienced fast growth both in rates of domestic competition and those of competition from imported goods. Domestic competition in that branch rose from 3.65 points to 4.32 points exceeding the “moderate” level for the first time since the beginning of the monitoring. The growth in competition from imported goods amounted to nearly one point (from 2.58 to 3.55) with the rate of such competition returning to the 1995-1996 level. Yet, the level of domestic competition remained definitely higher (see *Fig. 34*).



*Fig. 34*

It is worth discussing in detail development of competitive environment in food industry. While light industry is traditionally believed to be the worst hit by competition from imported goods, by contrast, the situation in the food industry is viewed as the most favorable as regards competition from foreign manufacturers. It is to be noted that survey result point to that as well (see *Fig. 35*).

Firstly, the dynamics of the levels of competition from imported goods in that industry tended to go down. While in the 1996-1997 period aggregate estimations of that competition on all markets were somewhere in the middle between the “weak” level and the “moderate” level, lately, “none” estimations have prevailed in respect of competition from imported goods. It is to be noted that the level of competition from imported goods started to decrease as early as the second half of 1997; prior to the default, competition was rated by enterprises as “weak”. As a result of the default, the index of competition from imported goods fell (in six months from April to October 1998) by 0.54 points, which was not the sharpest decline in the rate of such competition in that industry, though. At the end of 2001 and early in 2002, that index lost another 0.48 points and was the lowest figure to be observed with any of the manufacturing industries in Russia. Similar trends could be observed in competition from manufacturers from the CIS countries and Baltic states.



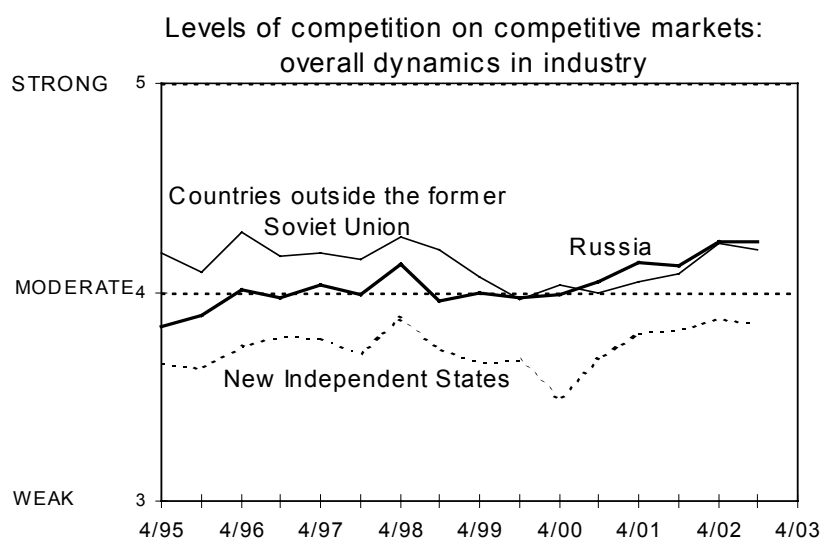
*Fig. 35*

Secondly, competition in food industry was predominantly domestic, that is, manufacturers mostly competed with other Russian manufacturers. It is to be noted that estimations of the level of such competition always fluctuated around the “moderate” level. The pre-default assessment of the level of domestic competition (3.75 points) was the all-time low of the 1996-2002 period. Since the first assessment of the level of competition following the default, estimations hardly ever went below the “moderate” level. In October 2002, the absolute maximum of 4.38 points was observed with that industry, which level was also the absolute maximum for all industries. On the average, in the 1995-2002 period domestic competition exceeded that with imports by 1.31 points in food industry. A higher value of that parameter could only be observed with the building materials industry which is, for obvious reasons, better protected from competition from imports. Late in 2002, the difference between the level of domestic competition and that of competition from imports in food industry amounted to 2.18 points, which was the maximum for that industry.

Dynamics of Levels of Competition on Competitive Markets

In calculation of aggregate estimations of competition on competitive markets, the following types of answers are used: “strong”, “moderate” and “weak”. Though such an approach reduces the number of processed assessments, in our view, it makes analysis of different types of competition more comparable. In surveys of competition from foreign manufacturers, the share of the “difficult to assess” answers amounted in the eight years of monitoring to 25 percent and in surveys of domestic competition, to 7 percent. Such answers do not contribute much to the aggregate level as they are assigned weight equal to unity. As a result, estimates of competition from imports are bound to be lower than those of domestic competition. This, certainly, reflects the actual situation on markets where Russian enterprises sell their merchandise, but makes calculation results somewhat incomparable. Analysis of competition on competitive markets alone solves that problem. However, it gives rise to another problem; in calculation of the aggregate level of competition from foreign manufacturers, 45 percent of estimations are excluded from calculations and in calculation of that of domestic competition, 19 percent. That permits us, however, to isolate markets where competition is not at the zero level, in other words it can be described as ‘strong” or “weak”.

Prior to default of 1998, on competitive markets of all branches of the Russian industrial sector competition from imports exceeded domestic competition, though insignificantly. While in 1995 and early in 1996 the average value of the index of domestic competition amounted to 3.98 points (that is, it corresponded precisely to the “moderate” level), that of competition from imports, to 4.19 points. Equalization of competition levels only took place in the second half of 1999. It is to be noted that that happened because of reduction of the level of competition from foreign manufacturers. Domestic competition remained at the same level (“moderate”) till the second half of 2000. Starting from 2001, there was simultaneous growth in both the types of competition (see *Fig. 36*). In 2002, the rates of those two types of competition were similar and showed little change.

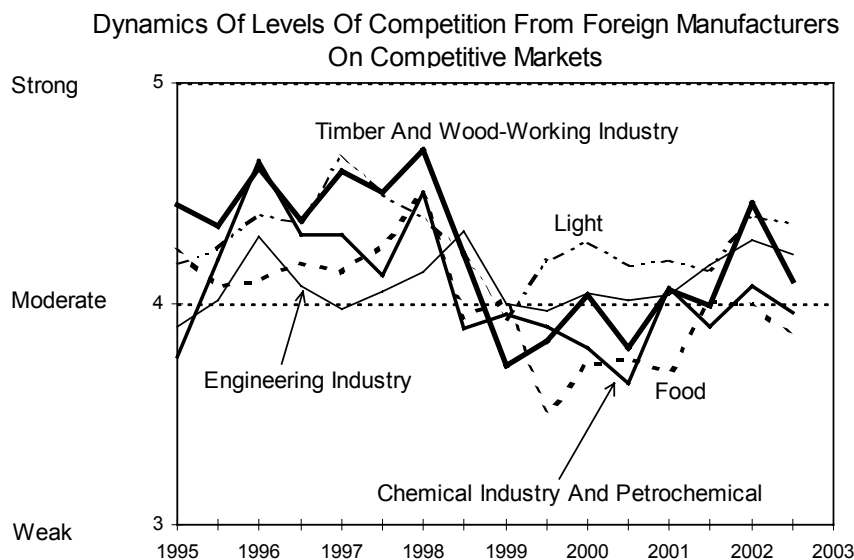


*Fig. 36*

Now let us discuss sectoral specifics of development of competition on competitive markets. The analysis of surveys' outputs and calculation of aggregate indices of competition brings us to the following conclusions.

Firstly, prior to the default manufacturing industries experienced on competitive markets stronger competition from foreign manufacturers. Food industry was an exception. It is to be noted that from 1996 (that is, long before the default of 1998) in that industry domestic competition exceeded on the average competition from imports by 0.18 points.

Secondly, because of the default the levels of competition from imports dropped. The most radical drop in levels of competition from imports was observed with the building materials industry. The difference between the pre-default maximum and the first post default minimum amounted to 1.55 points in the building industry, 1 point in food industry, and 0.84 points in chemical industry and petrochemical industry. The smallest reduction (0.34 points) of the competition level was observed with engineering industry.



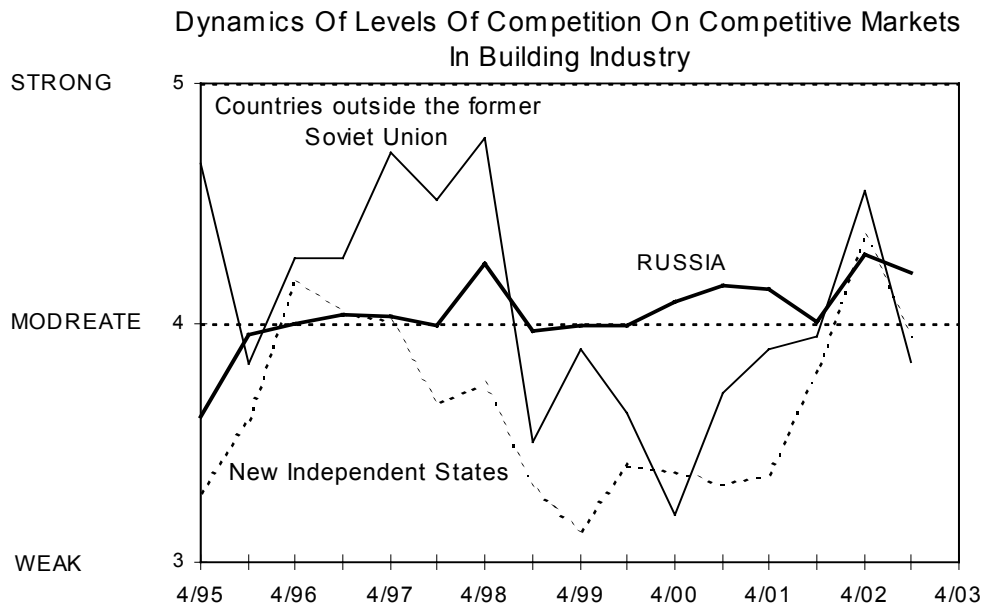
*Fig. 37*

Thirdly, the effects of the default on intensity of competition were different in the different branches of industry. For instance, as a result of the 1998 default the level of competition from imports in chemical industry, petrochemical industry and food industry became lower than that of domestic competition and remained at the same level till the end of 2002. The levels of the two types of competition in wood-working industry and light industry became similar. In engineering industry, competition from imports remained predominant; though the extent of such predominance decreased. On the average, prior to the default competition from imports in engineering industry exceeded domestic competition by 0.16 points, while after the default, by 0.13 points. The latest estimation (in October 2002) revealed that enterprises in engineering industry rated intensity of both types of competition as equal. It is to be noted that intensity of domestic competition had reached its absolute maximum by that time.

Dynamics of the difference between levels of competition in building materials industry was rather peculiar. Prior to the default (in 1996-1998), competition from imports on competi-



tive markets was extremely high. In April 1998, the index amounted to 4.77 points, which was the all-time high. However, by April 2000 it fell to 3.22 points. It is to be noted that domestic competition remained practically unchanged (see Fig. 38). In the following two years, competition from imports rose to the pre-default level (4.37 points in April 2002), after which there was an insignificant reduction. As can be seen from the Chart, it was early in 2002 that enterprises in that industry estimated the level of competition from imports as higher than that of domestic competition for the first time. And that was not a sudden leap.



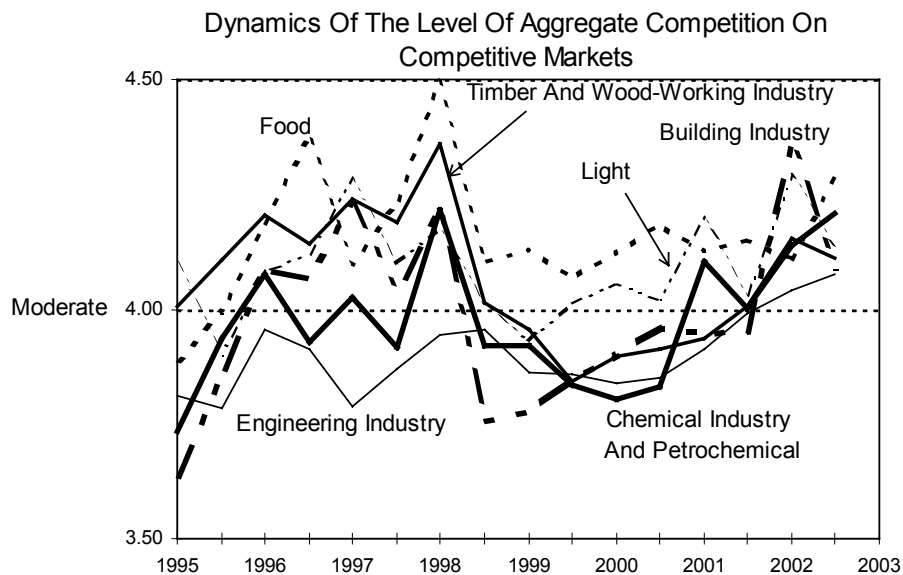
*Fig. 38*

By the end of 2002 when one would expect imports to be stifling domestic industries again, a higher level of competition from imports was observed (by enterprises themselves) only with light industry; and it is to be noted that even there the level of competition from imports exceeded that of domestic competition by a mere 0.09 points). In engineering industry, timber industry, wood-working industry and pulp-and-paper industry, intensity of the two types of competition was assessed by enterprises as similar. In chemical industry, petrochemical industry, building industry and food industry the level of domestic competition was higher than that of competition from imports.

Analysis of aggregate competition (domestic competition + competition from foreign countries + competition from CIS countries and Baltic states) reveals that manufacturing industries had in general similar dynamics of competition on their competitive markets. (See Fig. 39). Firstly, by the time of the default the level of competition in most branches of industry reached maximum values. The maximum of 4.49 points (that is, the middle between the “strong” level and the “moderate” level) was observed with food industry. The second highest level was observed with timber and wood-working industry and pulp-and-paper industry (4.36 points). Those two industries had also the highest levels of competition throughout the entire pre-default period (4.18 points each). The lowest level of competition in April 1998 and in the 1995-1998 period was observed with engineering industry. Before 2002, absolute val-

ues of the index of aggregate competition in that industry did not exceed the “moderate” level.

Secondly, the default brought about abatement of competition in all branches of industry. The greatest reduction (0.46 points) in the six months from April to October 1998 was observed with building materials industry. That value of the index of competition was also the absolute post-default minimum for all industries. No reduction in competition levels was observed with the engineering industry during that period. Only in 1999, enterprises in engineering industry experienced certain abatement of competition, which abatement was rather insignificant. On the contrary, timber and wood-working industry and pulp-and-paper industry ‘benefited’ to the greatest extent (0.20 points) from the default. By the “benefit”, we mean the positive difference between the average values of aggregate competition before and after the default of 1998. In other industries, such a “benefit” was much smaller; in some cases it was close to zero. “Disadvantage” (-0.06 points of the aggregate competition) was observed only with in the engineering industry. By “disadvantage” we mean negative difference between average levels of aggregate competition before and after the default.



*Fig. 39*

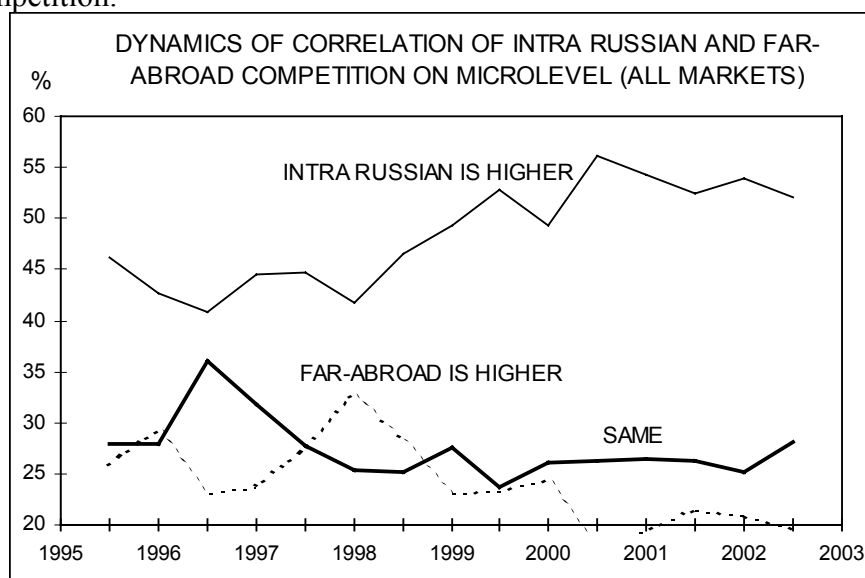
Thirdly, in the 2000-2001 period aggregate competition started to grow. It reached the post-default maximum in the first half of 2002. In the industrial sector in general and in some branches, the post-default maximum was higher than the pre-default one. Competition became quite intense again. However, in the second half of 2002 it abated again a little.

### **3.2.3. Relationship Between Different Types of Competition at the Microeconomic Level**

Hearing calls for protection of domestic manufacturers all the time, one gets the impression that competition with imported goods pose the toughest competitions to Russian manufacturers' produce in their respective niches of the market. Traditional statistics have failed to produce such quantitative data as could serve as the basis for an answer to the obvious, highly topical question of which competition tougher: Russian manufacturers' competition with one

another or their competition with imports. The feasible calculations of statistical parameters for each type of competition would not permit comparison of the levels of competition since the outputs (if at all obtained) would be using different scales. It is the surveys-based approach to monitoring of competition that permits getting the most grounded and least prone to criticisms answer to that question.

In our study of the correlation between the two lines of competition at the microeconomic level we used analysis of a matrix of conjugation of estimations of domestic competition and competition with imports from countries outside the CIS & Baltic states region. The sum of the matrix's diagonal elements shows the share of enterprises that believe that competition from those two groups of goods is equal. The supra-diagonal sum represents the share of enterprises that experience more severe competition from other Russian manufacturers than from imports, while the sub-diagonal sum, the share of enterprises that face greater competition from imports from countries outside the CIS & Baltic states region than from goods produced by other Russian manufacturers. The above parameters can be calculated for all markets (with the entire integral of estimations used), for estimated markets (with 'hard to say' estimations excluded) and for competitive markets (with 'high rate of competition' and 'low rate of competition' ratings used). It is to be remembered, though, that markets can be estimated or competitive simultaneously along two lines. Analysis of the conjugation matrix only permits one to find out which competition is stronger, but cannot help determine the absolute levels of competition.



*Fig. 40*

Let us first examine all the markets in which Russian industrial enterprises are active. For that purpose, conjugation matrixes are based on all the five types of estimations of the level of competition ('high competition', 'moderate competition', 'low competition' 'no competition' and 'hard to say'). The dynamics of correlation between the two types of competition in all the markets showed that the level of domestic competition was higher (see *Fig. 40*). The share of enterprises seeing domestic competition as higher was never below 40 percent; the high observed in the second half of the Year 2000 was 56 percent. In 2002, an average of 53 percent of industrial enterprises believed that competition from domestic manufacturers was



more intense than that from imports. The share of enterprises with the opposite opinion has never exceeded 33 percent in the period monitoring has been carried out. The all-time low (18 percent) was registered in the second half of the Year 2000. The average value of that parameter in 2002 was 20 percent, which was the lowest average annual value. The highest rate of identical estimations of the two types of competition by industrial enterprises (36 percent) was registered in the second half of 1996, while by 2002 the share of enterprises with such estimations dropped to 25 percent. This shows that for the totality of markets in which Russian industrial enterprises are active domestic competition was tougher than that from imports.

Enterprises in all the branches of industry surveyed also believed that in the totality of their markets competition from domestic competitors was more intense than that with foreign competitors (from countries outside the CIS and Baltic states region). The sole exception was light industry where in the period from late 1995 till early 1997 CEOs' estimations of competition with imports were higher than with other industries. However, starting from October 1997 the pattern with that branch became the same as elsewhere: the share of enterprises believing that competition from domestic manufacturers was more intense grew (to make nearly 50 percent) coming to considerably exceed the share of the opposite estimations (see *Fig. 41*). Early in 1999, when consequences of the default became felt on light industry enterprises' markets, the share of enterprises believing that foreign competition was more important than domestic dropped from 30 percent to 15 percent, while the share of equal estimations grew to make 34 percent. Manufacturers found that it was easier to compete with imports than before. By the beginning of 2000, the share of equal estimations of domestic and foreign competition dropped to 21 percent (which was close to an all-time low). That happened not because of intensification of competition with imports but because of an increase in the share of markets with tougher domestic competition, which reached a peak (57 percent). So, in the 1998-2001 period the brunt of competition in light industry was shifted to the 'home front'. It is to be noted that that process had begun back in the second half of 1997. However, in 2002 the situation started to change again. The share of markets with tougher foreign competition grew to 22 percent at first and towards the end of the year even to 29 percent thus relapsing to the pre-default level. The share of such markets grew at the expense of shrinking of the shares of the two other types of markets (those with equal domestic and foreign competition and those with tougher domestic competition).

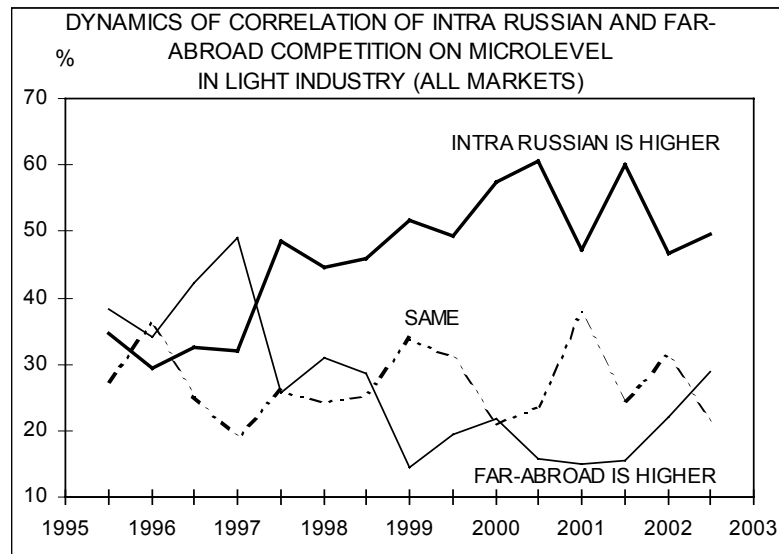


Fig. 41

The situation in food industry has always been very different. Prior to the 1998 default, domestic competition was more intense than foreign for most enterprises in that branch of industry. The pre-default high of that index (65 percent) was registered in the first six months of 1997, then it dropped to 39 percent due to growth in the share of markets with equal rates of competition (see Fig. 42). The share of markets with a higher extent of competition with imports remained low and nearly unchanging in the 1995-1998 period (16% to 18%). The default pushed that figure almost to the zero level and increased the share of markets with higher domestic competition to 70-80 percent. Last year Russian food manufacturers strengthened their positions even further. The share of markets with equal extents of competition went down from 26 percent to 9 percent (which is the all-time low). Just four percent of Russian food industries faced more intense competition from imports than from other Russian enterprises.

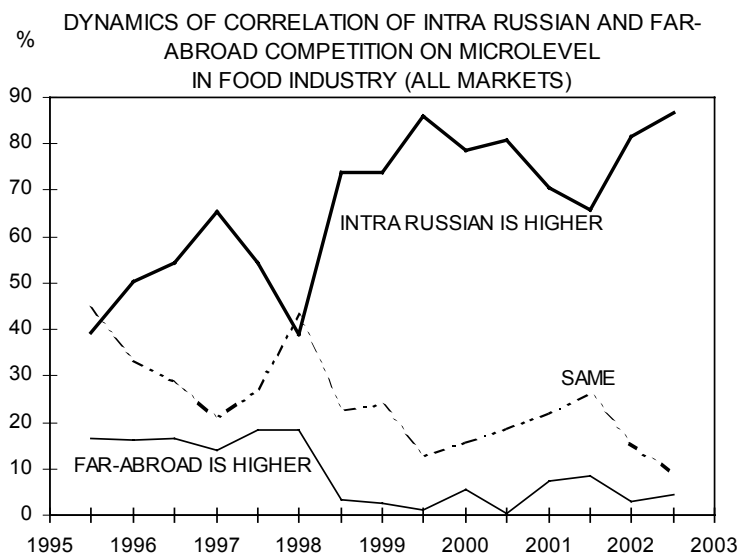
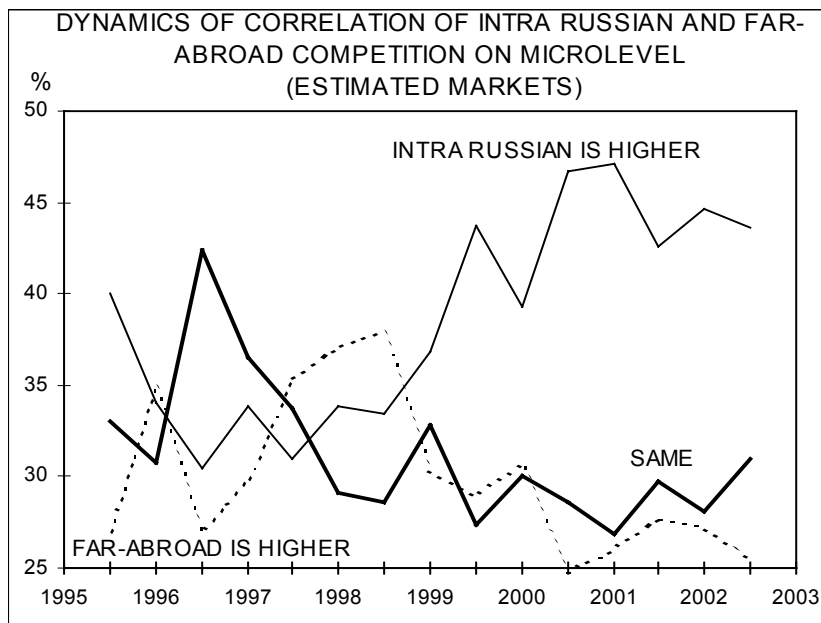


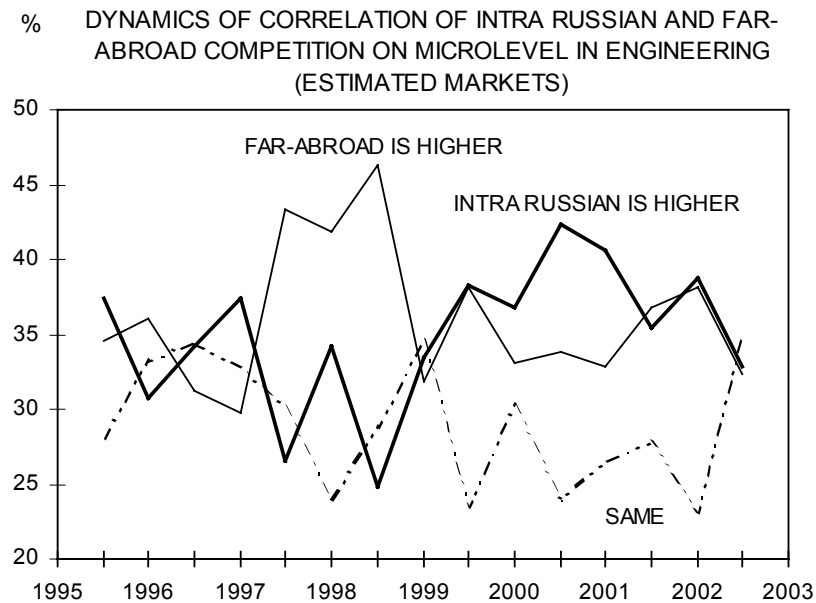
Fig. 42



The above ratios were calculated for all the categories of responses, including ‘hard to say’ responses. In this way, all the markets of Russian industrial enterprises were covered, including those where Russian enterprises did not face any competition for some or other reasons. Narrowing of calculations and analysis to ‘estimated’ markets permits assessment of situation on the markets where enterprises can produce definite estimations. In this context, it is to be remembered in this case only responses by such enterprises are taken into account as have made definite estimations of both types of competitions. The dynamic thus established is different (see *Fig. 43*). Prior to the default, the shares of markets with predominant foreign and predominant domestic competition were, on the average, equal, but the dynamic of parameters was different, as can be seen from the chart. While the share of markets with predominant domestic competition remained more or less on the same level, the share of markets with predominant competition from imports grew from 27 percent to 38 percent in the October 1996-October 1998 period. Early in 1999, the ratio of the markets began to change dramatically. The share of markets with predominantly foreign competition dropped to 25 percent, while the share of markets with the opposite competition ratio grew to 43-45 percent.



*Fig. 43*

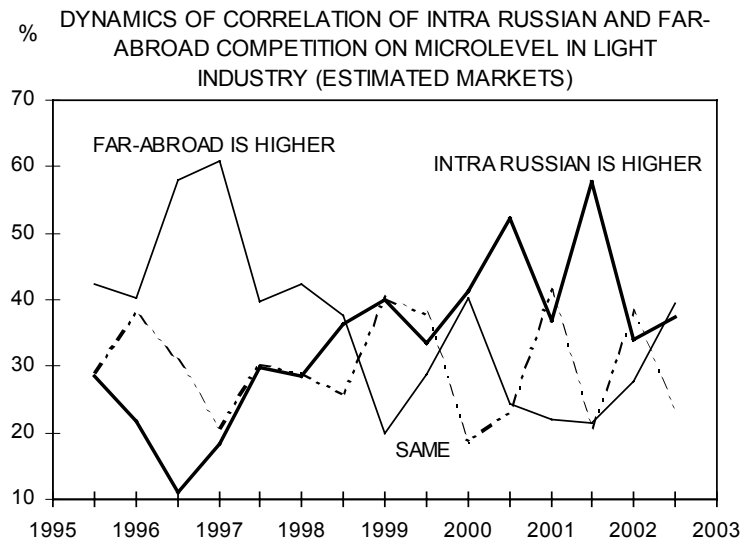


*Fig. 44*

Ratios of the two types of competition in estimated markets varied considerably from industry to industry. For instance enterprises in engineering industry had a particularly hard time in the October 1997-October 1998 period. At that time, 45 percent of enterprises believed that competition with foreign-made products posed a greater problem than competition with domestic manufacturers. Up till April 1997, the share of such a ratio of estimations was within the 30-35 percent range, roughly equaling the share of the opposite estimations. The situation in engineering industry only reached a balance by the first half of the Year 1999 (see *Fig. 44*). Up till the end of 2000, the shares of market with predominantly foreign competition and predominantly domestic competition were equal, then, markets with a higher level of domestic competition became prevalent. Late in 2001, parity was attained again which lingered for the better part of the Year 2002. Late in 2002, the share of markets with equal rates of foreign and domestic competition grew steeply.

In light industry, a higher level of estimations of competition with imports was observed in the 1995-1998 period. Late in 1996 and early in 1997, around 60 percent of manufacturers believed that the level of domestic competition was lower than that of competition with imports (see *Fig. 45*). Such high rate of estimations revealing prevalence of competition with imports was not observed in any of the other branches of industry. However, the situation began to change as early as the beginning of 1998. In the first six months of 1999, a picture exactly opposite to the above was observed: the share of enterprises facing greater competition from imports dropped to 20 percent, while the share of enterprises experiencing more severe competition from domestic manufacturers grew to 40 percent. By the end of 1999, however, the shares of estimations became equal; in the first half of 2000 both amounted to 40 percent. In the period between late 2000 and early 2000, estimations revealing higher levels of domestic competition prevailed in that branch of industry. The highest share of such estimations was observed late in 2001 when 59 percent of industries believed that domestic competition was tougher than that from imports. In 2002, the shares of the above two groups of enterprises became equal again (both amounting to 35 percent). It is to be noted that a mere 60 to 70 per-

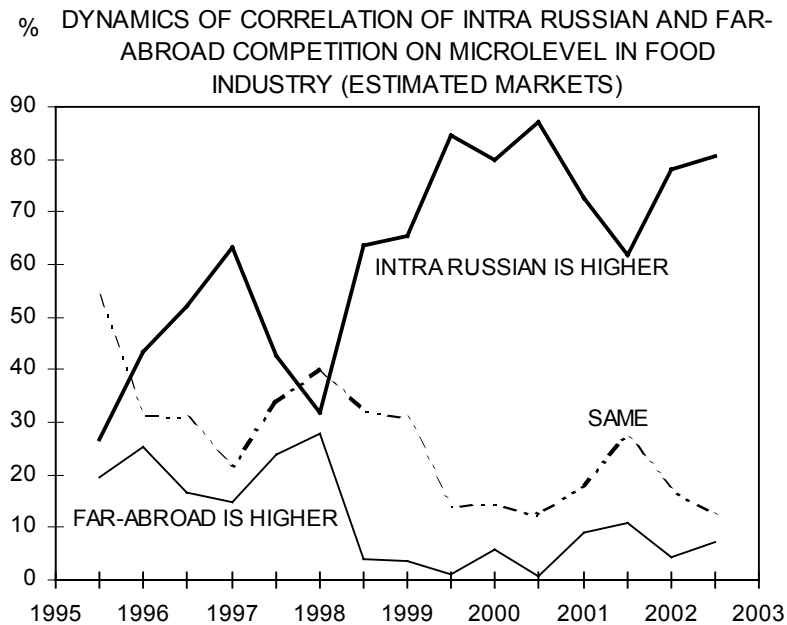
cent of enterprises in light industry were able to make definite estimations of both the types of competition. Others faced only one type of competition (mostly domestic) or none at all. Before October 1998, the share of 'hard to say' responses in respect of competition with imports fluctuated in the 20%-27% interval, in 1999, it grew to 34 percent, and in 2000, to 46 percent. The role played by imports in the markets where Russian light-industry enterprises were active clearly became less important. Later, the opposite trend came to be observed, though, and the share of 'hard to say' responses dropped to 22 percent.



*Fig. 45*

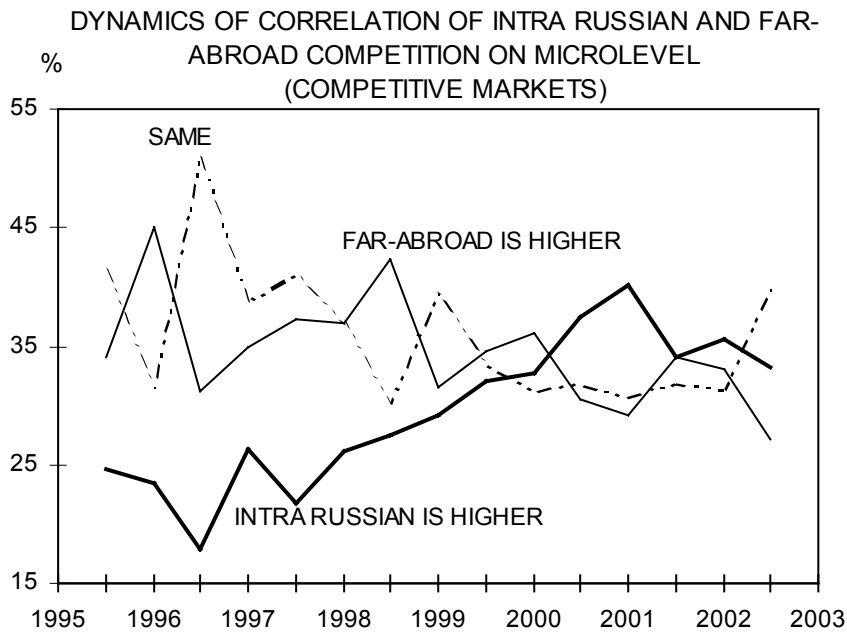
Positions of food-industry enterprises active in estimated markets were much stronger. They believed that domestic competition was more intense than competition from imports (see *Fig. 46*). True, by April 1998 the share enterprises seeing domestic competition as more intense dropped to 32 percent nearly equaling the share of enterprises with the opposite estimations. But the 1998 financial crisis made competition with imports easier for Russian food industries. The share of manufacturers facing stronger competition with imports immediately dropped to 4 percent, and in October 1999 even to 1 percent. Then, their share grew again (in 2001, it amounted to 10 percent, while in 2002, to 6 percent. As a rule, the share of estimations revealing equal levels of the two types of competition did not exceed 40 percent; in October 2002, it dropped to 12 percent.





*Fig. 46*

The dynamics of the ratio between the two types of competition changed even more in the markets where both domestic competition and competition with imports from countries outside the CIS and Baltic states region are present (with levels above the zero level). (See *Fig. 47*) Here, only responses by such enterprises as answered ‘strong’, ‘moderate’ or ‘low’ are taken into account, while ‘none’ and ‘hard to say’ responses are excluded from analysis. As the interval is narrowed, only certain specific markets are analyzed. One feature of those markets consists in existence of some or other rate of competition, while another one, in presence on those markets of both Russian and foreign manufacturers. In our belief, the latter feature is more significant as it permits us to exclude from analysis groups of goods and markets where there is no direct competition between domestic and foreign manufacturers.

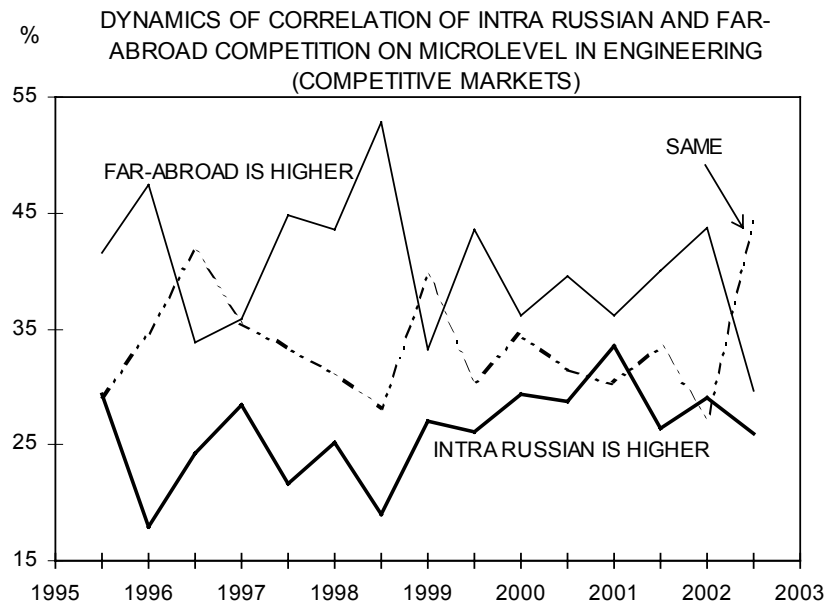


*Fig. 47*

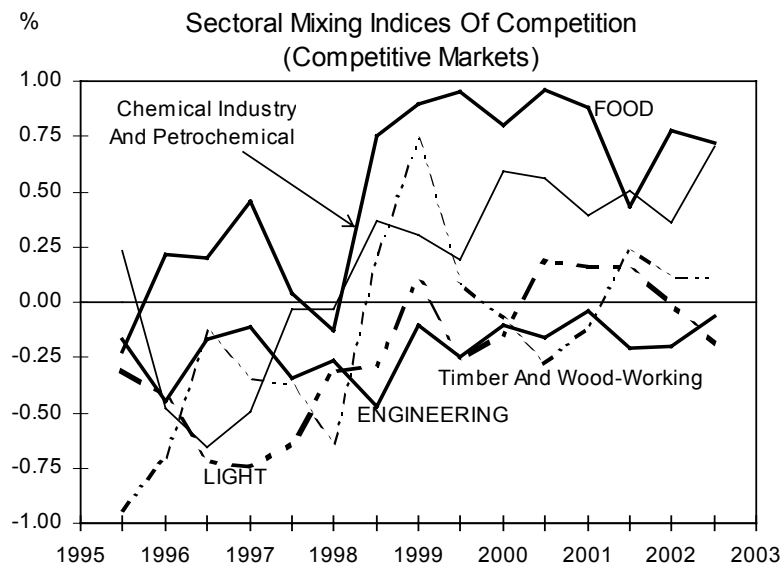
In such specific (in the above two meanings) markets domestic competition prior to the default was much less intense than competition with foreign manufacturers. In 1999 and early in 2000, the extent of predominance of foreign competition was reduced, yet such predominance remained. It is not until the end of the Year 2001, that the level of domestic competition exceeded that of competition with imports on such markets. As can be seen from the chart, the 1998 crisis did not strengthen much the positions of Russian manufacturers directly competing with imported goods. While prior to the default an average of 37 percent of enterprises viewed competition with imports as more significant, after the default that figure was 32 percent. In the same period, the share of enterprises with predominantly domestic competition grew by ten points, from 24 percent to 34 percent. As can be seen, the 1998 devaluation brought about equalization of the levels of domestic and foreign competition in Russian enterprises' competitive markets.

Domestic competition was always much less intense than competition from imported goods on the competitive markets where enterprises of engineering industry sell their produce (see *Fig. 48*). In the 1995-2002 period, engineering enterprises competing both with foreign and domestic manufacturers never estimated domestic competition as higher than that with imports. Moreover, the greatest difference was observed shortly after the August 1998 crisis, in October 1998. In our view, that can be explained by the fact that due to devaluation of the national currency holders of ruble funds tried to get rid as quickly as possible of their rubles buying mostly superior quality foreign-made machine-tools and equipment. Only in April 1999, intensity of competition from imports started to abate; it fell from 53 percent to 33 percent, while domestic competition became prevalent with 27 percent of enterprises. The greatest number of markets where domestic competition prevailed was observed with the engineering industry early in 2001. At that time, 34 percent of enterprises estimated competition from imports as lower than that from domestic manufacturers. Then, that index started to decrease to reach 26 percent by the end of 2002, which value was the pre-default minimum. It was

about that time that the minimum share of markets where competition from imports prevailed (30 percent) was observed for the first time since the beginning of monitoring. At the end of 2002, engineering industries experienced equal competition, from domestic and foreign manufacturers in most markets where both types of competition took place.



*Fig. 48*



*Fig. 49*

Light industry benefited from the default to a greater extent than engineering industry. Prior to the default, competition from imports prevailed on the average on markets where 46 percent of enterprises sold their merchandise, while after the default, 35 percent. Dynamics of markets with prevalence of domestic competition was more significant. That index increased



from 16 percent to 34 percent. At present, rough parity of the two types of competition is observed in light industry.

A more clear picture in respect of prevalence of markets with more domestic competition or markets with more competition from imports can be obtained with the use of the mixing index which is calculated as a ratio of the difference between shares of markets with more domestic competition and those with more competition from imports to their value. That index may have values below unity (competition from imports prevails on all markets) or over unity (domestic competition prevails on all markets). Sectoral mixing indices of competition (indices showing which type of competition prevails) are shown in Fig. 49.

The greatest and most continues prevalence of domestic competition was observed in food industry. Competition from imports prevailed only in two out of 15 assessments. It is also to be noted that that prevalence was neither significant, nor systematic. Small negative value (-0.13) of that index which was observed in April 1998 was replaced by the value of +0.75 as early as October 1998; such a big increase within six months was not observed with any other industry. A similar growth in the mixing index was observed with markets where enterprises of timber, wood-working and pulp-and-paper industry sell their merchandise. Before the default, the situation in those industries was different; markets with more competition from imports clearly prevailed there. The mixing index had never had a positive value. However, as early as October 1998 its value grew to 0.22 and in April 1999, to 0.74. Equalization of the levels of markets with prevalence of domestic competition and those with prevalence of competition from imports was observed at the end of 1999, while in 2002 and early in 2001 there were more markets where enterprises experienced more competition from imports. By 2002, the situation changed again “in favor” of domestic competition. Overall, the average post-default value of the mixing index was positive, which value pointed to the fact that markets with more domestic competition prevailed (See *Table 15*)

*Table 15*

**Average Value of the Mixing Index of Competition for Different Periods**

Branches	The 1995-2002 period	Prior to the default	After the default	Growth
Industrial sector in general	0.34	0.24	0.42	0.19
Metallurgy	0.41	0.50	0.32	-0.18
Chemical industry and petrochemical industry	0.17	-0.16	0.45	0.61
Engineering industry	-0.21	-0.28	-0.14	0.14
Timber, wood-working and pulp-and-paper industry	-0.14	-0.42	0.10	0.52
Light industry	-0.23	-0.49	0.00	0.49
Food industry	0.52	0.19	0.80	0.61

*Source:* calculations made using surveys' outputs

Prior to the default, competitive markets where Russian enterprises experienced more intense competition from other domestic manufacturers prevailed in the Russian industrial sector in general. However, such a situation was not observed everywhere. Of all the surveyed

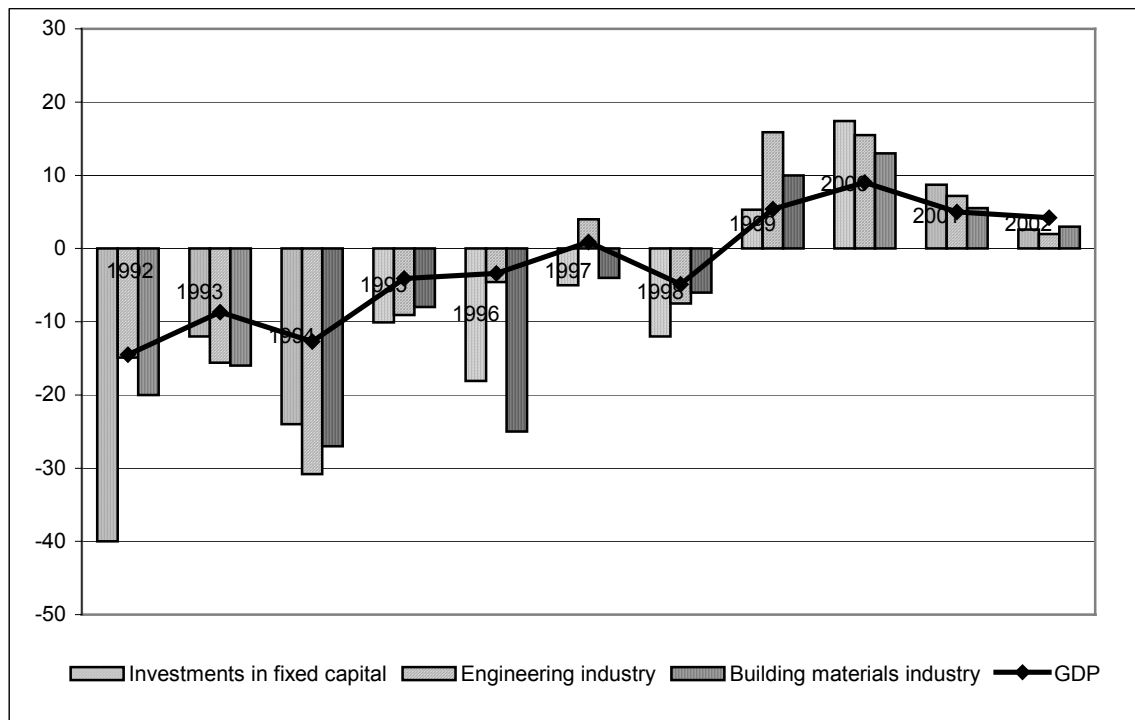
industries, such a relationship of markets was observed in the three pre-default years only in the metallurgical industry and food industry. After the default, markets with more domestic competition prevailed almost in all industries. Prevalence of markets with more competition from imports was observed only engineering industry. In light industry, markets only balanced each other after the default; the average value of the mixing ratio was zero. However, the “improvement” as against the pre-default period was evident (prior to the default, that ratio amounted to - 0.49, which value was “the worst” from the point of view of the domestic manufacturer).

If the default is to be viewed as a means of ousting foreign manufacturers from markets where Russian enterprises sell their merchandise, the difference between mixing indices of competition of the pre-default and post-default period can be used for estimation of the “benefit” brought about by the default. The greatest benefit was gained by food industry, chemical industry and petrochemical industry (see Column “Growth” in Table 15). The second largest “beneficiaries” were enterprises of timber, woodworking and pulp-and-paper industries. Growth in the mixing index was also observed with engineering industry, but since that index remained negative in the post-default period it is hard to say whether there was any “benefit”. Reduction in the mixing index was only observed in metallurgical industry where the index remained positive, though. In other words, the share of markets where iron-and-steel plants experienced more competition from Russian manufacturers decreased.

### **3.3. Investment Process in the Real Sector of the Economy**

One of the specific features of the Russian national economy in the 2000-2001 period consisted in growth in demand in investment. During that period, growth in investments in fixed capital tended to be faster than growth in the GDP and output of basic branches of the economy. In 2001, the share of investments in fixed capital in the GDP increased to 17.7%, as against 16.8% in 2000. Development of that trend was stimulated by broadening of domestic demand, preservation of a relatively high level of profitability of production and slowing down of the rates of growth in prices of manufacturers in the industrial sector and building industry. In 2002, that situation changed; as regards rates of growth, demand in investment yielded its leading positions to consumer demand. As a result, rates of growth in the GDP came to exceed the rates of growth in investments in fixed capital again.

In 2002, the volume of investments in fixed capital from all sources of financing amounted to 1,660.5 billion rubles, which is 2.6 percent more than in the previous year. That slowing down of the rates of growth in demand in investment determined the specifics of the dynamics of output of capital goods and construction work. In 2002, the volume of jobs performed by building companies increased by 2.6 percent, as against 8.7 percent in 2001, the volume of gross output in engineering industry, by 2.0 percent, as against 8.7 percent in 2001 and that in building materials industry, by 3.0 percent, as against 5.5 percent.



*Fig. 50.* Changes in dynamics of investments in fixed capital and output of capital-generating branches in the 1992-2002 period, % to the previous year figure.

In 2002, dynamics of demand in investment was determined by the combined effect of factors which influenced changes in sectorial, technological and reproductive structure of the national economy.

Reallocation of investment flows was accompanied by growth in the share of the service sector. The specifics of economic growth consisted in extensive development of infrastructure branches. In the 1999-2002 period, transport, communications and commerce accounted for 25 percent of the total volume of investments in fixed capital, as against 15 percent on the average in the 1992-1996 period. Growth in investment activity in infrastructure branches and growth in demand in services of such branches was an indicator of existence of potential for economic growth, the more so since in investment activity in that sector priority was given to long-term objectives. That enabled entrepreneurs to expand their presence on the market of services and accumulate resources for further development.

In analyzing the dynamics of investments with specific sectors of the economy, it is important to take into account the specifics of dynamics and structures of investments in housing construction. The specifics of the economic growth after the 1998 crisis consisted in transformation of an increase in the share of investment expenses on housing construction in the structure of investments. The structure of the housing completed shows that business activity in that sector of the economy is maintained primarily through contribution by private investors who play an ever greater role; such private investment accounts for 80 percent of the housing completed. It is also to be noted that in the past decade individuals also had ever more important role to play in financing of housing construction. The level of investment activity by individuals depends to a great extent on dynamics of prices on housing and amounts of individuals' savings. In the structure of housing completed, the share of houses built by

individuals at their own expense and with the use of loans amounted to 42.1 percent in 2002, as against 41.3 percent in 2001.

In conditions of economic growth, dynamics of investments in industry were influenced by significant changes in the sectorial structure. Pronounced upsurge in investment in industry began late in 1998. Starting from October 1998, rates of growth in investment in industry were much higher than the rates of growth in industrial output; that investment growth was the principal generator of economic growth. In the 1999-2001 period, the annual average increase in investment in fixed capital amounted to 12.2 percent with the increase in the volume of industrial output amounting to 7.3 percent. Growth in investment in fixed capital had a very strong effect on the dynamics of output and was accompanied by fast expansion of production in all branches of the investment complex. In 2001, growth in the volume of output on the 1998 figure amounted to 50.5 percent in engineering industry, to 40.0 percent in building materials industry and to 27.3 percent in building industry (volume of jobs and services). In 2002, the situation began to change. In a situation where rates of growth in industrial output started to slow down (that was a general trend) reduction in demand in investment became faster. In the total volume of investments in fixed capital, the share of industry decreased by nearly 1 point on the 2001 figure. It is to be noted that in 2002 the rates of growth in engineering industry were slower than the dynamics of investment, which situation limited potential of transformation changes in reproduction of fixed capital. In 2002, in the total volume of investments, expenses related to purchase of machine-tools and equipment fell to 37.0 percent, as against 38.0 percent in the previous year. In the total volume of investments in equipment, the share of expenditure on purchase of imported equipment increased. In 2002, it amounted to 8.8 percent of the total volume of investments in fixed capital, increasing by 0.4 points on the 2001 figure.

*Table 16*

**Structure of investments in fixed capital by the type, % of the total**

	1998	1999	2000	2001	2002*)
Investments in fixed capital – total	100	100	100	100	100
including:					
housing	16.3	14.3	10.7	9.8	12.1
Non-dwelling buildings	45.1	41.4	43.6	43.6	43.6
Machine-tools and equipment	29.9	36.4	35.7	38.0	37.0
Other	8.7	7.9	10.0	8.6	7.3

\*Preliminary data of the Ministry of Economic Development of the Russian Federation.

Source: The State Committee for Statistics of the Russian Federation.

At the same time, the share of expenditure on purchase of machine-tools and equipment in the overall volume of investment expenses remained high as compared to the 1992—1998 period. In the structure of capital expenditure, an increase in the volume of expenses on implementation of highly efficient modernization and re-equipment projects was observed, while the number of new construction projects was reduced.

In conditions of change in the market situation, enterprises gave priority to strengthening of their positions on the domestic market, both through increasing competitiveness of their products on the market of domestic produce and through development of production of goods serving as substitutes for imported products. It is to be noted that motivation of investment activity changed as well. In a situation where financial resources were strictly limited,



investment decisions were influenced by such considerations as upgrading of quality of products, ensuring of products' correspondence to present-day standards, expansion of the product range, as well as technological aspects of reduction of the cost of production. According to the State Committee for Statistics of the Russian Federation, investments made to build up production capacities while keeping the range of products unchanged were made by around 35 percent of industries, while those with expansion of the range of products, by 28 percent of industries; it is also to be noted that in making investments 37 percent to 46 percent of industrial enterprises sought to improve economic efficiency of their production through automation, mechanization, introduction of new technologies, reduction of costs of production and economy of energy resources.

Investment activity in the past few years was primarily aimed at active utilization of formerly unused competitive capacities and modernization of production. Analysis of utilization of production capacities shows that their potential is almost exhausted, since much of the equipment cannot be used in production due to being obsolete and worn. Utilization of production capacities differs greatly with different industries. In primary industries characterized by lower share of added value, utilization of equipment is much higher than in manufacturing industries. Even within the same branch of the industrial sector, in different types of production equipment can be utilized to different extents.

In manufacturing industries, especially in highly technological production, potential for increasing of output depends on quality of equipment and technologies applied. Fixed capital in manufacturing industries being so worn, it cannot be fully utilized and opportunities for further growth in output are rather limited.

*Table 17***Average annual extent of use of production capacities in production of specific types of industrial products, %**

	1995	1996	1997	1998	1999	2000	2001
Prime petroleum refining	62	61	65	60	62	68	68
Coal	72	72	70	66	73	84	87
Cast iron	70	70	73	71	84	86	86
Steel	67	68	68	63	71	77	77
Rolled stock (ferrous metals)	66	65	67	59	63	72	78
Market iron ore	84	81	81	81	90	92	93
Chemical fertilizer	50	46	49	47	58	63	67
Artificial resin and plastic-coal masses	45	36	40	45	55	62	62
Paintwork materials	20	17	17	15	20	24	22
Tires for cars, agricultural vehicles, motorcycles and scooters	43	52	62	59	69	71	76
Metal-cutting machine-tools	24	18	16	13	14	17	18
Press-forging tools	13	7,8	7,8	10	10	13	18
Tractors	11	10	9,7	8,4	14	19	15
Household refrigerators and deep freezers	37	24	27	25	31	39	52
Electric vacuum-cleaners	19	13	14	12	21	20	20
Household watches	40	22	16	18	28	55	50
Lumber	31	28	27	29	34	39	39
Plywood	52	53	53	67	76	82	80
Woodchip boards	39	27	30	36	47	55	63



*Table 17 (cont'd)*

	1995	1996	1997	1998	1999	2000	2001
Cardboard	41	29	35	38	52	63	67
Paper	57	49	47	54	70	79	81
Cement	45	36	36	36	39	44	48
Wall materials	50	41	38	34	45	48	49
Corrugated asbestos board	34	27	27	29	39	41	45
Soft roofing and insulation materials	38	30	30	34	37	40	43
Nonmetallic building materials	52	45	43	45	49	56	58
Ferroconcrete structures and prefabricated items	32	24	20	20	22	28	33
Rough cotton fabrics	28	24	31	29	39	55	58
Linen cloth and rough hemp fiber	32	27	25	17	23	28	32
Ready-made woolen cloth	16	12	12	11	14	17	18
Leg-wear garments	36	27	27	24	42	49	51
Knitted goods	21	13	12	13	24	28	33
Shoes	23	18	17	14	23	29	32
Beet sugar	86	85	81	75	77	76	81
Bread and bakery	44	41	38	35	39	40	40
Canned vegetables	21	15	16	20	24	32	45
Meat	32	25	19	17	14	18	18
Sausages	54	52	44	41	42	52	55
Butter	35	29	27	26	24	25	24
Whole milk products (converted into milk)	24	24	24	26	28	32	35
Flour	53	46	48	47	49	45	45
Cereals	39	28	27	28	22	24	27

*Source:* The State Committee for Statistics of the Russian Federation.

In the 2000-2002 period, average utilization of capacities in petroleum refining amounted to 68 percent, while the level of economic efficiency, to 80-85 percent. It is to be noted that the share of secondary processing (deep refining) in that branch was rather low, while existing facilities were worn extremely. In chemical industry and petrochemical industry, because of a favorable situation on foreign markets growth in domestic consumer demand on those industries' produce, the ratio of utilization of production capacities amounted to 53 percent, as against 43 percent in 1998. In engineering industry and metal-working industry, positive trends were maintained through optimization of production capacities, upgrading of quality of certain types of machine-tools and equipment, use in production of new developments and application of new highly efficient technologies. However, in that branch of industry in general and in individual types of production within that branch in particular utilization of production capacities is rather low.

The rate of wear and the age of fixed capital are such that there is an urgent need for modernization. As regards the extent of utilization of production capacities, engineering industry still ranks last among the branches of the industrial sector. A long pause in investment brought about conservation of the structure of engineering industry; in conditions of a switch-over to an investment based model of economic growth lack of equipment and machine-tools became a factor limiting expansion of production. With its produce failing to meet the quality standards prevalent on the market, engineering industry is unable to achieve such volume of sales as would permit it to make large-scale investments in modernization of its production capacities, which makes the situation even worse.

*Table 18***Age structure of fixed assets (machine-tools and equipment) in the industrial sector in the 1991-2002 period, % as of the beginning of the year**

	<i>Total equip- ment</i>	<i>Including equipment aged (years):</i>					<i>Average age (years)</i>
		<i>Up to 5</i>	<i>6-10</i>	<i>11-15</i>	<i>16-20</i>	<i>Over 20</i>	
1991	100	29,4	28,3	16,5	10,8	15,0	10,8
1996	100	10,1	29,8	21,9	15,0	23,2	14,3
2001	100	4,7	10,6	25,5	21,0	38,2	18,7
2002	100	5,7	7,6	23,2	22,0	41,5	19,4

*Source:* The State Committee for Statistics of the Russian Federation.

Since capital assets could not be replaced in a timely manner, inefficient machine-tools and equipment continued to be used for longer periods of time. In many cases, capital assets are written off only when they can no longer be used in production due to their physical wear. In 2001-2002 period, 81-84 percent of machine-tools and equipment were written off because of their physical wear and only 11-13 percent, because of their inefficiency. Replacement of worn equipment still remains the main goal of investment in fixed capital. As capital assets are getting very old, they are becoming ever more vulnerable to man-caused accidents and natural calamities. In the 2001-2002 period, such factors accounted for 1-2 percent of the total volume of capital assets written off and 2-3 percent of the volume of machine-tools and equipment written off in the industrial sector.

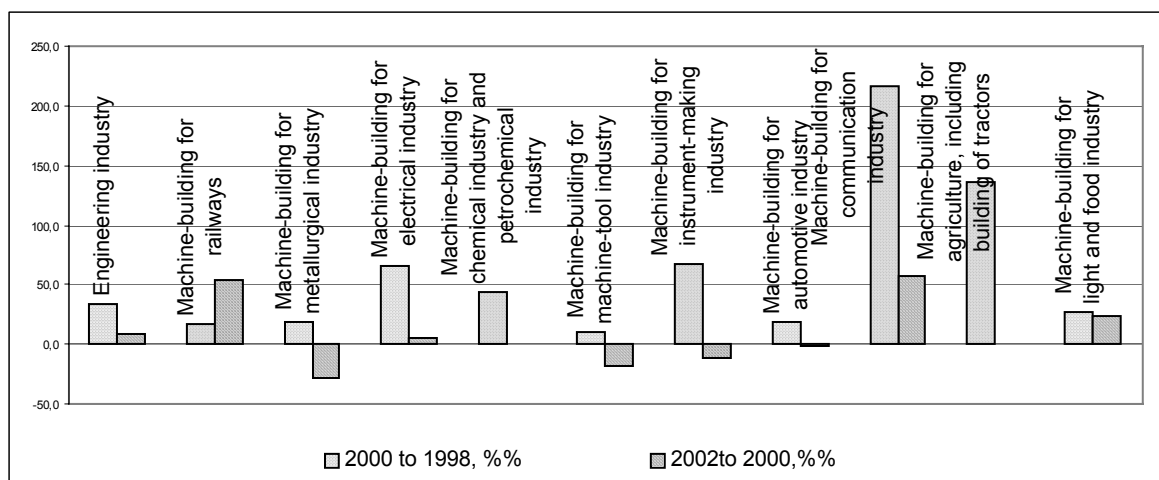
In assessment of the state and prospects of development of the Russian national economy, it is important to take into account the fact that the dynamics of investment activity is motivated to a great extent by the market situation. In 2002, the specifics and dynamics of demand in investment were largely influenced by reduction of the fuel complex's share in the total volume of investments in capital assets, both in the national economy as a whole and in the industrial sector, in particular. Taking into account the fact that transport, communications and the fuel complex accounted for nearly 50 percent of the total volume of investments in the national economy, it becomes clear that demand in investment and financial and economic situation in those branches have a considerable effect on dynamics and structure of the overall demand in investment.

Fuel industry retains dominating positions in the structure of investments; it accounts for 49.8 percent of the total volume of investments in the industrial sector, nearly 1/3 of investments are made in oil industry. In the past two years, extensive expansion of the oil and gas complex's demand in investment products was a major factor contributing to expansion of business activity in engineering industry and building materials industry. In 2002, due to cumulative effect of domestic and foreign factors profitability in fuel industry was reduced nearly by half on the 2001 figure and that had a negative effect on demand in investment. In conditions of preservation of the situation where revenues are traditionally concentrated in export-oriented branches of the oil sector and the primary production sector and there are no mechanisms of inter-branch capital mobility, growth in rates of investment and radical changes in reproduction of capital assets could hardly be expected. With the rates of growth in investment in fuel industry slowing down, that industry's economic performance declined. In 2002, in oil industry the rate of completion of new oil wells fell by 21.9 percent, volumes of production drilling, by 16.8 percent and volumes of exploring drilling, by 40.2 percent.

Changes in the structure of output of engineering industry were determined to a great extent by the growth in demand in engineering products on the part of metallurgical indus-

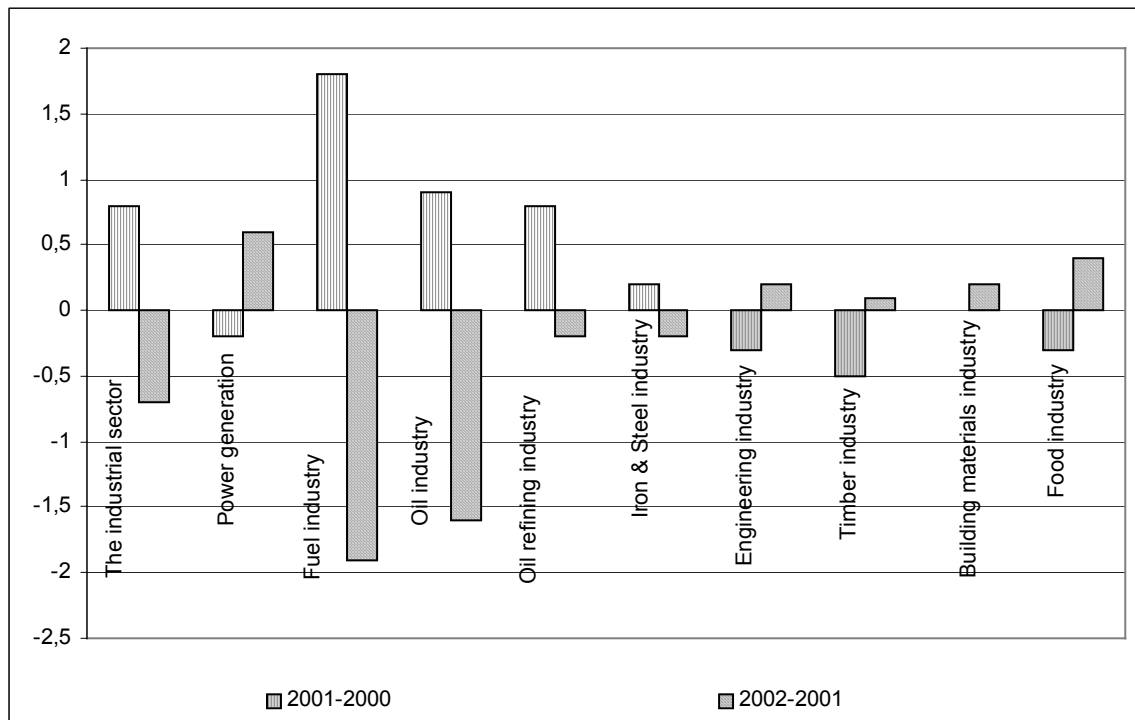
tries, oil industries, transport and communications. It was in those branches of the economy that particularly high rates of growth in investment in production were observed in the 1999-2002 period. Despite growth in the rates of production in related machine-building industries such factors as insufficient volumes of output and inefficient structure of production of machine-tools and equipment prevented proper reproduction of capital assets. Obsolete material and technical basis in engineering industry and low rates of investment activity in machine-building industry proper hampered sustained economic growth and high demand in investment. In machine-tool industry, instrument-making industry and electrical industry (industries determining the resource base for modernization of engineering industry) another recession has been observed since 2001.

In addition to that, demand in investment in the 2000-2002 period was mostly initiated by oil industry and metallurgical industry alone. Though exporters increased their volume of investment expenses on development of profile production they invested rather cautiously the rest of their available funds in the Russian economy. For that reason, the gap between export-oriented industries and a greater part of the rest of the economy became ever more wider. In 2002, the volume of output in the oil sector fell by 17.8 percent due to reduction in revenues and decrease in demand in investment. In machine-building for metallurgical industry, recession has been observed since 2001.



*Fig. 51.* Changes in the rates of production for branches of engineering industry in the 1999-2000 period and the 2000-2002 period, %

Though in the 2001-2002 period the share of investments in manufacturing industries somewhat increased, it is important to take into account the fact that investment intensive branches of the industrial sector and branches of the consumer complex accounted for 6.8 percent and 4.6 percent of the total volume of investments in the industrial sector, respectively.



*Fig. 52.* Changes in the structure of investments in fixed capital for branches of the industrial sector in the 2000-2002 period, % against the previous year.

Comparison of dynamics of the GDP in respect of different components of ultimate demand shows that investment expenses tend to fluctuate to a greater extent than consumer expenses, so analysis of the dynamics and structure of their changes gives us a better idea of trends in economic activities. With the share of gross accumulations in capital assets in the GDP going down continuously for a long period of time, normal cycle of reproduction of capital assets was broken. Calculations of the structure of gross accumulations in capital assets show that there has been absolute reduction in the volumes of net accumulations since 1995. In such conditions, investment activity was limited to preservation of accumulated potential. Comparison of dynamics of production and efficiency of utilization of labor and capital reveals that with a tendency towards decline in technical and economic parameters of production and investment activity branches of the industrial sector faced an «exchange» of factors of production. It is to be noted that in the 1999-2000 period growth in investment in the industrial sector had a considerable effect on efficiency of labor utilization. Growth in labor efficiency in the industrial sector increased by 23.2 percent during that period with higher efficiency in utilization of labor attained practically in all branches. It needs to be reminded that in the above period growth was ensured through engagement in production of reserve capacities and additional labor force. However, as there was no radical change in the production and technological base, as soon as the rates of investment activity started to decrease in the 2001-2002 period, the rates of growth in labor efficiency slowed down. High proportion of manual labor helped compensate for shortage of investment to a certain extent, but, at the same time, caused technological stagnation in production. The situation was made even worse by the fact that in a number of branches of the economy absolute reduction in physical volume of capital assets was observed. Recession of fixed capital in the industrial sector was par-

ticularly dramatic in manufacturing industries, especially, in engineering industry, chemical industry and light industry. The high rate of physical wear and moral depreciation of fixed capital and unfavorable age structure of the fleet of machine-tools and equipment considerably limit economic growth.

Among the principal factors which caused slowing down of investment activity in the 2001-2002 period, worsening of the financial situation in branches of the real sector of the economy is worth mentioning in particular. From the beginning of 2002, dynamics of balance profit was characterized by gradual slowing down of the rates of its decline in each quarter on the corresponding periods in 2001.

With industrial entities' financial results declining in 2002 (according to preliminary data), their share in the sectorial structure of balance profit of the economy decreased by 14.1 points on the corresponding period in 2001. Reduction in the value of that index for the industrial sector as a whole was caused by its reduction in export-oriented industries (by 10.6 points, including in fuel industry, by 6.4 points).

Positive effect on formation of balance profit in economy was produced by branches of the services sector. In 2002, the volume of balance profit exceeded the 2001 figure by 33.0 percent in communication industry, by 20.8 percent in transport and by 8.7 percent in commerce and public catering. However, growth in profit gained in the services sector did not compensate for the negative effect produced by reduction in profit in the industrial sector and building industry. As a result, balance financial result of enterprises and entities of all branches of the economy amounted to about 85.1 percent in 2002.

Reduction in profitability of branches of the fuel complex and metallurgical complex which form over 25 percent of demand in investment in the national economy had a negative effect on business activity in building industry. In January-September 2002, the share of profit in the structure of sources of financing investments was 4.9 points lower than in the corresponding period in 2001. The situation was made even worse by the effects of such adverse factors as high cost of commercial loans, insignificant volumes of financing of investments through budget funds and other financial institutions, high investment risks due to lack of mechanisms ensuring protection of the rights of domestic and foreign investors and lack of efficient mechanisms of transformation of households' savings into investments..

In January-September 2002, the ratio between own capital and borrowed funds in the structure of sources of financing of investments in capital assets remained nearly the same as in 2001. As compared to January-September 2001, the share of profit allocated for investment purposes in the structure of own capital of enterprises fell by 4.9 points, while the rates of depreciation rose by 4.1 points. It is to be noted that abolition from January 2002 of the tax benefit in respect of profit allocated for financing of capital investments in production facilities and housing had a negative effect on the dynamics of investment activity. Early in 2002, enterprises took a wait-and-see attitude towards investment activity due to a switch-over to new conditions of taxation.

In the structure of borrowed funds, the share of loans from banks increased by 1.2 points. As a result of positive developments in Russia's national economy in the past few years, Russia was assigned better ratings by international rating agencies than before. For example, according to the rating (as of the end of September 2002) by A. T. Kearney (a consulting company), Russia became more attractive to foreign investors; as regards the confidence index, Russia moved from 32<sup>nd</sup> place to 17<sup>th</sup> place with the value of that index growing by 19 percent (in October 2002 it amounted to 0.99). For the first time since 1998, Russia ranked



again among the 25 countries most attractive to foreign investors. Such a high ranking in the confidence index was gained by Russia thanks to sustained growth in its GDP and ability to meet its debt obligations and make investments in the economy of foreign countries. The investment class of ratings reflected Russia's high ability to meet its financial obligations, the country's financial stability and its high sensitivity to unfavorable economic conditions. Russia is just one point (BB+) short of reaching the Standard & Poor's foreign currency investment class of long-term ratings, two points (BB and BB+) short of that of the Fitch Ratings agency and two points (Ba2 and Ba1) short of that of the Moody's Investors Service.

With enterprises' profits going down, own capital limited and opportunities for long-term borrowing scarce, slowing down of the rates of domestic demand in investment is observed again in Russia.

In conditions of economic growth, it has become obvious that investment management is not coordinated with the dynamic processes of restructuring of Russian economy. Lack of investment financial institutions, underdevelopment of the stock market and inefficient legal system complicate the process of borrowing of funds and drawing of banking loans. There is no such mechanism in the economy as would permit inter-branch capital mobility, which complicates investment activity on the level of enterprises, branches of the economy and regions. As is known from experience, in a situation where saving reserves have been formed making of investment decisions requires a prudent approach and rationalization of investment flows. Lack of a long-term development strategy and business priorities reduces motivation for making of long-term investments.

*Table 19***Structure of investments in fixed capital by sources of financing, % of the total**

	1997	1998	1999	2000	2001	2002*
Investment in fixed capital — total	100	100	100	100	100	
Including by the source of financing:						
own capital	60,8	53,2	52,4	47,7	50,3	48,6
including:						
profit	13,2	13,2	15,9	23,4	26,6	20,0
depreciation	26,5	H/д	H/д	18,1	19,3	24,4
borrowed funds	39,2	46,8	47,6	52,3	49,7	51,4
Including budget funds (funds of the consolidated budget)	20,7	19,1	17,0	22,0	19,8	19,9
including:						
federal budget funds	10,2	6,5	6,4	6,0	5,8	5,6
Funds from budgets of constituent entities of the Russian Federation and local budgets	10,5	12,6	10,6	16,0	14,0	13,1

\*The preliminary data.

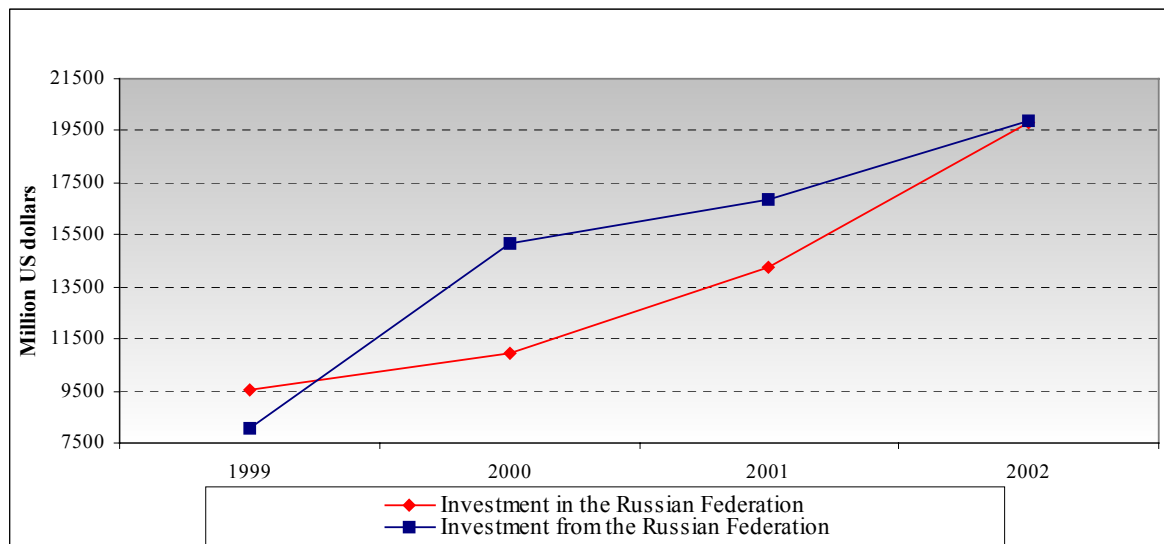
Source: The State Committee for Statistics of the Russian Federation.

**Foreign Investments in Russian Economy**

Analysis of the dynamics of foreign investments reveals that as soon as economic growth resumes foreign investors increase their presence on the Russian market. Low investment activity in the 1998-1999 period, which was caused both by Russia's domestic problems and a general recession in business activity on international markets was followed by expan-

sion of demand in investment services in the 2000-2002 period. For the past few years, the volume of domestic investments increased by 1/3 on the 1998 figure. It is also to be noted that the growth in the volume of foreign investment has been faster than in domestic investments in fixed capital.

As of January 1, 2003, accumulated foreign capital in the national economy of the Russian Federation, including investments from CIS countries, amounted to 42.9 billion US. Dollars.



Source: The State Committee for Statistics of the Russian Federation

*Fig. 53.* Foreign investment in the Russian Federation and investment from the Russian Federation abroad in 1999-2002 period.

*Table 20*

**Structure of foreign investment in Russia's national economy**

	In mil US dollars.				%, to the previous year figure			
	Total	Direct	Portfolio	Other	Total	Direct	Portfolio	Other
<b>1999</b>	9 560	4 260	31	5 269	- 18,8	26,7	83,9 % decrease	- 35,9
<b>2000</b>	10 958	4 429	145	6 384	14,6	4,0	370 % increase	21,2
<b>2001</b>	14 258	3 980	451	9 827	30,1	- 10,1	210 % increase	53,9
<b>2002</b>	19 780	4 002	472	15 306	38,7	0,6	4,7	55,8

Source: The State Committee for Statistics of the Russian Federation.

In 2002, the total volume of foreign investment in the non-financial sector of Russia's economy (not counting in monetary and credit regulation authorities and commercial and savings banks), including the US dollar equivalent of investments made in rubles, amounted to 19.78 billion US dollars.



Investment in Russia has been characterized by a low level of the volume of direct foreign investment, which is an adverse factor. As regards the volume of per capita accumulated direct foreign investment in the 1993-2001 period, Russia ranks 21<sup>st</sup> among the 25 Central and Eastern European countries and CIS states. As regards the ratio between the volume of foreign investment and the GDP, the situation is even worse. Even in 1997, when the inflow of foreign investment was record high Russia with the value of that ratio amounting to 0.1 percent ranked last but one among the countries from Central and Eastern Europe and CIS countries. In the 1995-2002 period, structure of foreign investment in Russia underwent considerable changes. In 1995, direct foreign investment accounted for 67.7 percent, while in 2002, for a mere 20.2 percent.

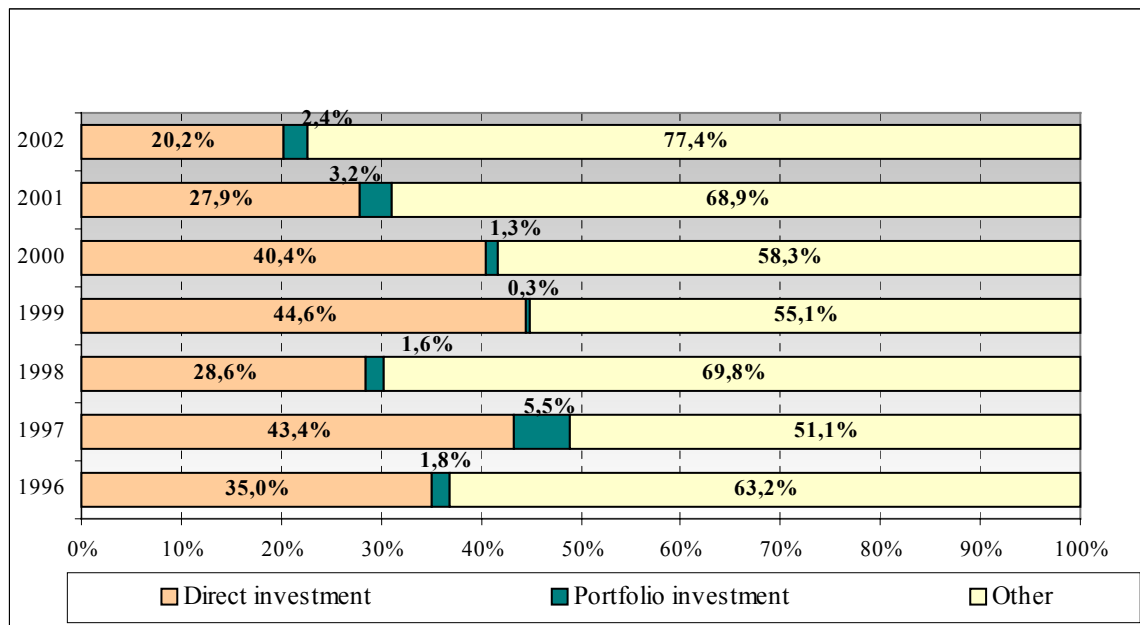
Unlike portfolio investment, direct foreign investment less sensitive to changes in the situation on the market. Portfolio investment reacted promptly to the 1998 crisis and the economic growth in the 2000-2002 period. In 1997, portfolio investment was record high and accounted for 5.5 percent of the total volume of foreign investment in Russia's economy. After a drop in its share to 0.3 percent in 1999 due to withdrawal by non-residents from the Russian stock market and its fast growth in the past few years, the share of portfolio investment has reached the level of 2.3 percent. Growth in portfolio investment is one of the symptoms of Russia having overcome the crisis. In developed countries, the share of portfolio investment is much higher than that of direct investment; it is to be noted that developed countries are major donors and recipients of portfolio investment.

Dynamics of direct foreign investment are strongly affected by the following factors:

- low competitiveness of direct investment as compared to the alternative of placement assets in commodity loans (which loans pay off soon) and deposits (of foreign legal entities) with Russian banks, which account for a greater portion of foreign investment related to the «other» category. Unlike direct investment, the above-mentioned alternative forms of investment are not only more profitable, but also better protected from investment risks;
- high investment risks for foreign investors, since investors' proprietary rights and title to profit are not adequately ensured.
- unstable situation on the Russian stock market and low efficiency of its operations due to its underdevelopment and dependence on the state of the global economy and stock market situation in the United States, Europe and developing countries.

In 2002 like before, 'other' investment accounted for a greater portion of foreign investment in Russia's economy (such investments are largely made up of loans extended by international financial institutions and investors' investment in state-issued securities), which is a factor adversely affecting the investment situation in the Russian Federation (as regards the mid-term prospects).





Source: The State Committee for Statistics of the Russian Federation.

*Fig. 54.* Structure of foreign investment in Russia's national economy in the 1996-2002 period, % to the total

Dynamics of investment are different in different branches of Russian national economy, which has caused structural changes. It is also to be noted that the share of investment in the services sector has been growing.

*Table 21*

**Distribution of foreign investment between different branches of Russia's national economy in the 2000-2002 period**

	In mil US dollars			%, of the previous year's figure			%, of the total		
	2000	2001	2002	2000	2001	2002	2000	2001	2002
Industrial sector	4 721	5 662	7 332	- 3,2	19,9	29,5	43,1	39,7	37,1
Transport and communications	1 947	1 259	610	114,7	- 35,3	- 51,5	17,8	8,8	3,1
Commerce and public catering	1 954	5 290	8 800	20,5	170,7	66,4	17,8	37,1	44,5
commercial activities related to market services	271	792	1 355	42,6	192,3	71,1	2,5	5,6	6,9
Finance, loans, insurance and pension provision	274	127	130	140,4	-53,6	2,4	2,5	0,9	0,7
Other branches	1 791	1 128	1 553	- 3,2	- 37,0	37,7	16,3	7,9	7,9

Source: The State Committee for Statistics of the Russian Federation

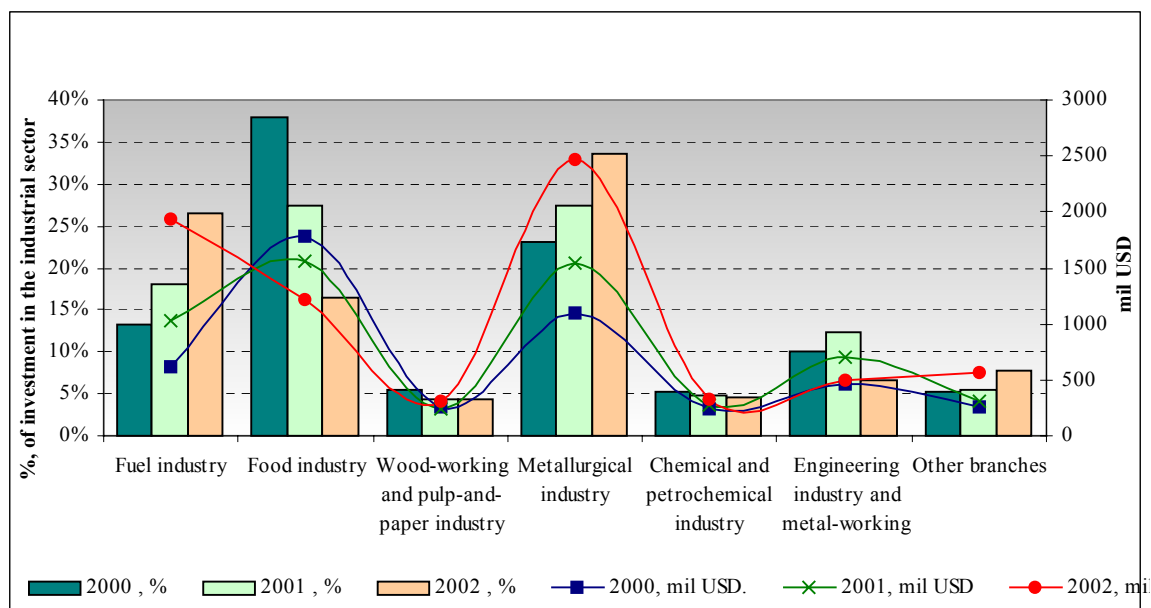
In the past few years, foreign investors have shown ever greater preference to commerce and public catering, since investment in the those branches pays off quickly. In 2002,

commerce and public catering accounted for 24.0 percent of direct investment, against 19.0 percent in 2001. It is to be noted that in 2002 the ‘other’ investment accounted for a larger portion of foreign investment in above branches of the economy (86.7 %); such ‘other’ investment are mostly made up of loans.

Though in 2002 the rates of growth in foreign investment in the industrial sector were somewhat lower than the rates of growth in the aggregate volume of foreign investment in Russia’s national economy, direct investment in the industrial sector increased by 10.2 percent on the 2001 figure and amounted to 1,932 mil US dollars (48.2 percent of the combined foreign investment in Russia’s national economy). ‘Other» investment in the industrial sector grew by 43.3 percent on the 2001 figure and amounted to 5,246 billion US dollars (34.3 percent of the combined other foreign investment in Russian economy). Portfolio investment in the industrial sector decreased by 37.9 percent.

Significant changes in the structure of foreign investment were caused by increment in foreign investment in Russia’s oil and gas sector and metallurgical complex. The share of fuel industry in the combined volume of direct foreign investment grew by 5.0 points on the 2001 figure with the share of food industry and engineering industry decreasing by 2.2 points and 1.4 points, respectively.

In 2002, 33.7 percent of the total volume of investment in the industrial sector went to metallurgical industry (against 27.3 percent in 2001), 27.4 percent, to the fuel and energy sector (against 18.3 percent in 2001), 16.5 percent, to food industry (against 27.5 percent in 2001).



Source: The State Committee for Statistics of the Russian Federation

*Fig. 55. Distribution of foreign investment between different branches in the industrial sector in the 2000-2002 period*

In the past few years, serious changes have been observed in geographic structure of foreign investment. While before, Western European countries were principal donors, in the past few years the United States has become the biggest investor. This can be explained by

US companies' extensive operations in the fuel and energy sector, as well as expansion of business activity of food companies. As regards the volume of accumulated direct investment, the United States ranks first and accounts for 27.0 percent of the total volume of direct foreign investment, about the same share as the combined investment of Germany, Great Britain and France.

In 2002, 93 countries made investments in Russia's economy, as against 109 countries in 2001. It is to be noted that in 2002 five largest investors accounted for 63.8 percent of the combined volume of foreign investment accumulated as of January 1, 2003. In 2000 and 2001, that figure was 73.2 percent and 67.7 percent, respectively. In 2002, five largest exporters of capital into Russia also accounted for 60.1 percent of direct accumulated investment, 67.0 percent of portfolio investment and 55.2 percent of other investment, while in 2001 those figures were 63.7 percent, 57.9 percent and 72.9 percent, respectively.

*Table 22*

**Accumulated foreign investment by major investor- countries**

	Accumulated as of 01.01.2003, mil USD.			
	Total	Direct	Portfolio	Other
USA	5 522	4 220	68	1 234
Germany	8 146	1 714	384	6 048
France	3 033	303	0,1	2 730
Great Britain	5 054	2190	128	2 736
Cyprus	5 627	3 927	305	1 395
The Netherlands	2 850	2 398	21	431
Other countries	12 696	5 599	567	6 530
<b>Total</b>	<b>42 928</b>	<b>20 351</b>	<b>1 473</b>	<b>21 104</b>

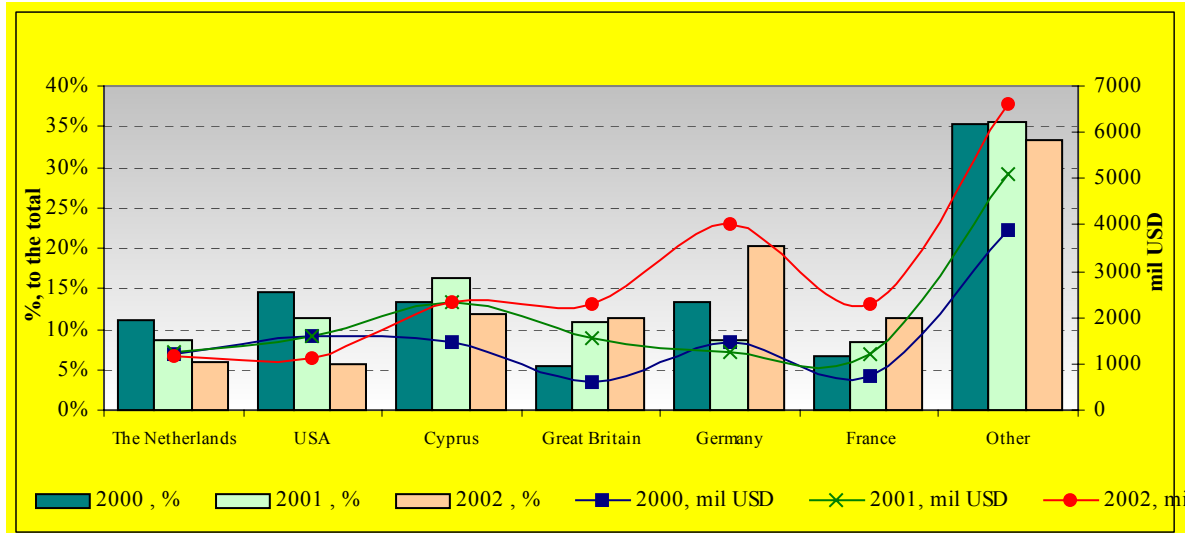
*Source:* The State Committee for Statistics of the Russian Federation

In 2002, investment from the USA fell by 29.4 percent, investment from France, by 1,4 percent and investment from the Netherlands, by 6.5 percent, while investment from other countries increased. In 2002, investment from Germany amounted to 4 billion USD (that is, 220 percent more than in 2001), while investment from Great Britain, to 2.3 billion USD (46 percent growth on the 2001 figure).

In 2002, German investment mostly went to trade and public catering. In those sectors, German investors invested 3,065 million dollars, or 76.6 percent of the total amount of investments from Germany in 2002. US investors prefer to invest in the industrial sector: 431 million US dollars (38 percent of the total US investment) went there. British investors show interest in trade and public catering (1,071 million USD, or 47.4 percent of the total investment from the UK in 2002), the industrial sector (634 million USD, or 27.9 percent) and general commercial activities ensuring functioning of the market (457 million USD, or 20.1 percent). Joint Russian-French ventures mostly engage in reseller services, advisory activities, financial services and other services.

The geographic distribution of sources of investment in Russia and targets of Russian investment abroad is somewhat alarming. While the investment attracted into Russia comes from countries with low levels of profitability and risk, Russian investments go to countries

with unstable economies and political systems and far higher levels of risk. Over half of Russian investments abroad go to Belarus, Iran, Liberia, Cyprus, British Virgin Islands, the Isle of Man, Moldova and Armenia.



Source: The State Committee for Statistics of the Russian Federation

*Fig. 56. Geographic structure of foreign investment in Russia's economy in the 2000-2002 period*

That is quite important since analysis of foreign investment in Russia reveals a continuous growth of the share of investment in 'tax paradise' countries. Comparative analysis of data on the dynamic and the structure of foreign investment suggests that a certain portion of exported capital returns to Russia disguised as foreign investment. It is widely known that foreign-economic operations transacted through offshore zones, especially Cyprus, constitute the biggest channel of hidden export of capital from Russia. According to Russian statistics, Cyprus ranks among the five countries with the largest amounts of investment in Russia. As of January 1, 2001, accumulated investment from Cyprus amounted to 5,627 million USD (while investment from the US amounted to 5,522 million USD and from the UK, to 5,054 million USD).

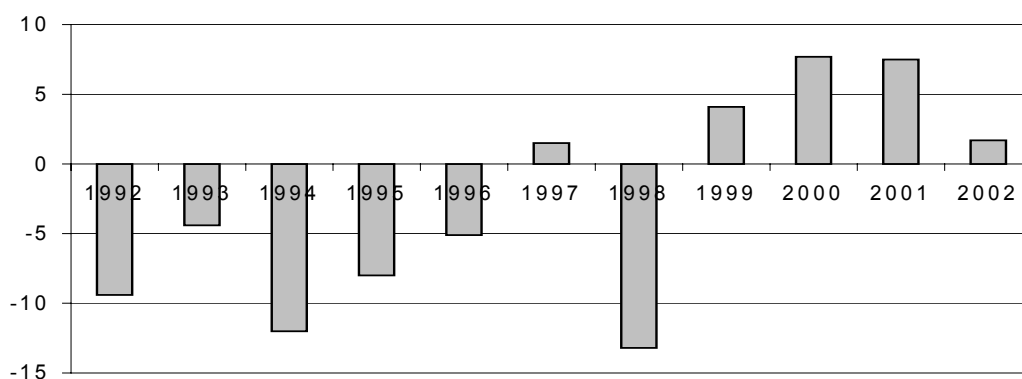
It is also indicative that nearly 70 percent of investment from Cyprus is direct investment, which is an absolute record unmatched by far by investment from any other foreign country. It is to be supposed that investment formally declared as coming from Cyprus does not actually originate in that country. It is likely that such funds are, in fact, Russian capital, which is illegally exported by its owners, legalized and then brought back to Russia as 'foreign investment'. Cyprus is by no means the only country from which Russian capital returns as 'foreign investments'. There are grounds to believe that a considerable proportion of investment from all the investor countries originates in capital illegally exported from Russia. Those grounds are as follows. Firstly, capital exported from Russia would meet with severe competition in entry on the international markets, while in Russia re-investment of domestically accumulated capital is much easier. Secondly, in Russia, much higher profit can be gained. Thirdly, re-investment in the form of 'foreign investment' can create much better guarantees for the capital.

It is difficult to assess the amount of capital exported from Russia and later brought back in the form of ‘foreign investment’. It seems likely that its share in foreign investment is quite large and accounts for a considerable proportion of the funds actually invested.

### 3.4. Agrifood Sector

In 2002 growth in Russian agriculture continued. While in 2001 it was largely attributed to weather conditions and the correspondingly high crop yields, the 2002 trends evidence that the sector’s recovery is due to its internal restructuring and improvement of the general economic situation in the country rather than to favourable weather. Today there are all grounds to assert that growth in the Russian agriculture is sustainable.

Within the first 6 months 2002 agricultural output was up 4% as compared with 2.3% in 2001. Due to the seasonal character of agricultural production, growth in the first half of a year is determined by livestock sector performance that is far less dependent on the weather factor. According to data of the RF State Committee for Statistics, the annual index of agricultural production in 2002 is only 101.7%. However, in all the preceding years the Committee reviewed its annual estimates by the middle of the successive year raising them by 1.5-2%. So, one can surely assert that the real agricultural growth in 2002 amounted to 3-3.5%.



Source: RF State Committee for Statistics.

*Fig. 57. Russian agriculture: percent change of annual output in 1992-2002*

Despite the continuing upward trend, the general agriculture’s performance in 2002 deteriorated eventually due to the overproduction of almost all agricultural products. It resulted in the drop of real (in some months – even nominal) purchase prices and respectively – in lower profits received by producers, smaller investments and larger share of insolvent farms.

Food industry continues to demonstrate rather high growth rates (about 6.5%) especially in the meat and milk sub-sectors (10.5%). However, these indicators are below the previous year level.

It’s noteworthy that processing and food industry grow faster than agricultural production. This is an evidence of their continuous reliance on imported raw inputs. By May 2002 the pre-crisis (1998) level of food imports has been restored. As a result the negative agrifood trade balance started to expand again despite growing exports.

Lowering of the sector’s profitability resulted in smaller investments. Farm machinery building fell by nearly 23% and by the end of the year the trend was aggravating, growth in



the production of protein and vitamin additives discontinued, investments in agriculture almost stopped to increase, less new capacities were put in operation in agriculture and food industry (except oil extracting facilities).

So, the window of opportunities that opened before the country's agrifood sector after the ruble devaluation in 1998 is closing, and other incentives are needed to foster further development.

The exhaustion of after-crisis growth factors goes in line with strengthening of protectionist trends in economic policies. Slower growth rates condition the wish to protect domestic market from resuming imports, and to defend protectionism agribusiness companies use the lobbying capabilities that they have acquired during the recovery. At the same time, the deviation from liberal principles on the world agricultural markets induces retaliatory actions. All this results in broader application of "amber box" measures in agricultural policies.

In other words, 2002 became to some extent a turning point marking the shift from the after-crisis recovery to a new pattern of growth.

### 3.4.1. Production trends in agriculture, upstream and downstream sectors

#### Agricultural production

In 2002 the total size of areas planted remained almost the same as in the previous year – 84.2 million hectares. Areas planted in sunflower and grains expanded (*Table 23*) in response to 2001 market situation. The protectionist policies on raw sugar market haven't resulted in larger sugar beets' planting. Areas planted in potatoes (93% of which is produced in household plots) actually do not change for a number of years being a sign of social and economic stabilization in the country – it means that alternative labour costs at least do not decrease which is usually the case during crisis periods.

*Table 23*

**Areas planted in major agricultural crops, million ha**

	1990	1995	1996	1997	1998	1999	2000	2001	2002
Grains	63.1	54.7	53.4	53.6	50.8	46.8	45.9	47.6	48.2
Sunflower	2.7	4.1	3.9	3.6	4.1	5.5	4.6	3.8	4.089
Sugar beets	1.5	1.1	1.1	0.9	0.8	0.9	0.8	0.8	0.814
Potatoes	3.1	3.4	3.4	3.4	3.3	3.3	3.2	3.3	3.2
Vegetables	0.6	0.8	0.7	0.7	0.7	0.8	0.8	0.8	0.8

Source: RF State Committee for Statistics.

Production of grains remained at the same level. In the structure of grain output the share of wheat is growing (it's already above the Soviet period indicator) while that of fodder grains (barley, oats) is falling. Output of grain corn is up 81.9% but still doesn't cover the demand. Rye crops are steady although very large stocks of this grain accumulated in Europe and the world prices for it will most likely fall in the nearest future.

The quality of 2002 grain is far below that of 2001: the output of food wheat is down 10%, the output of high-grade wheat – 9%.

In 2002 the share of individual farms in production of major crops (grains, sunflower seeds and sugar beets) enlarged. One can expect that grain prices' drop resulting from over-

production will be most damaging for such farms since they are usually less diversified and depend on sales of one or two crops.

Production of major livestock products grows for the second year in succession. But their output (unlike that of crops) still remains far below the pre-reform level. Production of milk grows despite the continuing decrease of cattle (including cow) inventories, i.e. becomes more intensive. Inventories of poultry, pigs, sheep and goats increased.

*Table 24*

**Gross output of major agricultural crops, million tons**

	1986-90	1998	1999	2000	2001	2002	2002 as % of 1986-90
Grain (weight after primary processing)	104.3	47.8	54.7	65.5	85.1	86.5	83
including wheat	43.5	27.0	31.0	34.5	47.0	50.6	116
Sugar beets	33.2	10.8	15.2	14.1	14.6	15.5	47
Sunflower seeds	3.1	3.0	4.2	3.9	2.7	3.6	116
Potatoes	35.9	31.3	31.2	34.0	35.0	32.8	91
Vegetables	11.2	10.5	12.3	12.5	13.3	13.0	116

Source: RF State Committee for Statistics.

*Table 25*

**Total production of major livestock products, million tons**

	1991	1999	2000	2001	2002	2002 as % of 1991
Livestock and poultry, slaughter weight	9.3	4.3	3.5	3.5	3.7	40
Milk	51.9	32.3	31.9	32.9	33.5	65
Eggs, billion pieces	46.9	33.1	33.9	35.0	36.2	77

Source: RF State Committee for Statistics.

The major contributors to meat output growth are large-scale farms: they increased production of slaughter livestock and poultry by 9.3% (that of pigs – by 13.5%, of poultry – by 11.6%).

Milk production is primarily enlarged by households (at large-scale farms it's up only 1.3%). The growing unemployment in rural areas forces people to look for income sources in household farming, and production of milk became one of the most common activities in countryside. Regional authorities everywhere (even in such regions of intensive milk production as Vologda oblast) actively support this self-employment.

The comparison of major agricultural products' output volumes and growth rates with the pre-reform level gives a certain idea about Russian agriculture's comparative advantages and the country's place in the international division of labour. Tables 24 and 25 demonstrate that domestic farming benefits from its competitive advantages on markets of grain, sunflower seeds, vegetables and potatoes while losing positions in production of sugar beets and meat. A more intent look at the production of major kinds of meat evidences that production of beef is least beneficial while that of poultry and pork has good prospects.



**Production of food**

As we have already mentioned, steady growth continues in the production of food (6.5% in 2002 as compared with 2001), especially meat and milk products (10.5%). Output of almost all food items is enlarging except for vegetable oils and sugar that seem to be overproduced (*Table 26*). The food industry development trends follow the trends of real personal incomes meaning that on the average it sustains the competition of imports (as different from primary agricultural production).

*Table 26*

**Production of major food products as % of the previous year**

	<b>1991</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Meat	87.7	84.4	112.4	104.0	108.5
Sausage	91.0	93.2	113.2	111.8	116.9
Butter	91.5	93.2	101.4	100.6	102.8
Whole milk products	89.4	99.0	110.1	109.6	111.0
Vegetable oils	100.5	112.8	174.4	90.1	92.5
Sugar	91.3	182.2	86.5	108.1	94.0
Flour	99.0	107.1	94.3	99.0	88.3
Groats	93.9	85.3	99.5	105.3	90.1
Macaroni	107.4	132.6	96.0	108.5	108.8
Margarine products	77.6	182.2	120.7	108.8	100.5
Canned meat	n.a.	169.0	82.7	106.4	106.2

Source: RF State Committee for Statistics.

Production of major food products ranges from 25% to 75% of the 1990 level (except for white sugar the output of which is almost twice above the 1990 volumes, and vegetable oils – 2.3% above the pre-reform level).

**Production of agricultural inputs**

Worsening of agricultural producers’ financial performance led to smaller demand for farm machinery. After several years of growth agricultural machine building resumes the downward trend (*Table 27*). The domestic demand for mineral fertilizers is still constrained by low solvency of most agricultural producers. Production of mineral fertilizers continues to grow slower than exports meaning that foreign markets are more attractive for suppliers as compared with the domestic one.

*Table 27*

**Production of agricultural inputs as % of the previous year**

	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Tractors	148.3	137.2	78.8	63.5
Tractor ploughs	99.9	170.8	113	68.9
Tractor seeders	2.3 fold	166.9	122	82.2
Tractor cultivators	69.4	165.9	118.5	93.4
Grain harvesters	188.5	2.2 fold	174.3	83.4
Tractor mowers	109.7	100.4	547	105.5
Mineral fertilizers	124.9	106.2	106.9	104.0

Source: RF State Committee for Statistics.



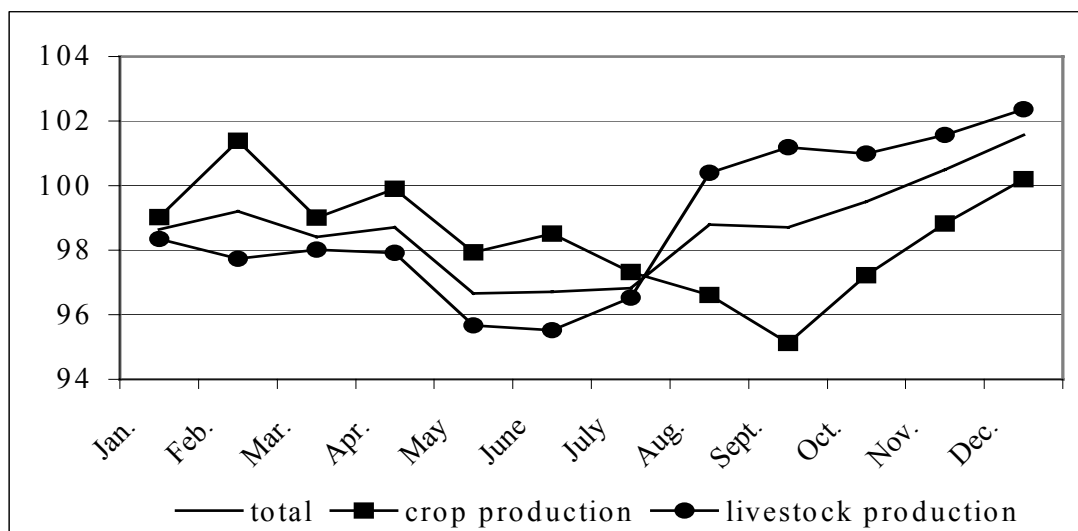
### 3.4.2. Financial performance of agricultural producers

As it has already been mentioned, financial performance of agricultural producers in 2002 has notably aggravated. Profitability of agricultural production dropped while farms' payable debts enlarged. In 2002 profits received by enterprises engaged in farming fell to 10.9 billion rubles, or were twice less than in 2001. Profitability of agricultural production averaged 3.9% as compared with 9.2% in 2001.

Insolvency of agricultural producers remains a serious problem. Both their total and outstanding debts on bank credits and loans grew throughout the year.

The financial performance of agricultural producers in 2002 was determined by an extremely unfavourable trend of purchase prices for major agricultural products. Within the first 6 months 2002 not only real but also nominal prices were falling (*Fig. 58*). From the mid-year prices for livestock products began to grow but in the last 3 months this growth slowed down while prices for crop products became higher. The average drop of real agricultural prices in 2002 totaled 2%. Poor financial performance of agricultural producers was aggravated by the substantial lifting of prices by input sectors (in September 2002 the price for electricity supplied to agriculture was 34.5% higher than in September 2001, the price for fuels and oils – 25.5% higher, for gas – 30.2% higher). So, the problem of notorious price disparity has re-emerged.

At the same time budget financing of the agrarian sector in 2002 has certainly improved as compared with the previous years. Then agriculture used to get smaller share of envisaged funds than other budget items and, besides, the bulk of these funds was transferred only at the end of a year. In 2002 this practice was discontinued: 51.3 billion rubles were allocated to the sector from budgets of all levels, and over 80% of this amount has been transferred by October.



*Source:* calculated using data of the yearbook “Social and economic situation in Russia in 2002”, RF State Committee for Statistics.

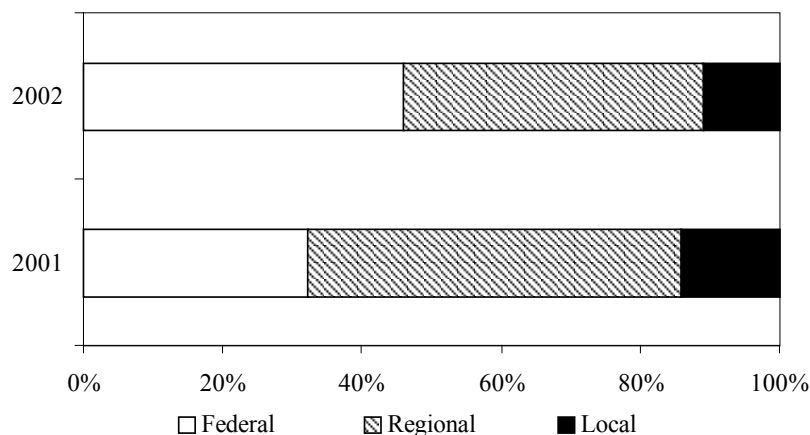
*Fig. 58.* Index of real (deflated by consumer price index (CPI)) prices received by agricultural producers in 2002 as percent of corresponding months 2001

Actual budget transfers to agriculture in January-September 2002 were 23.5% below the envisaged level. To understand the causes of shorter financing one should examine what items got smaller funds.

First, expenses on purchasing home-produced machinery and breeding stock on leasing terms were under-financed due to the late adoption of spending procedures and the short demand for state leasing in 2002. Second, funds for maintaining subordinate institutions were not allocated in full since the latter were transferred from the regional to the federal level. Since the mechanisms of their financing from the federal budget still need fine-tuning, funds were transferred with delays.

The amount of budget support to the agrarian sector continues to decrease. Expenditures on agriculture in consolidated budget fell by 11% in real terms and their share declined to 1.7% of the total as compared with 2.4% in 2001.

The share of federal budget in the consolidated budget support to agriculture sharply grew. This is partially explained by the general trend of budget expenditures' centralization: during the same period in 2002 51% of consolidated RF budget expenditures were financed from the federal budget. One more explanation has already been mentioned – it's the transfer of subordinate institutions to the federal level.



Source: the RF Ministry of Finance.

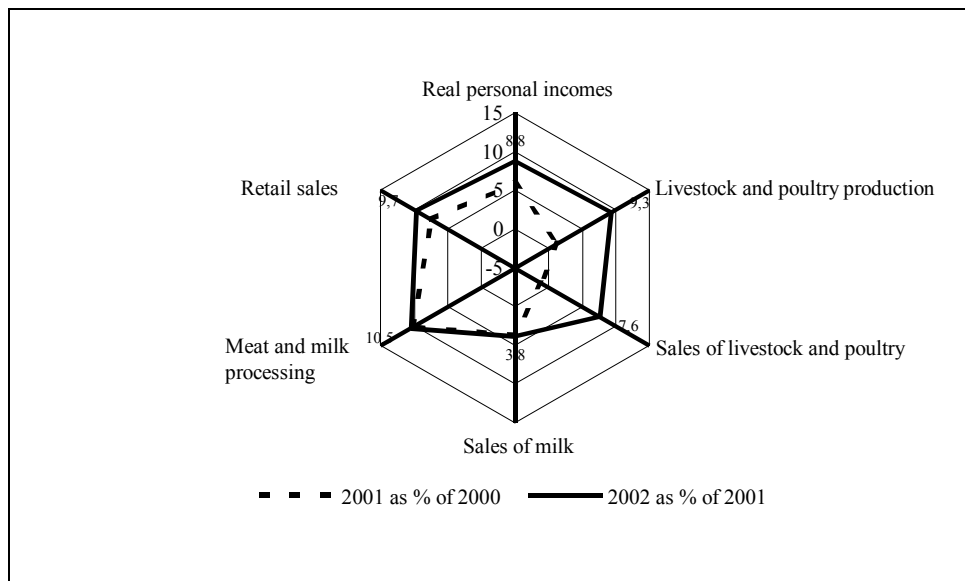
*Fig. 59. Structure of consolidated budget, %*

### 3.4.3. Agricultural and food markets

The situation on agricultural and food markets in 2002 was primarily determined by faster growth of supply as compared with demand. On the one hand, real personal incomes rose by 8.8%, or slightly more than in 2001 (8.5%), and differentiation of population by received incomes didn't increase. Exports expanded but so did imports of major agrifood products. On the other hand, supply followed the upward trend of the three preceding years. As a result, the situation on most agricultural markets in 2002 was shaped by overproduction and the corresponding drop of prices in real terms throughout the year (in some months – even in nominal terms).

Agricultural producers are the most affected by overproduction: food sales grow at a rather high rate (over 9% in 2002) while gross agricultural output (GAO) – much slower. This

means that bigger share of raw inputs for food production is supplied from abroad. Nevertheless, in the second half of the year the situation on meat and milk markets improved. In the first 6 months 2002 personal incomes and meat and milk processing grew faster than production of corresponding raw products in agricultural enterprises, i.e. a part of food industry's demand for inputs was met by import supplies. Annual indicators demonstrate a substantial increase of domestic supply (*Fig. 60*) the major contributors to which are large-scale farms. The market situation notably improved as compared with the corresponding period 2001. The rate of milk supply growth remained at actually the same level.



Source: Yearbook "Social and economic situation in Russia", RF State Committee for Statistics, 2001, 2002.

*Fig. 60.* Increase of personal incomes, agricultural and food production as percent of the previous year

### Grain market

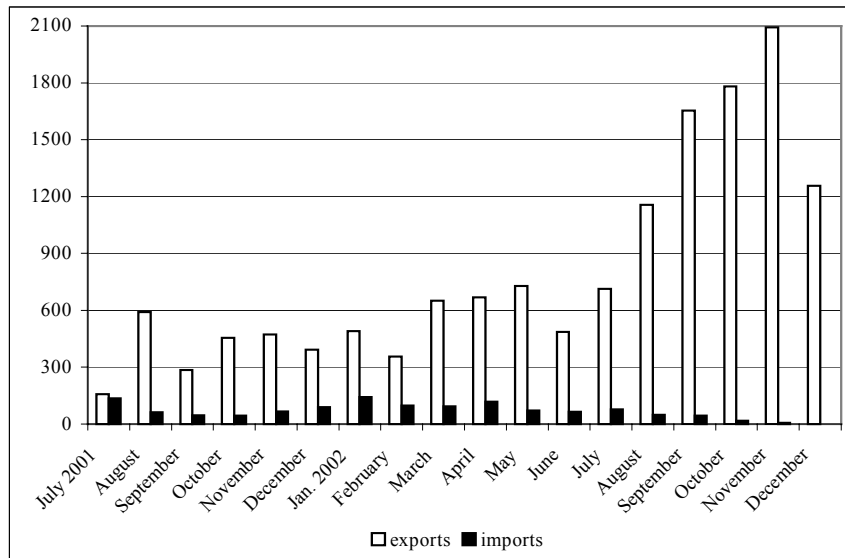
In 2002 the situation on grain market was shaped by excessive supply. Rather good crops in 2001 and 2002 combined with short domestic demand resulting in lower prices and bigger exports. In 2002 grain exports were record high. In 2001/2002 marketing year the annual grain export volumes totaled 5.7 million tons, while in 6 months 2002 (July - December) 8.7 million tons of grain were exported – an absolute record for the recent half of a century (*Fig. 61*).

Exports were fostered not only by grain surpluses on the domestic market but also by exceptionally favourable situation on the world grain market throughout 2002 and good demand prospects for the coming marketing year. The result was a large price spread: domestic prices were far below the world ones. For instance, by the end of October the ex elevator prices for soft wheat in the European part of Russia equaled 65-70 dollars per ton, in Novorossiysk port according to different estimates - ranged from 90 to 100 dollars per ton, FOB, while in Europe they amounted to 120 dollars per ton, in the US Gulf – to about 160 dollars

per ton. This price spread made exports profitable even despite high costs of overcoming poor institutional development.

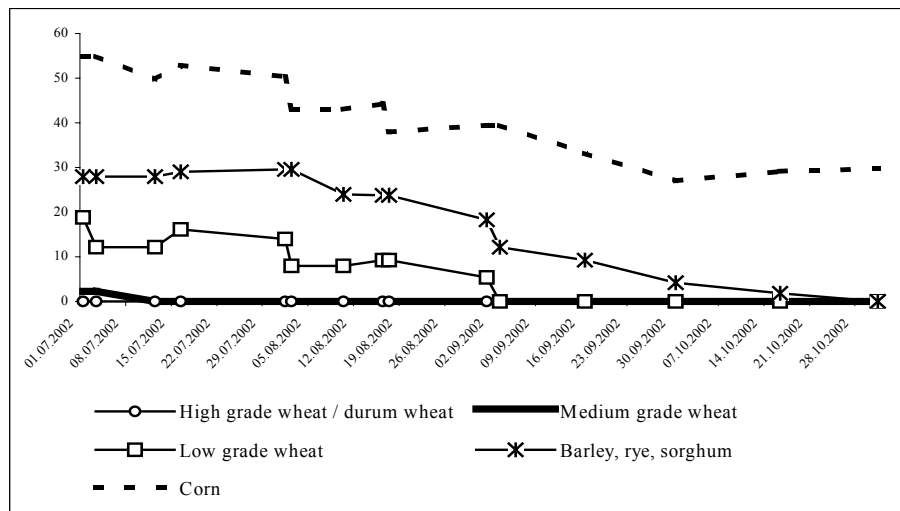
Another factor of intense export supplies at the end of 2002 was a gradual lowering of grain import tariffs in the European Union (*Fig. 62*). Besides, on the eve of new EU policies for 2003 affecting grain imports from Russia, traders intensified deliveries trying to offset forthcoming restraints on export to European countries. The new EU mechanism of quoting grain imports (based on the historic principle) envisages constraints on supplies of low and medium grade wheat the volume of which is not to exceed 2.98 million tons, and on supplies of barley – not more than 300 thousand tons. The customs duty on wheat within the quota is 12 EUR per ton, on barley – 16 EUR per ton. The duty on quantities supplied in excess of the quota amounts as high as 95 EUR per ton. Of the total quota volume 610 thousand tons are allotted to the US and Canada, the remaining 2.37 million tons – to other countries. Mean-time, in 2002 Russia exported to the EU over 1 million tons of low and medium grade wheat.

In addition to the EU grain quotas exports in 2003 will be constrained by the envisaged elevation of cargo railroad tariff.



Source: data of the RF State Customs Committee.

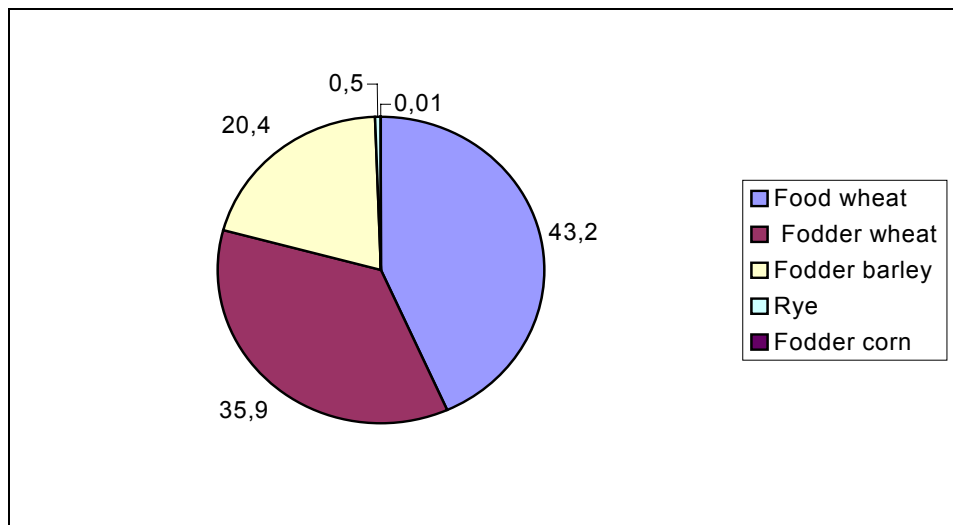
*Fig. 61.* Exports and imports of grain in 2001/2002 and 2002/2003 marketing years, thousand tons



Source: <http://www.proagro.com.ua>.

Fig. 62. EU import duties on grain in 2002, EUR per ton

Wheat accounted for the bulk of Russian grain exports (about 80%). Fodder wheat prevails in grain supplies to the EU (in some months its share reached 80%), while other countries import primarily food wheat.



Source: data of the RF State Customs Committee.

Fig. 63. Structure of Russian grain exports in 2002-2003 marketing year (January – December average)

In 2002 the imports of major grains to Russia sharply decreased and consisted primarily of traditionally deficit corn and brewer's barley. Larger share of corn in the total grain imports is due not only to a sharp drop of other grains' import supplies but also to an absolute growth of corn imports. This growth was temporary and was primarily conditioned by the need to cover the demand of domestic starch and syrup processing affected by small and poor

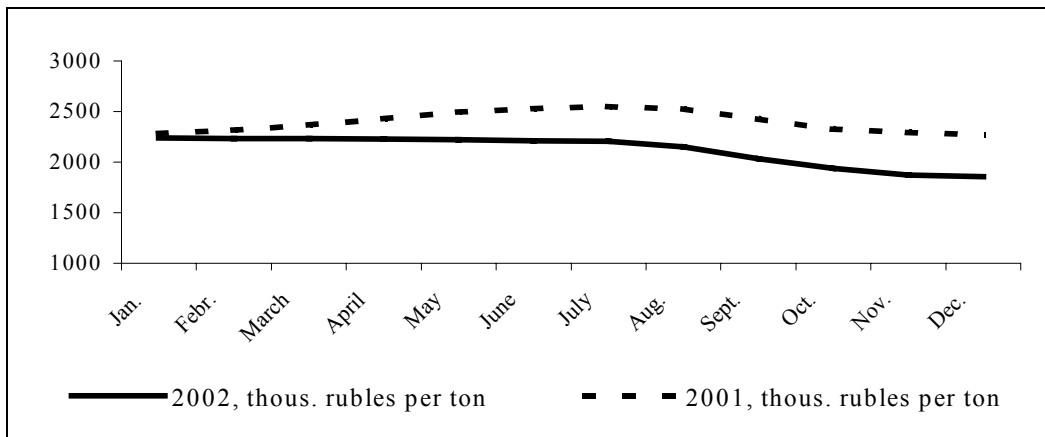


quality corn crop in 2001/2002<sup>6</sup>. Imported corn was also used for feeding purposes. However, in the last months 2002 corn imports reduced since the 2002/2003 crop was twice larger than that of 2001/2002, and there is no shortage of corn for processing on the domestic market. Given the current domestic prices for wheat livestock producers stop using corn for feeding.

Despite their sizable volumes, grain exports in 2002 were not sufficient to lift prices on domestic market. Throughout the year average prices received by grain producers were below the corresponding 2001 level.

To support agricultural producers affected by low grain prices the government for the second successive year carried out grain interventions. They started in mid-November 2002 and continued till January 22, 2003 (though in January the volumes of sales were already small).

Interventions clearly demonstrated segmentation of the national grain market. The greatest participation in trading sessions was observed in the Siberian regions where most volumes of grain were sold due to the abundant supply and low prices. At the same time auction sales of grain on the Russia's European South basis were rather slack. Traders didn't show much interest in them since this region is the basic Russian grain exporter.

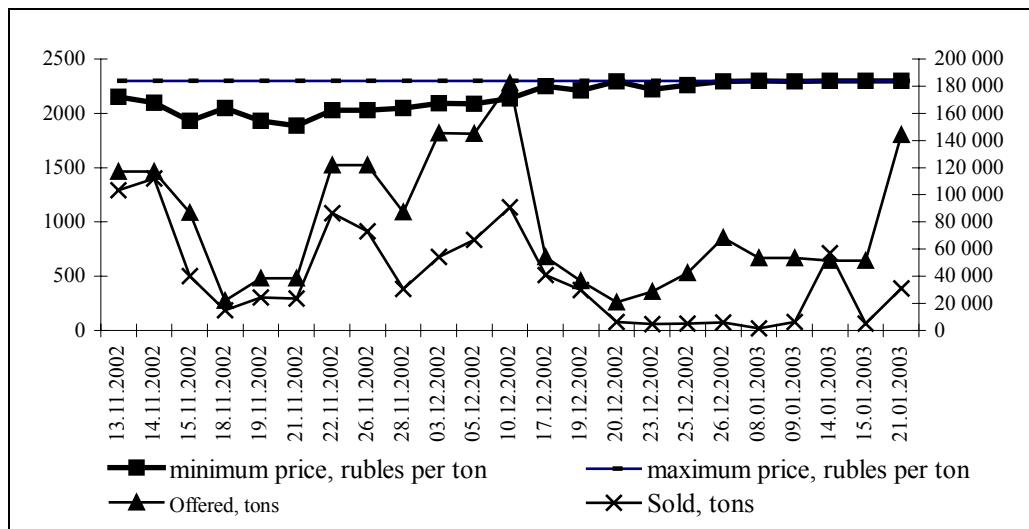


Source: RF State Committee for Statistics

*Fig. 64. Average real prices received by grain producers, thousand rubles per ton*

Though the price range for trading sessions was set, already in a month minimum prices lifted up to the maximum level, and grain was sold at maximum prices irrespective of the actually traded volumes.

<sup>6</sup> Marketing year for corn is October – next September.



Source: calculated using statistics of trading sessions (<http://www.birja.ru/price/index.html>).

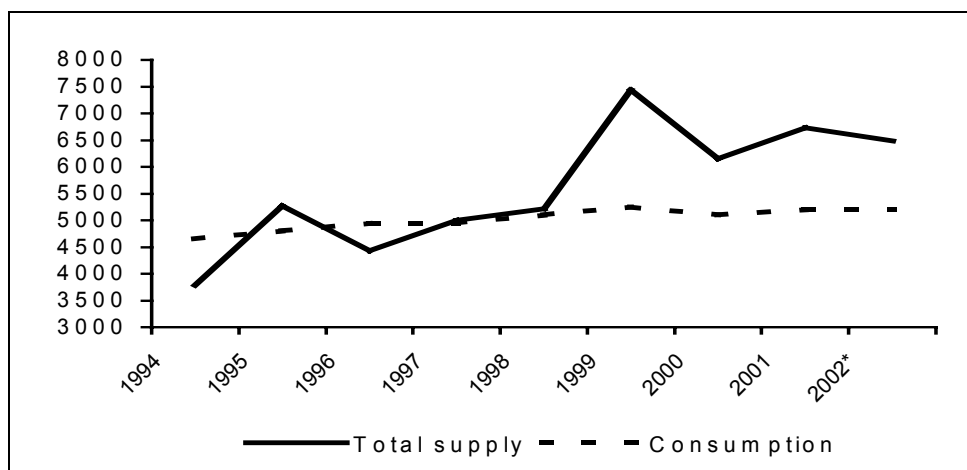
*Fig. 65. Statistics of intervention trading sessions for wheat #3 in 2002/2003 (volumes and minimum/maximum prices)*

In the course of intervention trading sessions about 3 million tons of grain were purchased and nearly 5 billion (of the allocated 6 billion) rubles of budget funds were spent. As a result prices in major producing regions (and first of all in Siberia) were stabilized. Within the two and a half months of auction sales prices for wheat #4 (that constituted the bulk of sales) in the Siberian region rose by about 30-36%.

### Sugar market

In 2002 the situation on sugar market remained actually the same as in the two preceding years both from the point of view of demand/supply ratio and the state market regulation.

The supply of sugar beets for processing enlarged. Higher crop (up 6% as compared with 2001) and yields (up 10%) were conditioned by intensive factors – larger fertilizer application and renovation of agricultural machinery. But due to the low content of sugar in 2002 crop, the output of domestic sugar remained at the 2001 level – 1.3 million tons.



2002\* - estimate.

Source: data of the Russian Sugar Producers' Union, Customs Statistics of Foreign Trade, corresponding years.

*Fig. 66.* Total sugar supply and consumption in Russia, thousand tons

State regulation of sugar market has failed to increase home production of sugar beets and to limit excess supply of white sugar on the domestic market (*Fig. 66*).

White sugar imports are constrained at the level of about 0.4 million tons by means of high import tariffs.

The only meaningful result of sugar market regulation is that quotas and import tariffs helped to separate the periods when processors get imported inputs (raw sugar) and sugar beets from domestic producers. On the whole the scheme of seasonal supplies works: almost all raw sugar imports are delivered in the first half of a year while in its second half sugar plants process primarily domestic sugar beets. At the same time, import supplies of sugar in excess of the quota remain beyond domestic regulation, the world prices being their major determinants. In case these prices go down, the non-quota sugar is supplied to the Russian market despite all ordinary, seasonal and even special elevated import tariffs since low prices for raw sugar make up for suppliers' losses from paying duties.

When the world prices are high, import of raw sugar even within the quota becomes non-profitable inducing an inevitable rise of domestic prices. That was exactly the case in the second half of 2002. High sugar prices on the world market became a natural barrier to import of sugar in excess of the quota. In 2002 raw sugar imports totaled 4.8 million tons of which 1.15 million tons, or 30% less than in 2001, were supplied in excess of the quota. As a result both wholesale and retail domestic prices for sugar in the second half of 2002 were growing (*Fig. 67*).

Another factor of domestic prices' rise was the September auction of sugar quotas the prices for which were very high. Wholesale and retail prices started to grow actually right after it and this growth continued till the end of the year.



Source: Bulletin of Russian Sugar Producers' Union, corresponding months.



Fig. 67. Wholesale and retail prices for sugar, thousand rubles per ton

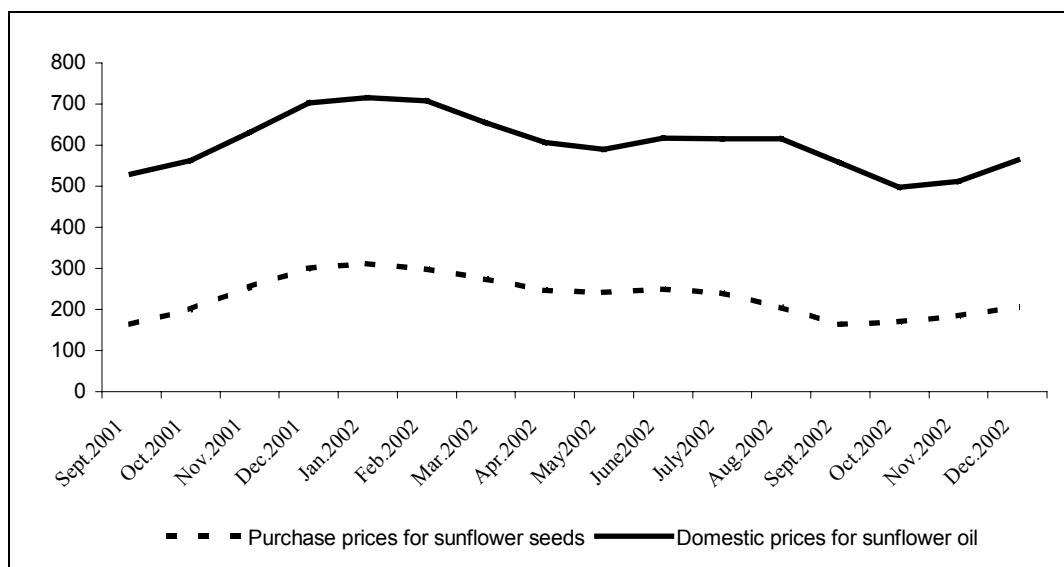
### Oilseeds market

The oilseeds market demonstrated an apparent reversal of trends in the second half of the year. In addition to the world market fluctuations (to which this market is very sensitive as compared with markets of other agricultural products), the 2002 market situation was determined by two factors: poor quality of new crop and the price dynamics.

In 2002 the output of sunflower seeds notably grew (by 35% - up to 3.6 million tons) as compared with 2001 when the scarce crop led to a sharp rise of domestic prices and the most part of produced volumes was processed by domestic plants. The new crop is sufficient to satisfy the processors' demand for inputs and to export about 300-400 thousand tons of sunflower seeds.

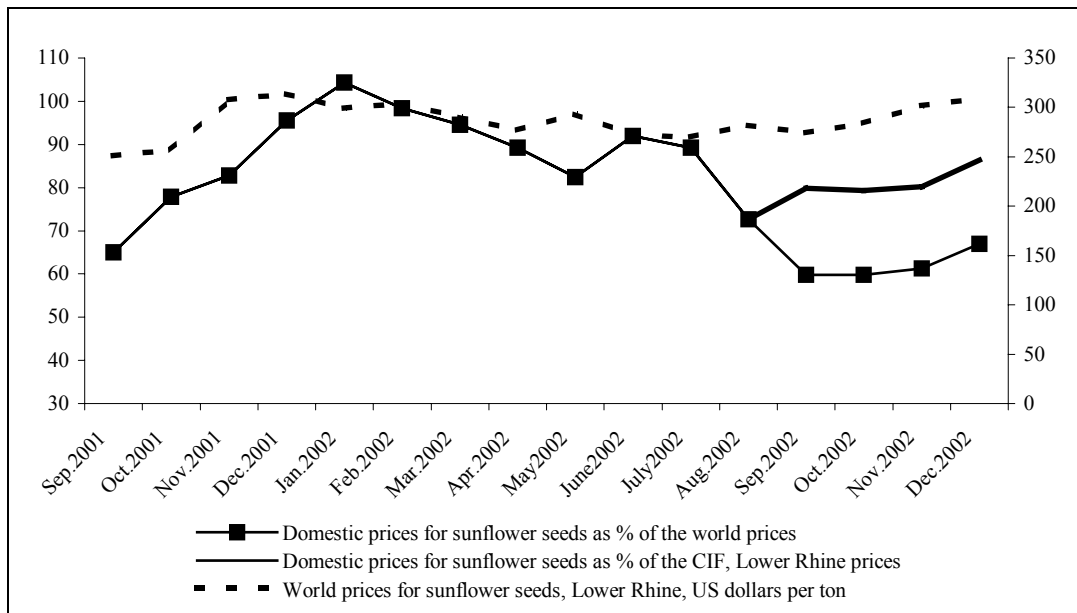
At the same time the supply of quality sunflower seeds in 2002 is rather short while the demand for them is large resulting in high prices. Despite the abundant gross supply domestic prices remained high throughout 2002 (except for a short period in September when harvesting started).

Still, domestic prices for sunflower seeds are far below the world ones (Fig. 69) and thus the situation is favourable for export. But supplies continue to be constrained by 20% export duty and high freight rates (on the average 30-35 dollars per ton) in major ports of loading in autumn-winter 2002 due to the intense shipments of grain and high demand for vessels. Fig. 69 demonstrates that the price competitiveness of Russian sunflower seeds on the world market is falling due to the high transaction costs of freight and duties. Besides, the poor quality of 2002 crop is also a limitation to export supply.



Source: calculated using data of EFKO company: <http://analitic.efko.ru>.

Fig. 68. Domestic prices for sunflower seeds and sunflower oil, US dollars



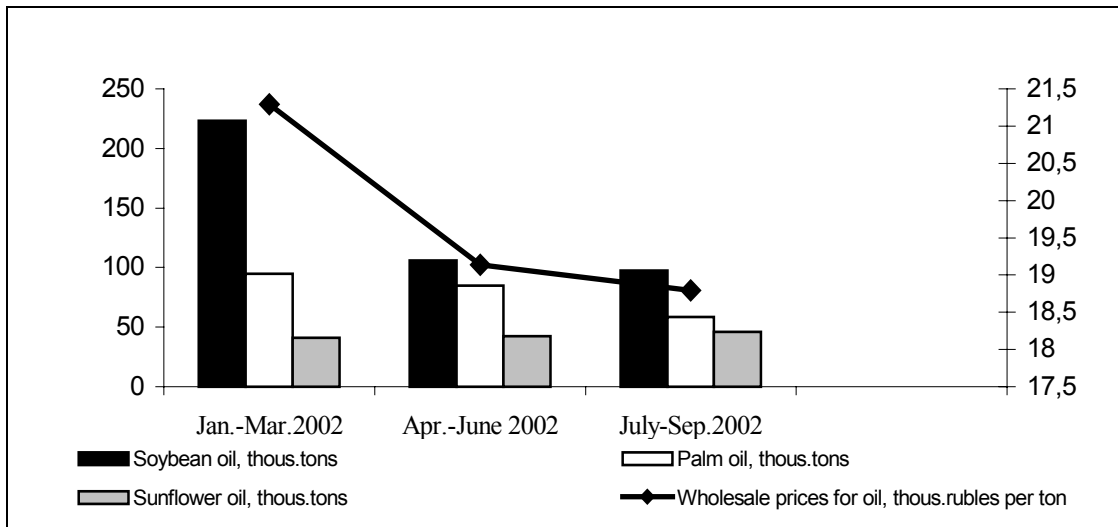
Source: calculated using data of EFKO company: <http://analytic.efko.ru>.

*Fig. 69. Domestic prices for sunflower seeds as % of the world prices*

In recent years Russian companies have notably enlarged processing capacities and thus the domestic demand for sunflower seeds is rather stable. The existing facilities are capable to process as much as 3 million tons of seeds. The continuation of this trend in the medium term can result in smaller sunflower seeds exports as well as in halting of vegetable oils import into the country. The determining factor in this situation is the level of prices for oil.

Throughout the first half of the year domestic prices for sunflower oil were above the world ones conditioning large imports: 0.6 million tons of vegetable oils were imported to Russia in January-June 2002 (Fig. 70). Lower domestic prices for oil in the second half of the year resulted in a sharp drop of imports of relatively cheap oils – the palm and the soybean ones the share of which in the total vegetable oils imports amounts to 87%.

At the end of the year further lowering of domestic wholesale prices for sunflower oil made its export profitable. Only within one month (December 2002) the exported volumes increased almost two fold while imports of vegetable oils reduced by about 11% as compared with November 2002.



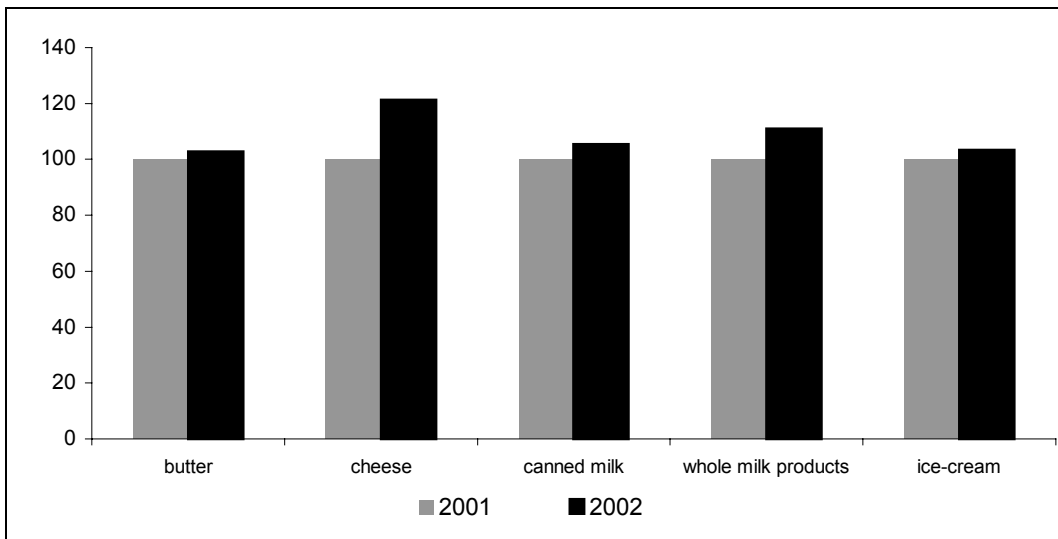
Source: calculated using data of EFKO company: <http://analytic.efko.ru> Customs statistics of foreign trade.

*Fig. 70. Imports of vegetable oils and domestic wholesale prices for sunflower oil*

### Milk market

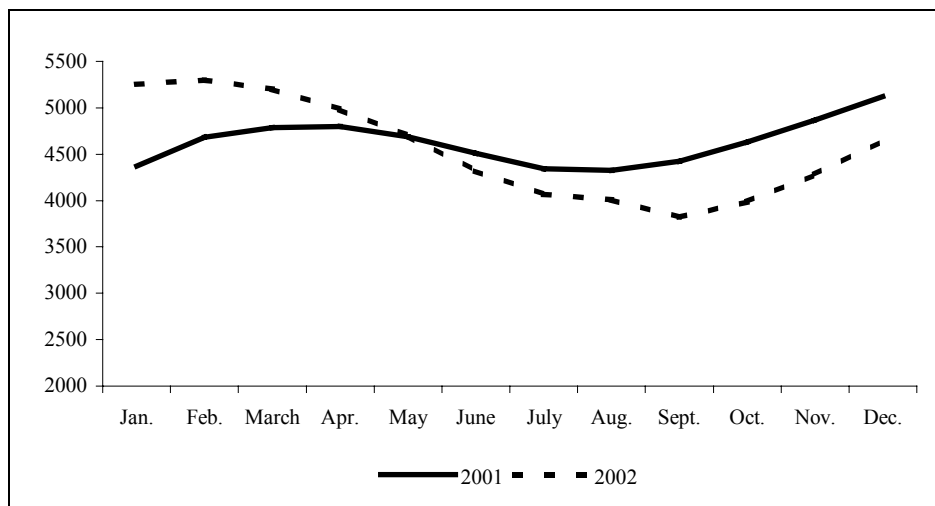
The growth of milk productivity in recent years resulted in larger supply on the primary milk market. Milk processing grew as well: for the first time since the beginning of 90's output increased in all the sub-sectors reflecting higher consumer demand and larger supply of raw milk.

The growth of milk production and processing from late 2001 was accompanied by lowering of prices for raw milk received by agricultural producers. Throughout most part of the year they were below the corresponding 2001 level (*Fig. 72*). Lower prices were a consequence of excess supply of raw milk to which the market failed to adjust in a short term. The sharpest drop was observed in summer 2002.



Source: Yearbook “Social and economic situation in Russia”, RF State Committee for Statistics, 2002.

Fig. 71. Domestic production of dairy products as % of the previous year



Source: Yearbook “Social and economic situation in Russia”, RF State Committee for Statistics, 2002.

Fig. 72. Average real prices received by milk producers in 2001 and 2002, thousand rubles per ton

The growth of prices for milk that started in September shows that domestic market is adjusting to the situation. The evidence of that are smaller imports of dairy products (especially the ones that need further processing) in the last months 2002 indicating the start of import substitution process. In January-November 2002 imports of condensed milk and cream fell by 32% as compared with the corresponding period 2001.

The growth of butter imports halted as well. In recent years the share of imported butter on the Russian market was rather large. It was more price-competitive primarily due to the non-compliance with domestic quality standards: the alleged butter was often a sort of marga-

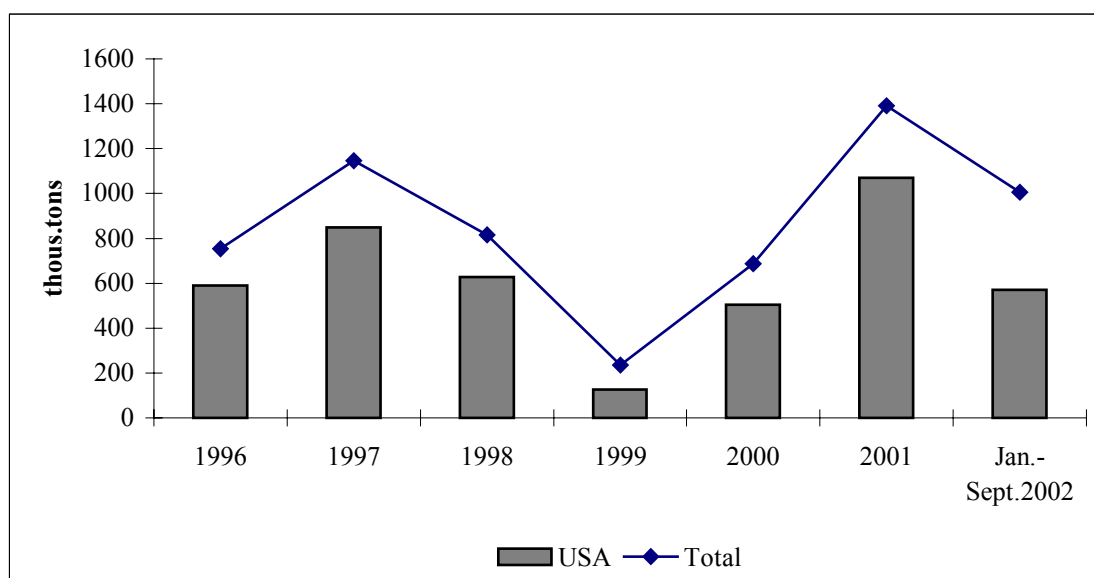
rine. At the end of the year butter imports were constrained by seasonal import duty on this product.

In 2002 opportunities emerged for enlarging exports of dairy products, first of all cheese, the production of which got investments from milk processing companies.

### Poultry market

The ban on broiler meat import from the US introduced by the government in March 2002 sharply reduced the supply of this product to the domestic market. From the 15<sup>th</sup> of April (when the first ban was lifted) till the 1<sup>st</sup> of August poultry imports totaled about 130 thousand tons while within the corresponding period 2001 about 100 thousand tons were shipped to Russia monthly<sup>7</sup>. Although already in September the American side met the requirements of the new Russian veterinarian regime, and the ban on poultry imports from the US was lifted, such import restrictions have led to some changes on the domestic market.

First, shorter supply of the US poultry legs resulted in higher prices for poultry on the Russian market. In July 2002 the price for imported poultry was 25-30% up from March, the price for domestic poultry – 10-20% up<sup>8</sup>.



Source: data of the Customs statistics of RF foreign trade and the RF State Committee for Statistics.

*Fig. 73. Poultry imports to Russia in 1996-2002*

Second, these developments opened the Russian market to other (besides the US) poultry exporters. A part of market niche formerly belonging to the US was occupied by poultry meat from other countries. The share of Brazil increased most notably: from about 2% of the Russian poultry imports in 2000 to 7.4% in 2001 and to 22.3% by May 2002.

The AFE Centre study<sup>9</sup> showed that in Russia poultry meat is not a homogeneous product and includes at least two large segments: whole broilers and broiler parts. Due to the mar-

<sup>7</sup> Data of the USA Poultry and Egg Export Council (USAPEEC).

<sup>8</sup> Ibid.



ket specifics the first product is primarily supplied by domestic producers while the second consists largely of broiler legs supplied from the US. The analysis revealed that these two products are hardly substitutable on the consumer market. Broiler legs are primarily consumed by families with low incomes while chilled whole broilers – by richer consumers. Accordingly, the development trends on these two markets differ greatly.

Such product non-homogeneity can mean only one thing: smaller supply on one market does not lead to an adequate growth of supply on the other. The practical implication is that any constraints on import of broiler legs won't result in a corresponding expansion of domestic production.

At the same time, higher personal incomes lead to larger demand for output of domestic poultry producers. Domestic poultry production demonstrates rather high elasticity of supply, the ability to respond to expanding demand. The growth rates of poultry meat production are currently above those of all other agricultural sub-sectors. Besides, active investments therein allow to assert that the elasticity of supply will continue growing.

In other words, the rise of real personal incomes and the decrease of social differentiation in the country will be followed by the growth of domestic poultry meat production and the reduction of broiler legs imports.

Meanwhile, high barriers to trade in poultry meat result in the growth of prices for broiler legs being one of the key sources of animal proteins for the poorest population group, and thus in the worsening of this group's quality of life. Since due to tough budget constraints the government is unable to compensate poor families for these losses, import restrictions become even more undesirable: in addition to failure to produce the expected effect on domestic producers, they aggravate living standards of a certain population group. The budget benefit cannot justify the social and economic detriment.

One more circumstance should be taken into account: since domestic production of poultry meat meets demand of higher income groups, the more likely substitutes for this product are beef and pork rather than broiler legs. Accordingly, when elaborating foreign trade policies targeted to support domestic poultry producers one has to take into account highly subsidized imports of these two items from the EU (that, besides, undermine the positions of domestic cattle and pig producers).

#### **3.4.4. Foreign trade in agricultural and food commodities**

In 2002 agrifood imports to Russia expanded despite growth in domestic agriculture and processing. This trend is due to two basic factors: first, the growth of real personal incomes and, second, the structure of imports that consist primarily of commodities, the domestic production of which is short or non-competitive.

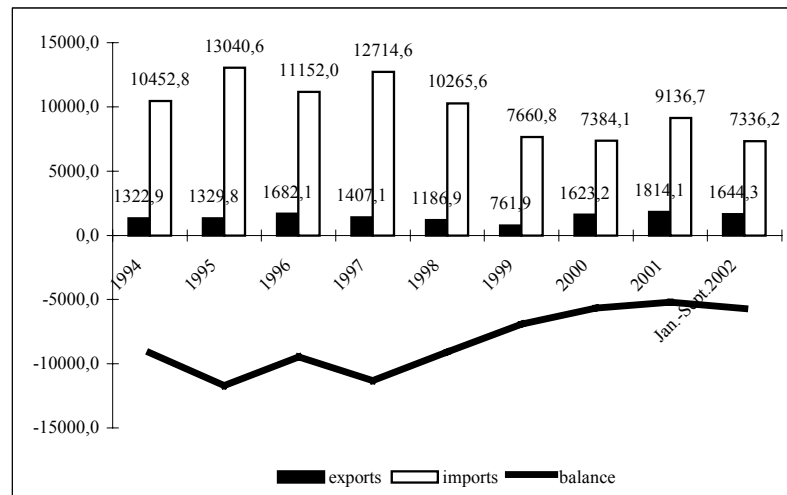
After the 1998 collapse imports of agricultural and food products began to restore only in 2001 (*Fig. 74*). Though official annual statistics of 2002 foreign trade are not yet available, it's already clear that the volume of agrifood imports hasn't shrunk and most likely - even grew. In January-September 2002 Russia imported 12% more agrifood products than in the corresponding period 2001.

The second apparent trend of 2002 is the expansion of agricultural and food exports. It started back in 2000, and in 2001 their volume was record high as compared with all the post-reform years. The 2002 indicators are likely to surpass this record. Already in January-

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<sup>9</sup> <http://www.iet.ru/afe/projects/poultry.pdf>.

September Russian food exports were 40% larger than in the corresponding period 2001. The intense shipments of grain at the end of the year give grounds to suggest that the total 2002 agrifood exports will be above the 2001 record.



Source: Customs statistics of RF foreign trade.

Fig. 74. Exports and imports of agricultural and food products in 1994-2001, million dollars

Table 28

**Structure of Russia's foreign trade in 1999-2002, %**

	1999	2000	2001*	2002*	2002/2001
<b>Export</b>					
Total	100	100	100	100	50.47
<i>Agricultural and food products</i>	1.1	1.3	2.39	2.24	141.06
Mineral products	45.1	54.2	85.39	55.24	97.34
Produce of chemical industry	8.2	7.0	11.18	7.09	95.33
Hides and skins including fur-skins	0.3	0.2	0.31	0.24	114.69
Timber, pulp and paper products	5.2	4.4	6.68	4.85	109.06
Textile	1.0	0.7	1.09	0.78	107.51
Jewels and precious metals	6.3	5.0	5.89	4.00	102.13
Metals	20.5	17.1	22.51	14.60	97.59
Machinery, equipment and means of transport	10.5	8.6	14.73	9.45	96.51
Other items	1.8	1.4	1.78	1.52	128.94
<b>Import</b>					
Total	100	100	100	100	109.79
<i>Agricultural and food products</i>	28.4	23.1	22.94	23.41	112.01
Mineral products	4.2	6.8	4.52	3.82	92.83
Produce of chemical industry	16.4	18.6	18.30	16.93	101.57
Hides and skins including fur-skins	0.2	0.3	0.51	0.44	94.66
Timber, pulp and paper products	3.5	3.8	4.00	4.28	117.41
Textile	4.3	4.8	5.46	4.95	99.56
Jewels and precious metals	0.1	0.2	0.07	0.08	122.90
Metals	7.2	8.3	7.76	6.19	87.48
Machinery, equipment and means of transport	32.4	30.6	32.32	35.81	121.64
Other items	3.2	3.4	4.11	4.09	109.33

\* - January - September.

Source: Customs statistics of RF foreign trade.



Agricultural and food products are perhaps the only commodity group that still sustains its share (that enlarged after the 1998 crisis) in the total Russian exports (*Table 29*). Besides, the growth of agricultural export supplies in recent years was above the corresponding indicators of other sectors.

The agrifood import trends also clearly differ from the ones of other commodities. The share of agricultural and food products in the total Russian imports fell to 23% and throughout the recent years remains at this level while the share of other sectors noticeably fluctuated and didn't demonstrate a steady downward trend. So, the contribution of agrifood sector in the improvement of country's trade balance is one of the most substantial. Besides, smaller negative balance of agrifood foreign trade strengthens the Russia's food security.

In 2002 the basic contributors to import growth were meat (except poultry) and fish products, white sugar, products containing cacao, citrus fruits, tea, coffee, alcohol and alcohol-free beverages, i.e. traditional import items.

*Table 29***Russian imports of major food products in 2002**

	January-November 2002 as % of January-November 2001
Meat, fresh and frozen	129.7
Poultry meat	101.2
Processed and canned meat	104.3
Fish, fresh and frozen	107.5
Condensed milk and cream	67.9
Butter	98.7
Sunflower oil	96.3
Raw sugar	84.6
White sugar	142.4
Food grains	74.5
Bread and bakery products*	115.6
Macaroni*	121.7
Products containing cacao	110.1
Coffee	116.9
Tea	106.8
Citrus fruits	124.3
Alcohol and alcohol-free beverages	116.6

\* - January - September.

Source: RF State Committee for Statistics.

Import of some commodities was restricted by government regulations: that of sugar, poultry meat and some other. The import of condensed milk and cream was not, and so its shrinkage is all the more noteworthy since it can evidence a growing competitiveness of domestic producers.

In 2002 Russia became one of the major suppliers of grain on the world market: it was the third after the US and the EU in exports of wheat, and together with Ukraine accounted for over 20% of the total world grain supplies (in the previous marketing year – only 5%). It also became a net exporter of some products of grain processing: e.g. the exports of macaroni increased 10.3 fold, the exports of bakery products – by 21.5% (*Table 29* and *Table 30*). Ex-



ports of macaroni in January-September 2002 exceeded imports by 36.7% and were primarily shipped to the CIS countries.

*Table 30*

**Russian exports of selected agricultural and food products in 2002**

	January - September 2002 as % of January - September 2001
Fish	91.6
Wheat	763.1
Bread and bakery products	121.5
Macaroni	10.3 fold
Sunflower oil	51.1
Condensed milk and cream	78.4

*Source:* the RF State Customs Committee.

*Table 31*

**Geographic structure of the world wheat production, %**

	2001/02	2002/03
USA	9.20	7.75
EU	15.82	18.27
Canada	3.54	2.77
Australia	4.14	1.85
Argentina	2.67	2.29
China	16.20	16.21
CIS	15.75	16.86
India	11.87	12.69
Other countries	20.79	21.30

*Source:* USDA.

The stability of Russia's position as a grain exporter will depend on its support by the state policies. In 2002 the grain exports' growth was primarily conditioned by the extremely favourable world market situation characterized by high prices for grain. But some internal problems impeding the expansion of exports still persist and it may turn out that the spread between domestic and the world prices is not large enough to cover the costs associated with their solution. Although the capacity of Russian seaports enlarged due to their modernization and putting in operation of new cargo berths, discounts on transporting grain to the Ukrainian and Baltic ports were still effective. Due to that these transport routes were rather popular in 2002. But already in January 2003 traders encountered problems when shipping grain through Ukraine: the cargo railroad tariffs there were elevated and requirements to the phytosanitary certificate needed for transporting grain through the country's ports became more strict. In 2003 railroad tariffs will grow in Russia as well. All these factors hinder Russian exports.

### **3.4.5. Changes in the agricultural policies**

The key accomplishments of 2002 agricultural policies were the adoption of agricultural land transferability law and the implementation of program of subsidizing interest on medium-term credits to agriculture. Restrictions on poultry imports from the US also had a certain political resonance. The rest of agrifood sector support measures remained the same.



## Land legislation

Adoption of the land law by the State Duma (in June) and the Council of Federation (in July) has put an end to the long-lasting dispute on agricultural land transferability. The federal legislation permitted actually all transactions with farmland as far back as 1993. However, in 1998 the RF Law on mortgage forbade to use it as a pawn. The growth of agricultural production after the 1998 crisis and the devaluation of ruble resulted in bigger demand for agricultural land, first of all the arable one. The transfer of land in agriculture became rather intensive (see *AFE Centre Bulletin*, April 2002). Still, economic agents felt permanently uncertain of the stability of existing land relations: the question of whether to permit the purchase and sale of farmland was broadly discussed in the society and the outcome of this discussion was not clear at all. This uncertainty became a noticeable hindrance to agrifood sector development. Thus the adoption of the above mentioned law is to have an important stabilizing effect. Society as a whole and agricultural market operators in particular got a distinct signal that the current system of land relations is to stay for long.

At the same time the adopted law does not and should not make a revolution in the farm sector land relations. One should expect neither breaks through in agricultural production nor drastic changes in farm structure resulting from the new law's adoption.

Together with the new Land Code adopted earlier the Law on agricultural land transferability codifies, puts in order and fills the gaps in land legislation that formed before the start of reforms. And this is the second important mission of the adopted law.

Earlier we have already scrutinized the draft of this Law introduced to the State Duma by the government<sup>10</sup>. After the first reading the bill was seriously amended. Let's examine the most significant of these amendments.

The government draft bill inherited the spirit of the new Land Code and contained actually no limitations on non-residents' title to agricultural land: they could not acquire only areas near the state border. The adopted law denies their right to own farmland *de jure*. Individuals having foreign or no citizenship and legal entities with over 50% of stock controlled by non-residents can only rent agricultural land (the term of rent may be up to 49 years). Thus people concerned with the "Russian land's buying up by foreigners" (numerically they prevail in the society) got a positive signal. In other words, when combined the new Land Code and the Law on agricultural land transferability permit non-residents to own only urban and industrial land.

It should be noted that almost in all the European post-socialist countries (except Latvia and Estonia) the non-residents' title to farmland is restricted in one or other way (in the OECD countries such restrictions are quite rare). In this regard the Russian law doesn't stand aside of the transition countries' general trend. At the same time given the country's social, economic and legislative conditions this regulation won't have a noticeable restrictive effect. Given that legal entities are permitted to own farmland, its execution is actually impossible to control: there is no effective mechanism of tracing companies' affiliation. Moreover, the ban on individual non-residents' ownership of farmland will stir up sham marriages just the way registration did during the Soviet period. So, this limitation won't seriously influence the *status quo*.

Another novelty of the law as compared with the government draft is the lowering of upper limit that a constituent member of Federation can set for one landowner. The Law

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<sup>10</sup> *AFE Centre Bulletin*, № 2 (12) 2002.

stipulates that regional authorities can (but do not have to!) set such a limit that is not to be below 10% of the total farmland area of an administrative unit. The latter implies a rayon, but since the effective legislation doesn't contain its definition the euphemism is used.

This provision is targeted against monopoly. There are no regulations restricting monopolization of access to land (the key factor of farm production) in the Russian anti-trust legislation. The Law on agricultural land transferability fills this gap.

Agrifood sector will be mostly affected by the Law's regulations pertaining to transfer of land shares. There are almost 12 million of them issued in the process of collective and state farms' restructuring in 1992-1994. In recent years their transfer became a common practice. Moreover, in the last 3-4 years it was the predominant form of land transfer in agriculture (primarily effected through renting of land shares).

The new Law defines land share as a title in joint share ownership with minor (as compared with the Civil Code) transfer peculiarities.

The initial version of the government bill actually did not alter the existing mechanism of buying and selling land shares while abolishing their rent (rent was declared a trustee management agreement)<sup>11</sup>. This regulation stirred up heated discussion. It affected interests of both large business (the Russian Industrial and Entrepreneurial Union appealed to Prime-Minister twice asking to review this clause, Russia's Grain Union (representing interests of large grain operators) also spoke against) and individual farmers that so far enlarged cultivated area by renting shares (AKKOR (the Association of Peasant and Private Farms) opposed the idea). None of the 5 draft bills introduced to the Duma by its deputies abolished the existing transfer of land shares signifying that they didn't support such an approach.

In the course of perfecting the bill after its first reading these provisions became even more unacceptable as compared with the initial version. First, the procedure of buying and selling land shares became so complicated that a rural resident can hardly go through it. To sell a land share its owner has first to notify (in writing or through a local newspaper) all other co-owners of the joint land holding. In case none of them is interested, the owner has to notify the local administrative body of his wish to sell the share. Only in case this body also rejects the offer, the land share can be sold to an outside buyer but the price cannot exceed the one declared in the first two notifications. In case the price is lower the procedure is to be repeated from the very beginning.

According to the final version of the Law land share rent is not automatically transformed into a trust agreement but the transaction can actually no longer be conducted by individuals. Until recently a land share owner could rent it out individually and it was the tenant's problem to consolidate rented shares into one land plot. From now on it is to be done by share owners. Earlier a tenant wishing to cultivate a certain land area could sign individual agreements with all shareholders and then require to parcel out the corresponding physical plot (or several large plots). Each owner in this case received rentals individually (in theory they could differ but in practice it happened rather seldom). Under the new Law shareholders have first to come to an agreement on joint renting out of the common land holding, to parcel it out from mother farm lands and only then to rent it out on behalf of the whole collective. The latter becomes the recipient of rental payments.

What's the difference? First of all, collective rent will raise rentals, i.e. the cost of getting access to land for outsiders: reaching an agreement with each individual shareholder is

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<sup>11</sup> Ibid.



*ceteris paribus* less expensive than that with the whole collective. This in turn will result in smaller outside investments in farming: external investors will have to pay more for accessing land and respectively will have less funds for investing in production. Besides, collective rent is most likely to get under control of large farms' managers thus enhancing their power to dispose of land that they do not own.

One more after-effect is the lessening of social buffer function performed so far by share renting. In many cases shares were not even rented out - they were transferred on the condition of life-long upkeep. This mechanism ensured some (although minor) support to elderly rural residents that were largely deprived of basic social securities. The new Law makes no provisions for such a transfer. Rentals received by each shareholder under collective tenancy agreements may be far below the ones under individual agreements (although the total amount of rent to be paid by the tenant is most likely to increase).

As a result this provision of the new Law will induce holders of shares to invest them in authorized capital of their mother agricultural enterprises: all other options are too complicated and non-beneficial. This is just the process reformers fought against all the years of reforms and that agrarian opposition secretly dreamed about: all land is transferred to the large farms' ownership.

Summing up the above, the adoption of Law on agricultural land transferability 1) gave a clear signal that development of private land ownership in agriculture is a long-term strategy, and 2) laid the legal basis for land transfer. This act won't bring about (and was not supposed to) revolutionary changes in the agrarian sector. At the same time it will result in a certain cut of investments therein. It will also lower the level of social security of rural residents (especially the elderly ones).

The pole conducted in three Russian regions (Ivanovskaya, Nijegorodskaya and Rostovskaya oblasts) at the end of 2002 showed that most agricultural producers have not realize the radical alteration of land regime as regards land shares: they still plan to rent individual land shares. The negative sides of the new law will be most likely leveled off by its poor implementation, as it has not once happened in the recent decade.

From the political point of view adoption of the above described Law signifies the redistribution of power at the federal level: the Government insisted on its version regardless of opinion of various and numerous social groups.

### Financial programs in agriculture

In June 2002 the RF Government Resolution specified the Rules of partial compensation of interest paid on 3-year-term credits granted by Russian banks to agricultural producers for purchasing farm machinery and equipment. The subsidy can amount up to 2/3 of the Central Bank's refunding rate and is to be paid monthly. This government decision signifies a further step away from the former highly inefficient system of agricultural credit support that formed after the start of reforms.

Before 2000 the only actual source of short-term credits to agriculture were budget funds. Initially they were distributed by officials, later - by commercial banks. Still, the essence of these operations remained actually the same. Beginning from 1995 state commodity crediting got widely spread. We have continuously stressed the inefficiency of these credit schemes and advocated subsidizing of interest on loans granted by commercial credit institutions. The Nijegorodskaya oblast was the first to conduct this experiment in 2000. Later in the

year (by the beginning of harvesting) the federal government tested the same scheme to be initially applied as an experimental one. In 2001 the system of subsidizing interest on private loans was finally approved at the federal level and almost in all oblasts that launched similar regional programs of supporting credits to the agrifood sector. Already the first year brought remarkable results. In 2002 agriculture got additionally nearly 23 billion rubles under the program. This amount is above the federal budget expenditures on agrifood sector in the past year and exceeds the 2001 indicator by almost  $\frac{1}{4}$  in real terms.

However, growth observed in the agrarian sector for the fourth successive year enables agricultural producers to set to attaining further goal - the restoration and restructuring of production facilities, the technological re-equipment of farming. Until recently the only mechanism of supporting medium-term investments in agriculture was state leasing developed both at the federal and regional levels. Not once we wrote about its shortcomings. In addition to raising the cost of agricultural inputs, it creates a monopoly that hampers the development of competitive and efficient system of leasing companies in the agrifood sector.

The limitations of state leasing system became more and more apparent. Some regions abandoned it or supplemented with other schemes: e.g. Chuvashiya in 2001 complemented leasing with the program of subsidizing medium-term loans for purchasing farm machinery, Perm oblast replaced leasing with compensation of expenses on buying machinery. Finally, the federal government took the same decision: it adopted the program of subsidizing medium-term (3-year-long) private credits to the agrifood sector. In addition to its own obvious merits, the program will offset negative after-effects of creating the state "Rosagroleasing" monopoly and the apparent failure of leasing program in 2001-2002. When the program was initiated we predicted that the subsidizing of interest on medium-term credits would be more attractive for producers as compared with state leasing. That's exactly what has happened: as of October 2002 the first program helped to attract over 6 billion rubles to the sector while supplies under the leasing program totaled less than 4.8 billion rubles.

At the end of 2002 the decision was taken to subsidize also interest on 5-year-long credits. It further widens agricultural producers' opportunities to benefit from medium-term credits.

To our mind, further steps in this direction should be the dismantling of federal leasing system in its current form and the extension of subsidies on 5-7-year-long credits and on interest paid under private leasing contracts.

The problem of financial sanitation of Russian agricultural enterprises remains in the agenda beginning from 1994 when their debts were restructured (actually - written off) for the first time. Afterwards various bills in one or other way pertaining to agriculture's financial recovery were introduced to the Legislative Assembly. During the 2002 spring session the State Duma has at last adopted such a law. At the beginning of 2003 a package of government regulations was approved to implement this law.

First of all we'd like to discuss the compliance of the Law's name with its contents. Already the first clause reads that the subject of the law is restructuring of agricultural producers' debts. But then the Law's name implies much more as compared with the issues that are actually regulated by the document. Financial performance of the farm sector is affected by a great number of external factors the effect of which cannot be eliminated by restructuring of debts and reorganization of agricultural enterprises.

There is a lot of marginal enterprises in the country. Slightly over 40% of financially healthy farms produce  $\frac{3}{4}$  of the sector's gross output. Profitability of producing basic commodities in the 300 best farms is from 3 to 4 fold over the agriculture's average. In case the



most obvious failures discontinue operation, the efficiency of all other farms will grow. For instance, northern areas still get subsidies for purchasing seeds of grains because people there need to have a source of income. That's why they sow free seeds, harvest less than it was sown but thanks to the subsidized seeds and fuel their output competes with grain from major producing regions pulling prices therefor and, respectively, profitability thereof down. Nevertheless, all around the country the task is formulated to preserve all agricultural enterprises; bankruptcies are still rare to say nothing of bankruptcies resulting in liquidation of an enterprise. One may argue: what to do then with population of these areas? There are examples of solving such a problem in the world. For instance, in Europe rural employment dropped 4-fold beginning from 1960 but the problem of rural unemployment was somehow resolved. Russian authorities still prefer to do it at the expense of successful farms: one should understand that employment in farms-bankrupts is primarily supported at the expense of profits received by highly efficient farms and only secondly - at the expense of taxpayers (budget subsidies) and energy consumers from other industries (cross subsidies and restructuring of natural monopolies' debts).

Thus, the most essential problems of agriculture's financial performance are excessive rural population, poor mechanism of bankrupting agricultural enterprises and the lack of strong rural development policies targeted at creating alternative employment opportunities in rural areas. None of these problems is mentioned in the adopted Law. Moreover, the new bankruptcy law adopted during the same session of the State Duma doesn't tackle the problem of rural bankruptcy (having some specifics that need to be addressed by legislators).

One more problem of agriculture's financial performance is the level of prices for basic agricultural commodities. This is an extensive topic and we have no intention to examine it here in full. Still, the efficiency of the recent campaign of restructuring agriculture's debts was undermined by agricultural prices' trend. Many farms that joined the restructuring program in autumn-winter 2001 already in spring found themselves unable to meet their current obligations: due to the limited export of grain domestic prices for it were very low, prices for milk dropped due to the non-coordinated tariff policies of the CIS countries. As a result farms did not receive the revenues that they counted upon when signing the restructuring agreements. In this case too they were made financially responsible for errors in the agrarian policies.

Russian farms urgently need investments but legislators passed the Law on agricultural land transferability that, as noted above, will hinder their growth that has just started. Here again we see that the problem of solvency lies beyond the farm managers' competence.

We could cite many more examples of unsound agrarian policies affecting the efficiency of farm production, but here we won't do it. Our goal is to show that agriculture's financial recovery implies far more than restructuring of debts. Such a narrow view makes the problem perpetual: debts are first restructured, then deferment becomes an actual writing off, then debts are accumulated again and everything is repeated from the very beginning. From 1994 several such cycles have already been completed.

The adopted Law doesn't go beyond restructuring of agriculture's debts. The mechanism is actually the same as the one used during 2001 campaign. The only novelty is an attempt to involve in this process natural monopolies, i.e. the energy and gas concerns (RAO EEC and Gazprom). In addition to debts to budget and non-budget funds, agriculture accumulated debts and penalties to these two organizations. All attempts to involve them in the previous restructuring campaign failed. Now legislators decided that this could be done with legal

means. We find it hardly possible: no law can make a creditor to write off debts if he sees no benefits therein.

But even in case large creditors agree to restructure agricultural producers' debts, the latter will find themselves in even a more difficult situation since small creditors will get an opportunity to recover their debts through bankruptcy proceedings and it will induce them to submit applications to arbitration courts. Thus, after the "financial sanitation" agriculture will face many small poorly predictable creditors instead of few well-known, large and quite predictable ones.

Besides, the procedure of "financial sanitation" envisages the division of all agricultural producers in 5 groups by their solvency. This means that an official without any judicial proceedings will actually declare some enterprises insolvent, and thus many farms that haven't yet been adjudged bankrupt will be deprived of an opportunity to normally operate since no potential counterpart will wish to deal with an entity included into the insolvent group.

In view of the above we have to state that the Law in its current version will hardly contribute noticeably to the farm sector's financial recovery. It can have only one positive effect - people will see at last that the problem's origin is not where it was believed to be for several years. Then there is a hope that the problem will be ultimately solved.

#### Market regulation

For a number of years the market regulation policies demonstrate one remarkable trend: as soon as an agrifood sub-sector makes progress, large players emerge therein and in a little while protective or supportive measures are introduced for this particular sub-sector. For instance, during all the reform years quite profitable and historically record high sugar production has been the most protected agrifood sub-sector. As soon as Russia became a stable producer of grain, grain interventions started. Today the fastest growing agricultural sub-sector is meat poultry production – just the field of the trade war launched by Russia against the US. Finally, meat sub-sector that started to grow recently, at the beginning of 2003 has also succeeded in setting quotas. These developments are in full concord with political economy of the Russian agrifood sector: large producers, private businesses emerge in growing sub-sectors and thus influential groups of interests capable of conducting effective lobbying campaigns are formed. Thus the so called protective measures eventually protect not the weakest links of the food chain but *vice versa* – the most successful ones.

In 2002 the major tools of regulating domestic markets were grain interventions, conducted for the second year in succession.

#### Foreign trade regulation

Foreign trade regulation becomes more and more targeted at import substitution instead of supporting export. It has been shown above that growth in the agrifood sector is slowing down. Further progress will be determined by an increase of real personal incomes that is hindered by expectedly low GDP growth rates, steady rise of population's expenditures on housing, communal and other services, persisting differentiation of consumers by income level (since the demand for food is primarily determined by income trends in the poorer strata). In this situation import substitution will result in sharp agrifood sector's growth within 2-3



2-3 years, and then the boom will be curtailed by purchasing power of population. To further develop the sector will need access to foreign markets but due to protectionism the competitiveness of medium-scale producers will weaken and the country's export potential will be undermined. So, given currently low rates of domestic demand growth import substitution is a way to agrifood sector's stagnation. Today the only opportunity for it to expand is the implementation of aggressive export policies that unfortunately does not take place.

In 2002 the agrifood foreign trade regulation primarily focused on protection of two domestic markets: those of sugar and poultry meat.

The traditional regulation of raw and white sugar markets was effected with the help of the same tools as in the previous years – import quotas and tariffs. Any unbalanced measure entails new and new regulation efforts on adjacent markets. The sugar market regulation is an illustrative example of self-escalating protectionism. The introduction of quota auctions necessitated additional protection of domestic white sugar market – as a result seasonal tariffs were enforced. In 2002 special import duty on caramel was set that will be in effect for 2.5 years. All this leads to higher prices for sugar, shift of industrial consumers to maize sweeteners, import of sugar in the syrup form, etc. That's why there are plans to limit import of sugar syrup in 2003. Later on constraints on maize sweeteners and sugar substitutes are likely.

The auction sale of raw sugar quotas demonstrates its inability to fulfill the set tasks. First, the import of raw sugar in excess of the quota is beyond domestic regulation: its basic determinant is the level of world market prices. In case they are sliding down, non-quota raw sugar is supplied to Russia despite ordinary, seasonal and even special rates of import tariff since low prices make up for suppliers' losses from paying duties. For instance, in 2001 (i.e. already after the quotas' enforcement), imports of raw sugar increased by 18% as compared with 2000 (when there were no quotas) due to the supply of over 1.5 million tons in excess of the quota. Second, the domestic sugar beets production has not undergone any radical changes. The state has no idea of how to support home producers while private investments therein have not yet altered the existing market trends and, besides, negatively correlate with import supply of raw sugar. In case large volumes of cheap sugar are supplied to the country, it's hard to expect that investments in domestic production will grow.

The Ministry of Economic Development has already declared its intention to review the mechanism of sugar market regulation in Russia. This is the basic outcome of auctions conducted for three years. Quotas will remain but they won't be distributed at auctions (just as we advised as far back as 2000). There are three potential ways of distributing quotas so that to really support domestic producers of sugar beets:

- the quota sets the share of processed raw sugar in the total volume of processing at each sugar plant;
- distribution of quotas by companies proportionate to the average volume of quotas purchased by them at auctions in the three preceding years;
- setting of the common upper limit of imports distributed according to “the first come” principle.

The second way would be a form of rewarding companies that fairly participated in auctions. But this way as well as the third one will benefit large sugar speculators while sugar plants may be faced by higher prices. We find the first way to be the most rational since it will be a kind of miller limit that was effective for grain in some European countries in XIX – early XX century.



The auction distribution of import quotas will be discontinued only in 2004. In 2003 3.9 million tons of raw sugar will be supplied within the quota – more than in the two preceding years. However, import duties on both quota and non-quota sugar are elevated.

Meat market was also an object of active state regulation. In March 2002 a temporary ban on poultry imports from the US was enforced. Although in April the deliveries resumed, their volumes were much smaller than before. The bilateral conflict was settled only by September. On September 15, 2002 a new veterinary certificate on broiler meat import was validated that set more strict sanitary and hygienic requirements as compared with the former ones. This measure is rational from the point of view of veterinary control but does not fulfill a protective mission for home poultry producers due to the non-homogeneity of domestic and imported products (see section “Poultry market”).

In 2003 imports of basic meats – beef, pork and poultry – will be limited by quotas.

At the end of January 2003 the government introduced quotas on import of basic meat products: beef, pork and poultry meat. Three principal questions arise in this connection: what is the rationale for their introduction, how will they affect domestic producers and consumers and what will be their impact on Russia’s position on the world markets.

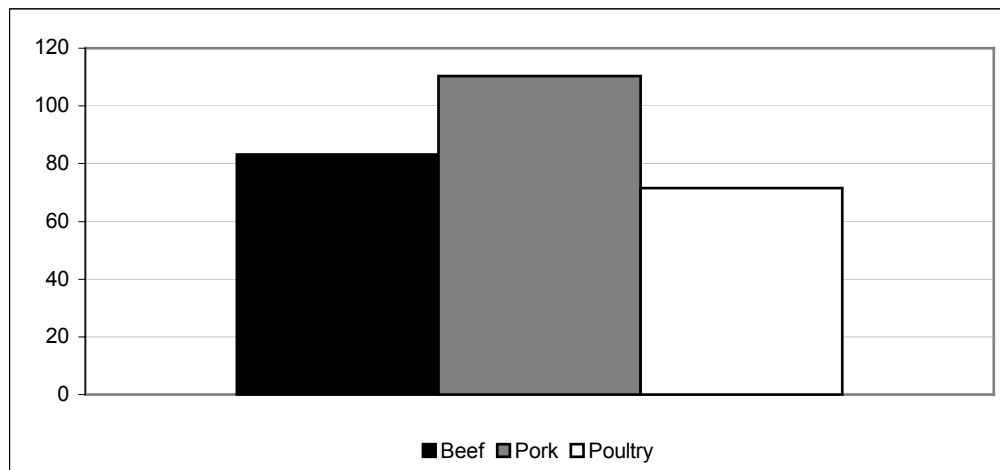
90% of pork and beef import quotas are distributed between countries-suppliers on the basis of previous supplies (proportionate to the average imports in 2000-2002) while the remaining 10% are to be sold at quota auctions. The import duties on supply of these commodities to Russia in excess of the quota will be higher. The import of poultry meat is rigidly restricted by the quota volume that is fully distributed between countries-suppliers proportionate to previous imports.

The size of quotas for 2003 is as follows:

- beef – 315 thousand tons; customs duties on import within the quota equal 15% but not less than 0.15 EUR per kilogram (selected items – 0.2 EUR per kilogram), on import in excess of the quota – 60% but not less than 0.6 EUR per kilogram;
- pork – 337.5 thousand tons; customs duties on import within the quota equal 25% but not less than 0.25 EUR per kilogram (selected items – 0.2 EUR per kilogram), on import in excess of the quota – 80% but not less than 1.06 EUR per kilogram;
- poultry meat – 1050 thousand tons.

The data on meat imports in 2002 is not yet available, that’s why we compare the set quotas with the average import volumes in 2000-2001. It’s easy to notice that the pork quota is quite liberal – it’s above the average 2000-2001 indicators, the beef quota exceeds 80% of the previous import volumes while the poultry quota is most restrictive – about 73% (Fig. 19). Due to the large size of quotas they are not preventive and won’t result in higher prices. Still, an upspring of retail prices is quite possible as a psychological reaction to the mere fact of quotas’ introduction. But their growth won’t be long-term due to the consumer demand constraints.

Formally, the respective normative acts declare that the rationale for introducing quotas is the protection of domestic producers. However, in 2002 the growth rates in all the meat sub-sectors concerned exceeded the average for 4 preceding years that were not the worst ones. Besides, the size of quotas is rather large and they are not to be applied against the CIS countries. This means that the effect of constraints on import from the non-CIS countries can be well offset by gray supplies through the CIS countries. Accordingly, the quota mechanism will hardly support domestic producers.



Source: calculated using provisions of the Government Regulations and the data of RF Customs Committee.

Fig. 75. Quotas as percent of average imports in 2000-2001

Another matter is that this growth led to overproduction, lower prices received by producers and the corresponding worsening of their financial performance in 2002. Still, last year almost all agricultural products were overproduced (e.g. the overproduction problem encountered by milk producers was no easier). In other words, the need to protect just meat producers and just in 2003 is poorly motivated. Besides, protectionist measures of this kind always result in lowering of the sector's competitiveness – one moment quotas are lifted and then domestic producers are left unprotected from foreign expansion, unready for stiff competition.

Quotas could have had sense if they were introduced not in general but against countries dumping their meat on the Russian market. Then it would have been an economically justified measure. In particular, European beef and pork are apparently dumped on the Russian market. Anti-dumping measures against the European meat could have supported domestic producers as well as played their role in the dialogue with the EU concerning quotas introduced against Russian grain beginning from January 1, 2003. Grain quotas restrict Russian export to Europe and thus affect Russian grain producers. The share of groups interested in export of meat to Russia in the EU is supposedly higher than that of groups lobbying restriction of grain imports from Russia, and just a mere threat to introduce meat quotas could have fostered alleviation of grain restraints against our country.

Thus one can conclude that the introduction of meat quotas won't favor development of the Russian agricultural sector. The only positive effect can be the replenishment of federal budget.

The overproduction of dairy products resulted in the excessive supply of butter on the domestic market and lower prices received by milk producers. In October-December 2002 an attempt was made to constrain imports of butter with the help of special customs duty (5% but not less than 0.07 EUR per kilogram) that is to supplement the constant 20% duty.

Export was supported primarily by measures fostering shipments of grain. With this purpose the difference between transport tariffs for internal and export deliveries was diminished, lower tariffs were set for grain shipments in autumn season. The government discusses plans of port infrastructure development. The licensing of sunflower seeds, rapeseeds and soybeans export was abolished although export tariffs on these items remained in force.

At the same time the government hasn't taken any steps to counteract grain import quotas introduced by the EU against East European countries (including Russia) although they severely constrain access of Russian grain to the European market.

#### **3.4.6. Outlook for agrifood sector development in 2003**

On the one hand, positive trends that originated in the country's agrifood sector in the 4 preceding years will stipulate its successful performance in the nearest future: investments will start to bring results, yields and output will become more sustainable to the weather factor, a class of rapidly growing producers highly competitive on both domestic and foreign markets has formed.

On the other hand, factors that conditioned the after-crisis<sup>12</sup> growth are vanishing, the ruble revaluation induces imports, exports become less profitable. The price scissors that reopened in 2002 undermined the sector's financial potential, made it less attractive for investments. The over-production of grain has already resulted in smaller areas planted in winter grains (down almost 13%). As different from other experts<sup>13</sup>, we do not find that this will entail a drastic drop of grain output but it will surely be a constraining factor.

Protectionist measures enforced in 2002 may foster growth but their effect will be short-term and will benefit processors rather than farm producers: agricultural cycle is rather long while market regulation measures are implemented too spontaneously to influence farm production decisions. As shown above, in the medium run these measures can lead only to the agrifood sector's stagnation.

On the whole we can suggest that in 2003 the sector will continue growing but the rate of this growth will hardly exceed 2%. The grain crop will be smaller as compared with 2002 but won't fall below 80 million tons (unless serious natural calamities take place). Growth in the livestock production will slow down due to the limited purchasing power of population. The process of producers' differentiation will accelerate both in agriculture and in the upstream sectors; the number of bankruptcies will increase despite the government's preventive efforts; this will urge steps fostering social development in rural areas. It's hard to expect larger investments in the sector as compared with 2002 implying that farm machinery building has poor chances to grow. Still, it should be noted that here we make general forecasts for the country at large while the situation will increasingly vary by regions, companies and producers, i.e. breakthroughs in specific fields are possible.

### **Appendix 5. Producer support estimate**

Large amounts of budget expenditures on agriculture say nothing about the efficiency of government policies. There are special methods of its estimation. These are indicators based on the comparison of current domestic prices for agricultural products with prices on similar markets that adequately reflect alternative production costs, i.e. with prices assumed to be equilibrium. When calculating estimates of state support to agriculture, it's customary to assume world prices for similar products to be the equilibrium ones. This approach is based upon the presumption that given no state intervention and free competition on domestic and foreign markets, prices thereon would be the same without any spread.

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<sup>12</sup> The 1998 financial crisis.

<sup>13</sup> See, for instance, *Agribusiness*, № 1 2003, p. 58.



As a result of state policies implemented in specific countries such a spread appears. Its positive value implies support to domestic producers, negative – their taxation.

The most widely applied coefficient of such a kind is *producer support estimate (PSE)* that gives the most comprehensive estimate of the state support level. This indicator does not require calculating of value added and thus is simpler to compute.

The PSE indicator includes two components: *direct support*, or *budget transfer* (i.e. budget expenditures on supporting agriculture) and indirect support otherwise called *market price support*, or *price transfer (MPS)*. MPS reflects the spread between domestic and reference prices.

$$PSE_i = (P_i^d - P_i^b) + (S_i - T_i),$$

where  $P_i^d$  – domestic price for  $i$ -product,  
 $S_i$  and  $T_i$  – direct subsidies and taxes,  
 $P_i^b$  – reference price.  
 $(P_i^d - P_i^b) = MPS$  - market price support,  
 $(S - T)$  – budget transfer.

Here we'll examine percent PSE – the ratio of PSE money value to the sum of gross agricultural producers' money receipts from marketing their output at domestic prices and budget transfers received by them.

$$PSE\% = \frac{PSE}{\sum_i P_i^d Q_i + (S - T)} * 100\%,$$

where  $\square P_i^d Q_i$  – value of marketed output in domestic prices,  
 $S$  – subsidies to producers,  
 $T$  – taxes paid by producers.

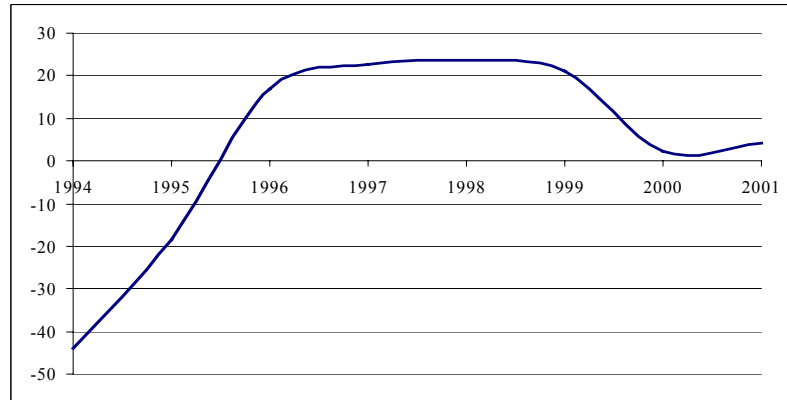
In 1994 PSE started to grow and since 1996 became positive. Greater support level was provided by introduction of protectionist measures in foreign trade and by some shifts in infrastructure development. In 1995 PSE grew due to the sharp increase of direct budget transfers.

After the 1998 ruble devaluation Russian agricultural producers' performance improved despite lower budget support since their output has got competitive advantage over imported products. In 2000, when favourable crisis' aftereffects vanished, PSE dropped sharply. In 2001 it started to rise again evidencing that producers managed to build up a certain growth potential. Besides, 2001 was the first after-crisis year when budget subsidies to the sector enlarged. Still, the level of state support to agriculture in Russia remains below that of other countries. For instance, in other transitional economies PSE ranges from 10 to 20%. In 2002 price situation was unfavourable for agricultural producers and one can expect that PSE will fall again since the market price support (MPS) reflecting spread between domestic and the world prices was down while budget transfers did not increase.

Pictures 77 and 78 show PSE levels for selected products in 2000 and 2001. During these years the bulk of budget subsidies was allocated to livestock sector. In 2000 PSE indicates inefficiency of beef production support since positive budget transfer did not offset negative market price support. Negative PSE for milk was also due to low prices received by producers. In 2001 market price support for all livestock products becomes positive and PSE accordingly grows.

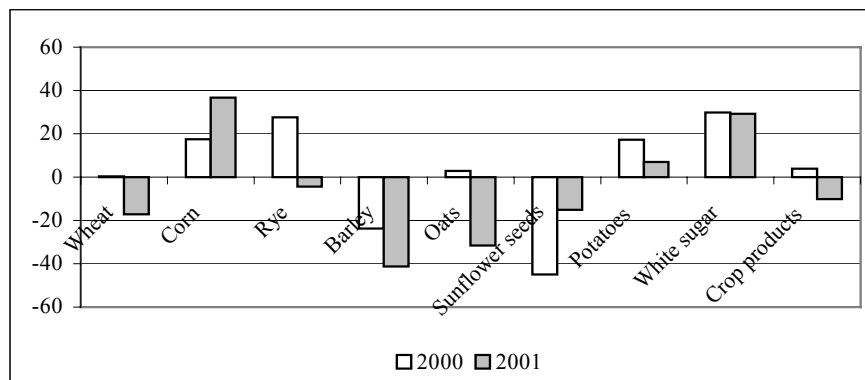
Meanwhile, the trend for crop products is opposite – PSE decreases as compared with the previous year. The overproduction of grains resulted in lower purchase prices and respectively market price support for most of them became negative. Budget transfers did not offset

negative MPS values evidencing inefficiency of crop production support programs (and first of all that of state leasing) in 2001. The state support level for corn remains high due to the high domestic and relatively low world prices for this crop.



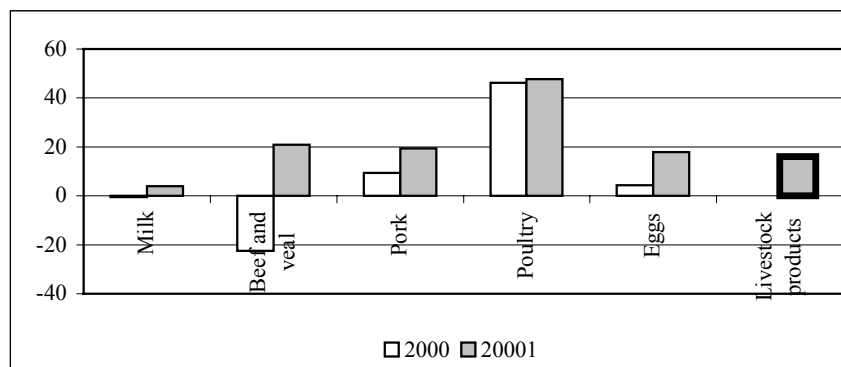
Source: own calculations.

Fig. 76. Russia: producer support estimate (PSE) in 1994-2001



Source: own calculations.

Fig. 77. Crop production: producer support estimate (PSE) in 2000-2001



Source: own calculations.

Fig. 78. Livestock production: producer support estimate (PSE) in 2000-2001

## Section 4. Institutional and Macroeconomic Challenges

### 4.1. The Dynamics of the Privatization Process in Russia

As the name suggests, the entire period of the so-called ‘cash’ privatization (from 1994 until now) was primarily influenced by budget considerations and it was not uncommon for biggest and most important deals to get governmental approval only by the end of the year, incidentally also the time for reconciliation of budget revenues.

All the more heartening that since 1999 the government at least no longer expects on receiving a fixed amount of revenue from privatization, which hopefully would translate itself into a sounder privatization policy.

Table 1

#### Revenues from Sale and Use of State Property between 1995-2003 (in current terms<sup>1</sup>)

	1995	1996	1997	1998	1999	2000	2001	2002	2003 (est)
<b>Actual Number of Privatized Enterprises</b>									
	6000	5000	3000	2583	595	320	170	2200 (planned)	1063 (planned)
<b>Revenues from Sale of State Property (non-renewable source) in billion Rubles</b>									
Approved Budget in rubles	4,991 all revenues	12,3 all revenues	6,525 all revenues	8,125 (c)	15 (e)	18	18	35	51
Actually Received Funds in rubles	7,319 (a)	1,532	18,1 (b)	15,442 (d)	8,547	31,368	10,11	91,2 (f)	-
<b>Actual Revenues from Use of State Property (renewable source) in billion Rubles</b>									
Dividends on Federally-Owned Stakes in Enterprises	92,8	118 (35 JSC)	270,5	575 (200 JSC)	848 (600 JSC)	3,675 (1050 JSC)	6,478	10,25 (708 JSC)	10,5
Payments on Lease of State Property	116,7	N.D.	305	466	2,191	3,427	4,896 on assets 3,917 from land	7,843 on assets 2,3 from land	7,3
Revenues (profits) from State-Owned Enterprises	-	5	26	783 from Vi-etsovpetro (VS)	5,675 from VS	11,687 from VS	13,622 from VS; 209 from 131 State Unitary Enterprises	9,9 – VS .9 from 809 State Unitary Enterprises	12,3 – VS, 2,5 from State Unitary Enterprises
Total	209,5	123	610,7	1,824	8,714	18,789	29,122	31,19	-
<b>Cumulative Revenue from Use and Sale of State Property in billion Rubles</b>									
Actually Received	7,529	1,655	18,702	17,266	17,262	50,157	39,233	122,39 vs. 70,6 planned	-

Since 2001 another positive trend regarding state property and its effect on the budget came with a shift of reliance from non-renewable to renewable sources of income. In other words instead of receiving big one-off sums for selling its property the government is now

<sup>1</sup> a) approved budget was adjusted in December 1995, 70.8 % of actual revenue came from share-for-loans auctions; (b) including US\$1.875 billion from sale of stake in Svyazinvest holding; (c) adjusted to 15 billion rubles in April 1998 (on governmental level); (d) including 12.5 billion rubles from sale of 2.5% stake in Gazprom; (e) from 1999 funds from privatization are not included in the budget revenue; (f) includes .775 and 1.86 billion from the sale of state stakes in Lukoil and Slavneft respectively

more keen on extracting stable revenue via retaining and better management of its assets. Thus in 2001, 75% of government's cumulative revenue from its property (includes sale and use) came from renewable resources, whereas in 1997 that number amounted to only 3%. Encouragingly enough the trend continued in 2002 and the government's revenue from renewable resources 3 times exceeded the sums received from privatization (excluding a deal on Slavneft and Lukoil shares which remained uncertain till the end of the year).

Preliminary 2002 data from the Ministry of Property the cumulative budget revenues from use and sale of state property amounted to 122.39 billion rubles, three times the number from previous year. Cumulative income from use of state-owned property came up to be 31.19 billion rubles including the 7.8 billion from property lease, 10.25 billion from dividends on state-owned shares, 9.9 billion from the shares in Vietsovpetro, 2.3 billion from lease payments on federally-owned land and 0.9 billion from profits in state unitary enterprises. In the meantime revenues from sale of state property in 2002 were only 91.2 billion rubles with more than 80% of that sum coming from 2 large deals in (surprise!) December of 2002 (sale of stakes in Slavneft and Lukoil). Sale of state-owned land brought in .6 billion rubles.

Although the new privatization Law came into force only in 2002 much of the privatization program for the year is based on changes introduced by this legislation. Thus the privatization program expects that thanks to a row of newly available methods of privatization the government would be able to get rid off its minority stakes and illiquid holdings and thereby drastically reduce the number of entities in state ownership, a goal that has been widely discussed since the mid-nineties. This should also apply to state unitary enterprises a number of which, especially with November 14, 2002 enactment of Law on State and Municipal unitary Enterprises, is expected to be cut to 2.5 thousand by the end of 2003. In addition, re-organization of such enterprises (mergers, liquidations, incorporation, partial sale, etc) would also affect their subsidiaries.

However ambitious the Property Ministry's plans appear at a first glance, most of actual privatization revenues come from large individual sales. Often, final decisions on whether to put a particular enterprise up for sale are made abruptly and arbitrarily, regardless of an approved privatization plan. At the same time sale of other enterprises can be put off a year after a year, and similarly, a deal on a verge of being closed can be cancelled at the last moment.

In 2002 state-owned stakes in the following enterprises were expected to go for sale: Lukoil (5.9%), Slavneft (19.68%), Eastern Oil Company – EOC (36.817%), Svyazinvest, a telecom holding (25% minus 2 shares), Vorkutaygol (38.41%), Magnitogorskii Metallurgic Plant (17.77%) and a number of others.

On May 24, 2002 results of the EOC auction were announced and Yukos' victory did not come as a surprise. Since Yukos is already a majority stakeholder the final bidding price exceeded the starting bid (\$225 million) by only \$.4 million. Conveniently, TNK, Yukos' main contender made a decision to withdraw from the auction following a scandalous court row and, also, perhaps, due to an understanding that Yukos was unlikely to let go of shares of EOC subsidiaries.

State-owned 5.9 % stake in Lukoil was planned to go up for sale in the form of ADR on London Stock Exchange in August 2002. The Board of Directors presiding over Privatization Project Company, an outfit responsible for the sale deemed the price offered at the time too low (close to current price offered at the Russian Stock Exchange) and suspended the sale. The stake was finally sold in December 2002 for what some sources cite was a maximum feasible price of \$15.5 per share with demand outstripping supply by a factor of 2 and the Rus-



sian government walked away from the deal with a total of \$775 million. It still owns a hefty 7.6% in Lukoil and has no immediate plans to sell the stake, although any decision to do so would obviously depend on the world oil prices as well as the company's success at restructuring.

Sale of government's stake in Svayzinvest, a telecom holding was also scheduled for 2002 but did not go through and is now included in the 2003 privatization plan. A need for further consolidation of the holding and creation of 7 interregional operators, which would be completed only by the end of 2002 were cited as possible reasons for the sale postponement. In addition, the government hopes that a tariff reform would help the company raise its capitalization, and with it the value of state stake in the company.

Table 2

**2002 Privatization Program**

	<b>Total number of Entities in Possession of the Russian Federation</b>	<b>% of total registered in the Russian Federation</b>	<b>Designated for Privatization in 2002 (2001 Privat'n Plan)</b>	<b>Additional list of Privatization Designated Entities from the new Law</b>
Federal <i>UNITARY</i> Enterprises (FUE) Total FUE 20,000, and 65,000 municipal	9394 (9708 as of October 2002)	12	152	1500
Joint Stock Companies with shares owned by the state	4407	9	426	700
Including state stakes of:				
100%	90	-	6	-
above 50%	646	-	33	-
25-50%	1401	-	127	-
25% and less	2270	-	260	-
<i>GOLDEN</i> share	750	-	-	-

Source: data from the Ministry of State Property, and the currently updated Property Registrar of the Russian Federation. Data from this Table can be compared with data from September 1, 2001: 9855 federally owned *UNITARY* enterprises and stakes in 4308 joint stock companies. Some sources claim that the number of joint stock companies with state stakes exceeds 6,000 far from completion and creation of Federal *UNITARY* Enterprise Registrar.

A more complicated story concerns the sale of state-owned 19.68% stake in Slavneft. Initially, a simple auction was scheduled for October-November 2002 with an expectation that it would raise somewhere between \$300-350 million. The mechanism of sale, however was subsequently changed several times and scandals involving changes in Slavneft management all but guaranteed a 'delicate' nature of the deal. First of all, the stake in Slavneft was the last Russian oil company where a major state-owned stake was offered for sale (the government has not plans to privatize Rosneft anytime soon). Add to that a bitter feud between various industrial and financial clans, an "international" element brought in by the Belarusian-owned stake of 10.83% and here is a Russian privatization drama.

Prior to the privatization, the Russian government owned 75% of Slavneft shares (55.27% were held by the Ministry of Property, 19.68% belonged to *RFII*). DKK, a closed joint stock company owed another 13.18% (Sibneft and TNK owed 25% each of the remaining stake and the rest of the shareholders are unknown).



The battle for the government's stake fired up well before the start of the auction. In April, 2002 Mr. Gutziriev was replaced from this post of President of the company by Mr. Sukhanov who was widely seen as a Sibneft favorite. While the government was busy discussing various models for privatization of Slavneft, Sibneft and TNK were buying up shares of Slavneft subsidiaries. Such acquisitions (blocking stakes in Yaroslavnefteorgsintez and Megionneftegaz among others) allowed TNK and Sibneft not only send an unambiguous warning to potential rivals but also gain considerable leverage for making changes in the Board of Directors and issue additional shares. Control over subsidiary companies also reduces a risk of harsh competition for buying up the holding company itself and lays out the necessary groundwork for consolidating the companies' shares and ultimately obtaining a controlling stake in the future.

The government in the meantime has reconsidered its initial plan to sell only 19.69% of Slavneft stake thus retaining government control and changed a scenario in favor of what some experts argued was going to be a more transparent and competition-enhancing deal of selling an entire controlling stake of 74.95%.

Sadly when the sale did go through on December 18, 2002 competition hardly triumphed. The 74.95% stake of about 3.5 billion went to Investoil, a Sibneft's and TNK frontage for \$1.86 billion, a merciful increase over the starting price of \$1.7 billion and significantly below expert estimates of \$2-4 billion. Although the high end of that range was probably exaggerated given the TNK and Sibneft control over major stakes in Slavneft's subsidiaries, a fair auction and a higher return for the government could have taken place.

Even a faintest chance for competition was eliminated when TNK's and Sibneft's main possible rivals in the bid, Lukoil, Surgutneftegas and Yukos withdrew literally on the eve of the auction. The spokespersons for the companies muttered something about unexpected financial and legal difficulties. Rosneft's participation in the auction (legally murky from the very start, it is after all a state-owned company) was ordered to withdraw by a regional Court. CNCP, a Chinese petroleum company and potentially the most dangerous rival was also forced to pull out under threats that its victory would be deemed invalid. Apparently the government suddenly changed its initial zeal to attract foreign bidders to the deal. All in all, 7 companies withdrew from the auction and the 7 remaining were in one way or the other affiliated with the interests of TNK and Sibneft. Clearly, large privatization deals in Russia remain beyond mere economics, while political muscle still generates a lot more than simple respect.

As a result of the auction, the two winning companies now owe 98.96% of Slavneft shares. Although at this point it is unclear what kind of re-structuring the new owners plan to undertake, their attitude to minority stakeholders is obvious. Article 80 of the Law on Joint Stock Companies clearly states, than a majority shareholder (30% of shares and above) must make an offer to purchase shares from minority shareholders at a price no-lower than a 6 month weighted average. The new majority shareholders at Slavneft, however, intend to avoid the 'cumbersome' procedure by pushing for an appropriate vote in the general shareholder meeting.

Such unfair moves could be forestalled with right changes in the Law on the Joint Stock Companies that would specify minority shareholder rights in cases of mergers and buy-outs of 95% of shares and above. A similar law is already planned in the European Union.

The government approved the new 2003 privatization plan on August 20, 2002 (amended on October 9, 2002), according to which the revenue from privatization in 2003



should amount to about 51 billion rubles. Please see table 1 for details on renewable sources of income. Land privatization is expected to generate approximately 2.2 billion rubles.

The privatization plan also calls for sale of 628 joint stock companies (including 598 joint stock companies, or 95% from the total thus completing the privatization process) and 435 Federal unitary enterprises (fue). The remaining state-owned joint stock companies would continue to have state ownership of 51 and 25.5% of charter capital respectively (this sentence makes little obvious sense). fue, privatization of which is considered at the Ministry for Property as a primary goal for this year, would be re-organized into joint stock companies or sold in their entirety as commercial or industrial complexes.

In 2003, joint stock companies and fue in the agrarian, energy and defense industries would be affected the most.

In the energy sector, the plan calls for sale of government stakes in oil and gas companies, electricity generation and transmission enterprises as well as a completion of privatization of the coal-mining sector.

Most of the agrarian sector is already in private hands and the plan focuses on further privatization of baking and food storage companies.

A number of enterprises listed in the 2003 privatization list are in the maritime and auto transport industry.

Some of the larger planned privatizations concern the sale of government stakes in Svyazinvest (25.5% minus 2 shares), Magnitogorsk Metallurgic Plant (17.84%), commercial port Pevek, Baikal airline, etc.

The government also plans to divest of its stakes in 600 (714 apparent) commercial banks, a majority of which (about 80%) are currently held by the Ministry of Property.

Beside launching of a whole row of new privatization models, the new 2001 Privatization Law brought about another interesting innovation specified in the December 3, 2002 Governmental Decree # 845. The Law now allows exchange professionals (i.e. brokers and brokerage companies) to take part in privatizations, who for instance, can win a right to represent the government when it tries to sell its stakes on the market. A well-meaning innovation, granted of course, that the selection process for a market intermediary is based on objective professional factors and not on a whim and fancy of a bureaucrat in charge.

## **Appendix 6. New Privatization Methods and Their Legal Provisions**

The numerous changes proposed by the 2001 Law on Privatization acquired a more concrete shape by summer of 2002.

On May 31, 2002 the Russian government passed a Decree On Affirmation of Rules for Determining a normative Price for Privatization of State and Municipal Property. normative price is defined as a minimum price at which state divestiture of a particular piece of property is acceptable.

According to the aforementioned decree, such normative price for privatization of a federal unitary enterprise has to be based on figures from an interim accounting report prepared in compliance with Russian legislation on privatization of clean assets belonging to a state unitary enterprise. That includes the following guidelines:

- a) value of land that is a part of an enterprise being privatized has to be calculated in accordance with norms and regulations envisaged by the Russian legislation for purchase of land plots

- b) value of a stake (share, contribution) to charter (*joint*) capital of enterprises as short-term and long-term financial contributions has to be calculated on the basis of the normative price for the said property;
- c) value-added tax has to be levied on assets purchased as a result of privatization
- d) book value of assets that are not covered by a privatization deal should not be included in the calculations
- e) Expired debt obligations should not be included in the price calculations

Normative price of a unitary enterprise calculated for its transformation into a joint stock company can only be used for determining a share price of the newly created venture.

If no more than a year passes by since the date of a jsc registration (transformed from a unitary enterprise) and till the date when a normative price for its shares is determined, the latter shall be adjusted by multiplying the normative price of a firm's assets by a proportion of state-owned shares intended for sale, lawfully determined control coefficient and "golden share."

Otherwise, i.e. more than year passes by since the date of a JSC registration till the date when a normative price for its shares is determined, or if a firm has not been transformed and registered as a jsc, then a normative price for its assets intended for sale is equals a weighted average of the following figures in a company's last accounting report (value of shares based on net profits, value of shares according to sales results, market value of shares, and book value) multiplied by a "golden share" coefficient.

A government decree #512, from July 9, 2002 lays down the **rules for establishment of terms and condition for privatization of federal property**. The decree states that in establishing of these rules the government first has to specify a list of all federal property it intends to privatize, methods it expects would be used for that purpose, estimated revenues as well as other information necessary in the process.

The decree imposes the responsibility for preparation of the aforementioned information on the Ministry of Property and its regional offices, which have to consult with Russian Federal Property Fund in issues pertaining to a preferred method of privatization.

In addition, the Ministry of Property also has to specify any obligations/conditions imposed on a prospective buyer of a particular federal property as well as future use of federal property ineligible for privatization.

Naturally, all Ministerial decisions for privatization of a particular asset have to correspond with the annual general privatization plan. Should a first attempt at sale of a federal asset fail, the privatization method shall be re-considered or a decision to privatize it be cancelled altogether.

Details pertaining to sale of state and municipal property via public offering with and without prior price announcements are provided by a July 22, 2002 eponymous governmental decree #549.

According to the Article 23 of the Privatization law, **a sale of state and municipal property via public offering with prior price announcement** shall proceed only if an auction for a property in question was deemed invalid. In these cases an auction organizers have to announce the following: a starting maximum price, time period during which lower bids are accepted and a minimally accepted 'cut-off' price at which a federal/municipal property can be sold. In addition, the starting maximum price can be set lower than a starting minimum price of a previous auction that was deemed invalid. A normative price for such fed-



eral/municipal asset equals 50% of a starting bid of a previously held auction that was deemed invalid.

A federal/municipal property sold via such public offerings is awarded to a first bidder whose offer equals the starting maximum price. If no such bids are submitted, then the price is lowered within the appropriate period specified in the initial public announcement. In these cases, a first bid received in the amount specified by the new starting price wins. Upon the registration of the first appropriate bid, no other bids are admitted. The price can be lowered successively down to a cut-off price.

According to the Article 24 of the Privatization Law, a **sale of state or municipal property without prior price announcement** can proceed only if a property was not sold via public offering with a prior price announcement. In these cases, normative price of such enterprise does not have to be calculated.

A purchase deemed valid and a buyer is recognized in the following instances:

- a) Only one bid was submitted and he/she was the bidder
- b) Several bids were submitted and he/she submitted the highest bid
- c) Several bids were submitted, all with the same offers, and he/she submitted their bid first, prior to others

Should no bids be submitted a legally allowable period, or no bids were accepted for consideration, such sale is annulled and a record of that is included into final sale report.

On August 12, 2002 the government passed another decree (#585) this time specifying the rules for auctions of state and municipal property. According to the Article 18 of which an enterprise can be offered for sale via an **auction** only in cases when a future owner is to have no obligations concerning the property. The property is to go to a highest-bid participant. Such auctions can be held either publicly or carried out via submission of bids in written form.

The Article 19 of the Privatization Law states that a **specialized auction** is a sale of shares at an open auction during which all winners receive the shares of a purchased enterprise at one price per share, which has to be calculated in accordance with the following rules:

- a) only bids/offers submitted by the eligible participants of a specialized auction can be considered in the final price calculations
- b) the final price must be equal to a maximum share sale coefficient, which in its turn, equals to a ratio of a number of shares being bought at the auction to the total number of shares made available for sale.

The share sale coefficient can be no lower than .95. Each winning participant of a specialized auction receives a number of shares that corresponds to the ratio of an amount he/she specified in his/her submitted bid to a final price per share.

Another governmental decree# 584, signed on August 12, 2002 details rules and regulations pertaining to the sale of state and municipal property via **tender**. According to Article 20 of the decree, an entire enterprise or its shares in the amount exceeding 50% of its charter capital can be sold via a tender in cases, when an eventual buyer has to carry certain obligations as to its purchase. An eligible participant with a highest bid wins a tender. Tenders with participation of only one bidder are deemed invalid. In cases when two or more highest bids are equal, an enterprise in question is awarded to a bidder who submitted his/her bid prior to others.

A buyer's obligations as to a tender purchase may, for instance, require the following:

- retaining of a certain number of employees

- providing re-training or professional development opportunities for an enterprise's employees
- restrictions on changing a type of industrial/commercial activity; or restrictions on cancellation and/or launch of certain types of communal services of, for instance, transportation, educational or similar nature
- repair, restoration and/or upkeep of certain important objects of cultural/historic heritage or high communal service value

List of conditions/obligations imposed on a buyer of particular enterprise offered on a tender shall be complete and not subject to change. A new owner of such enterprise shall take no longer than a year for delivery of obligation imposed on it by the tender.

Sale via a tender of joint stock companies gives its buyer a right to cast votes according to the number of shares he/she purchased at the company's shareholders meetings even before an official transfer of the deed. Such right for early vote-casting, however, excludes voting on the following subjects:

- changes and/or amendments to a company's founding charter documents
- divestiture, giving up as a collateral or lease or other such measures able to cause a divestiture of a company's assets, if these assets exceed 5% of a company's charter capital or 50,000 times federal minimum wage
- giving up as a collateral or divestiture of a company's real estate
- securing a loan in the amount exceeding 5% of a company's free assets
- subsidiary creation
- issuance of securities not convertible into a company's shares
- approval of a company's annual reports, accounting records, profit and/or loss statements as well as decision on distribution of profits and/or losses

In addition, a buyer is precluded from early voting on issues pertaining to a company's re-structuring and/or liquidation. Prior to fulfillment of all tender imposed obligations, a company's shareholders may not make decisions altering a company's charter capital, new share issuance and other securities with a potential to be converted into a company's shares.

On the other hand, a newly purchased joint stock company may not make the following decisions prior to the official transfer of an ownership title to a tender winner without his/her approval:

- reduce number of a company's employees
- sign off on a deal, or a combination of deals, whose total value exceeds 5% of a company's assets book value according to a last accounting report or 50,000 times a federal minimum wage;
- sign off on a deal, or a combination of deals that may directly or indirectly lead to a divestiture of a company's assets in the amount exceeding 5% of a company assets book value according to a last accounting report or 50,000 times a federal minimum wage;
- secure loans
- issue securities
- create subsidiaries or wholly new companies as well as purchase or divest of their shares/stakes in charter/joint capital of such companies

Should a new owner fail to timely deliver on any of the obligations in accordance with the terms and conditions specified by a tender, the contract of purchase of a state property



shall be terminated upon the parties' agreement or in accordance with a court's decision. In addition, the delinquent party shall be subject to payment of an appropriate penalty, and shall cede all authority as to his/her purchased assets, which are to be transferred back into the state ownership.

Details on **Lease of federal property with a subsequent right for its purchase** are specified in an eponymous September 25, 2002 governmental decree # 707. The said decree specifically regulates all federal property lease agreements that were signed prior to enactment of a 2001 Federal Law on Privatization.

According to the decree, a lessee of federal property may submit a request to purchase it to a local office of the Ministry of Property. The latter shall within the following 2 months consider a request, retain an independent valuator and render an appropriate decision. If an independent valuator values a property at 10,000 times federal minimum wage or less the lessee's purchase request shall be approved.

If a property, however, is valued at more than 10,000 times federal minimum wage, a local office of the Ministry of Property shall propose the lessee to create a joint stock company, with the property in question becoming a government's contribution to the charter capital. The lessee may, in its turn, contribute assets obtained as a result of the lease of state property or any other assets in its lawful possession.

Should a lessee agree to that proposal, a local office of the Ministry of Property, shall in a month's time review all relevant documentation submitted by a prospective buyer and in its turn prepare relevant paperwork for registering the property as a contribution of the Russian Federation towards a new company's charter capital. The lessee and a new co-owner of the property shall have a primary right for buying the state's stake in the company.

Although the government has provided details for use of 6 out of 10 privatization methods made available by the new Law on Privatization, the remaining 4 methods still require further clarification and detailed legal base for their successful application. The need for further legal guidance is made especially apparent by the fact that these 4 remaining methods are the least familiar in Russia but potentially the most attractive privatization models in the eyes of many prominent interest groups:

- 1) sale of Russian government stakes in foreign joint stock companies through issuance and underwriting of depositary notes
- 2) sale of state-owned shares of joint stock companies through brokers
- 3) contribution of state-owned property towards a company's charter capital
- 4) sale of state-owned shares of joint stock companies upon results of trust management.

## **4.2. Key Issues for Improving the Current Privatization Legislation in the Russian Federation**

By 2003 the legal base for property reform in Russia has matured and acquired a wealth of new legislative acts and presented a marked contrast to the state of the affairs back in the nineteen nineties.

A bitter confrontation between the Legislative and the Executive branches of the Russian government led to a situation where the privatization's key objective (structural reform enforcement and establishment of an institutional framework for property transformation) was carried out single-handedly by the Executive through its ability to pass decrees such as for

instance, the Presidential decrees on Voucher Model Establishment, Loans-for-Shares Auctions, etc. The 1997 Privatization Law was aimed to resolve the conflict and officially leveled the Executive and the Legislative ability to affect the privatization process.

The confrontation, however, did not fully subside since certain poorly drafted parts of this well-meaning law rendered it practically unenforceable. The government's attempts to circumvent the inopportune piece of legislation proved futile and by the end of the nineties the privatization process had slowed significantly, although other objective reasons (please see next paragraph) were also responsible for the trend. Despite the slowdown however the government's task to raise funds via privatization kept more or less on track (please see Table 1, Chapter on The Dynamics of Privatization Process).

The aforementioned deceleration in the privatization process also had its objective roots in the nature of the "left-over" state property that placed certain limitations on its investor attractiveness. Thus most of these enterprises either offered only minority share packages and were unattractive because of an already formed majority-vote shareholder control; or offered a majority package, appeal of which however was undermined by enormous investment requirements.

On the other hand, attractive and potentially lucrative opportunities that offered controlling or blocking stakes in national monopolies now had to be pursued in a competitive market and bought at a market-set price with strict adherence to all legal norms which also decelerated the process of privatization.

In 1999-2000 the changes in the political landscape of the country saw an end to the long-standing dispute on privatization between the two branches. On December 21, 2001 the conflict was resolved by yet another law on privatization, this time titled, the Federal Law on Privatization of State and Municipal Property, # 178.

The new law came into force on April 26, 2002 (only 3 months after the day it was first published) and its approval by the Federal Council (Russia's Upper Legislative Chamber) was made possible thanks to a compromise that divided the power to privatize between several governmental layers. Thus privatization of all so-called strategic enterprises as well as decisions for including an enterprise into a "privatization forbidden" list were to be made by President. Privatization of big natural monopolies, such as Gasprom, RAO UES and Federal Railroads was assigned to the Federal Council and required enactment of a separate law, while jurisdiction for all other federal enterprises was given to the government. Municipal and regional properties were to be privatized by local authorities.

In general the law provided for 10 various methods for privatization, based on an enterprise's size, liquidity and/or results of initial sales:

- 1) transforming a closed, single-owner enterprise into a publicly listed company;
- 2) sale of state and/or municipal property through actions
- 3) sale of shares of publicly listed companies through special auctions
- 4) sale of state and/or municipal property via tenders
- 5) sale of state-owned open joint stock enterprises abroad
- 6) sale of shares of open joint stock companies through brokers and exchanges
- 7) sale of state and/or municipal property via Dutch-style auctions open to general public (where final sale price or the cut-off point is exactly a half of the price offered at the onset of the auction)
- 8) sale of state and/or municipal property without disclosure of target prices (should it fail then the sale proceeds via Dutch-style public auctions)



- 9) incorporation of state and/or municipal property as charter capital contributions for open joint stock companies
- 10) sale of share of open joint stock companies in accordance with results of trust management with a subsequent right to buy shares.

In addition, under the Law state-owned share packages whose value at the time of sale exceeded 5 million units of minimum wages (annual?) were to be privatized only by means of becoming a joint stock companies via auctions, specialized auctions, sold abroad, or in accordance with terms and condition specified in the presidential decrees, by contributing of federally owned assets to the charter capital of a strategic joint stock company.

All other types of state properties could be auctioned off, turned into joint stock companies, tendered, or privatized by contributing shares to charter capital, etc. Should a first attempt at a tender and/or an auction be deemed invalid, due, for instance, to a lack of bidders, the Law allowed for the pursuit to continue through other privatization methods described above.

The 2001 Privatization Law undoubtedly introduced important new mechanisms for transferring state assets into private ownership. Thus the Law officially recognized that: a) land of a privatized enterprise constituted an integral part of a privatized property; and b) intellectual property could be counted as a contribution to a charter capital.

By and large the new Law upheld a view, a traditional one of late, that privatization must maximize its fund-raising utility by concentrating on big-ticket sales pursued with individual strategy based on prevailing market conditions and use of newly available methods of privatization.

The next two to three years should demonstrate whether these newly devised methods of privatization provided by the Law are successful and conducive to the government's overall aim of financial stability, maintaining budget surpluses and ensuring that its revenue sources are diversified and do not run dry even in the event of tumbling oil prices and peak external debt servicing. The first such results can come as early as in the current 2003, the first year in which the legislation can be applied in its full spectrum.

In theory, the variety of models for privatization should boost growth, hearten institutional reform, cut government's costs and help it get rid off illiquid assets while stimulating a minimum demand from individuals and small businesses. Encouragingly enough, the experience with privatizing a number of enterprises since 2000 demonstrates that given a continued economic growth and enough political will the government may indeed reap significant benefits from new privatizations.

Because transferring assets into private hands will not merely cut government's costs but also create new holding-type structures that would promote competition and growth in a number of key industries such as defense, research and development, transport and communications. Unfortunately, such hopeful prospects stand less assured for small and medium-sized companies, which in all likelihood would remain bogged down by taxation and administrative barriers.

Lastly, the inclusion of an enterprise's land under its privatization as well as a revamped access to market financing give reasonable hope that investment will indeed be followed by a much-needed restructuring. Please see more on the subject of new privatization models in the attachment to the Chapter on The Dynamics of the Privatization Process.



In spite of the number of aforementioned positive *technical* advances the Law fails to lay out a comprehensive *strategic* vision of how the privatization process should be pursued and what indeed it hopes to achieve.

Such long-term strategy, for instance, should first of all, in addition to overall budget goals, outline which enterprises in which industries would not be subject to privatization whatever the circumstance. Only upon determining a list of these off-privatization enterprises should the government decide which remaining entities go for sale in the short-, medium- and long-term based on an enterprise liquidity status.

The 2001 law also falls short of curing some of the biggest “headaches” of Russian privatization such as transactions transparency and lack of buyer equality in the conditions of systematic corruption – issues that obviously should come to the forefront of any technical aspects of the process. Sadly this lack of focus on bigger picture means that the Law is riddled with a number of loopholes a detailed account of which is provided below.

A first questionable innovation brought about by the Law concerns the abolition of a previous 1997 requirement to annually pass a federal law specifying a list of enterprises available for privatization in the next year, as well as expected terms and conditions for their privatization. That, in effect, takes the Duma out of the decision process and grants the executive an exclusive right to determine annual privatization program.

Curiously enough the law officially lifted another 1997 requirement for setting up separate list of enterprises that must remain in federal control, thereby giving a misleading impression that no enterprise may be beyond the privatization’s reach. The impression is false because deeper in the body of the Law, article 6 line 43 to be exact, it clearly states that unless legally specified otherwise, all state property that had been included into the privatization-banned category up to January 1, 1995 (date of enactment of the 1<sup>st</sup> section of Russia’s Civil Code) must remain in the same.

Thus the new Law in effect upheld the 1993 privatization program, which banned privatization for 44 categories of enterprises over the less restrictive 1992 program, which did the same for only 22 categories.

Secondly, just as its 1997 predecessor the 2001 Law also failed to provide clear selection criteria for enterprises for which privatization is banned on the grounds of their strategic importance, because goods and service they produce are essential for national security. With an aim of policy consistency in mind the 2001 Law instead entrusted the government with an authority to form lists of such strategic enterprises and then subject it to approval by the President. The definition of a strategic enterprise included all federal enterprises and state-owned joint stock companies which produce goods and services essential to national security, public health and morals (hereinafter referred to as strategic enterprises and strategic joint stock companies respectively)<sup>2</sup>.

If earlier these strategic privatization-banned category amounted to approximately 700 enterprises (211 enterprises and 495 joint stock companies) the new list may be cut in half. With respect to joint stock companies and perhaps also unitary enterprises which undergo incorporation the new Law introduced one important criteria: to qualify as a strategic entity the

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<sup>2</sup> Earlier these enterprises were included either in a 1996 List of Defense Enterprises not Eligible for Privatization or a 1996 List of Enterprises which Produce Goods and Services Essential to National Security not Eligible for Privatization. Clear principles for lists inclusion were also lacking although the Ministry for State Property did have 7 criteria. It is currently absolutely unclear whether the enterprises from either of these 2 lists would also be banned from privatization.



government's stake in an enterprise should exceed 50%. According to the 1997 law the requirement was that an enterprise was carrying out government orders and more than 70% of its goods and services were defense-related.

In January 2003 the Russian government produced a list of 18 federal joint stock companies, where the state's position on all issues pertaining to their management, governing and oversight was to be determined by the government.

A third loophole can be found in a requirement that all amendments, changes and recommendations to the existing lists of strategic entities (including proposals for decreasing government's control over such enterprises, their gradual or immediate removal from the list for the purpose of their eventual privatization) be made in the same manner, i.e. initiated by the government and then sent to president for approval review.

The new Law however is vague on the process and details of the presidential review of government's proposals. One would imagine that the President would have to rely on technical expertise provided to him by his staff and that is, of course, granting the President does indeed review and not merely rubber-stamps government's proposals. In any case, it is unclear whether the technical expertise should come from staff in his own administrative apparatus, Security Council or some other institution. Coupled with the lack of clear criteria for selection of strategic entities this confusion certainly does little for improving the already hazy environment surrounding Russian privatization.

Yet another, fourth loophole of the new 2001 Law arises from an implication that annual privatization programs should be handed for parliamentary review together with an annual budget draft. The Law however provides no guidance to a situation where a budget draft along with the privatization program is not approved, as if the creators of the Law simply deemed such "difficult" scenario as too unlikely ever to occur.

Fifthly, the 2001 Law also fails to set unambiguous criteria for dividing the large notion of "state" property into federal, regional and municipal subclasses. Last such criteria were set in 1991 by the Supreme Council of Russian Soviet Federative Republic and are obviously outdated. The lack of clarity is muddled further by a number of often conflicting bilateral agreements made between the federal center and various regions back in the nineties following the break-up of the Soviet Union.

Many hoped that the 1999 Conception for Management and Privatization of State Property and a row of new legislation that followed it would provide better guidance. Disappointingly enough most of these new laws concerned only federal enterprises and federal joint stock companies and thus was not entirely helpful for sorting out the municipal and regional property concerns. One exception was the January 11, 2000 Governmental Decree on Registrars for Economic Efficiency of Federal Enterprises and Federally-Owned joint stock companies. The latter merely *recommended* that regional governments set up the aforementioned registrars.

In other words the regulation of regional and municipal property, which as of 1999 consisted of over 65 thousand entities, continues to be in local governments' domain and to a large degree because of that is plagued by a particularly heightened form of inefficiency and waste so typical of all state-owned enterprises in general.

On a more encouraging note, the government as of late is pursuing a policy of delineating authority and accountability between the federal, regional and municipal governments. An administrative reform, of which such vertical division of powers is an important element, is in

the making and a special Committee set up at President's behest in 2000 had already produced a first draft of a Federal Law on State and Municipal Property.

The latter document is seen as radical in its strict and rather narrow-minded classification of state property, which according to the draft can only come in federal, regional or municipal form (the latter type concerns mostly education-related property). All other property that does not fall in either of these 3 categories is considered as commercial property eligible for lease, trust management and/or privatization. According to the draft unless a property falls clearly under the 3 mentioned categories or is a public-concern not-for-profit organization in which government's participation is required<sup>3</sup>, all federal, regional and municipal governments are prohibited from purchasing it.

The reasoning behind the restriction is that it will help complete the process of delineation and neat classification of property. Once the law passes and appropriate changes are made in the Civil Code, the logic goes, the legal institution of state-run business will cease to exist.

In reality it means that all current state-owned unitary enterprises must either be transformed into *kazennye* (i.e. managed on an operational basis as all *uchrezhdenia*)<sup>4</sup>, incorporated or liquidated altogether. An exception is made for certain state social-aid agencies, which will be offered an interim form of ownership and may be transferred into concession.<sup>5</sup>

A draft of the Law on General Principles of Local Self-Governance, yet another piece of legislation that will affect the privatization future, is scheduled for Duma discussion in February 2003. A lot of it will be based on the reform concept put forward by the State Council, which calls for a complete inventory review of all state and municipal property, its classification and 'optimization.'

The suggested classification of property would necessarily include re-allocation of property between federal and regional governments with many items falling into municipal ownership. The proposed re-allocation would not only affect enterprises themselves but also their land (if it is within a municipality's boundaries) and even some utility companies. The State Council says that this re-allocation would serve a purpose of 'solving socio-economic problems of municipalities, improving living standards and creating a beneficial environment.'

The process is likely to involve some kind of mechanism of determining value of municipal holdings, however the Ministry for Property Relationships reckons that municipalities should be prohibited from starting and owning enterprises for purpose of extracting profit. The Ministry instead proposes that municipalities get by with collecting property taxes, of which Russia now boasts to have 5 kinds, as well as assistance from the regional and federal governments.

Although at this time it is difficult to predict in what form, if at all, these drafts become laws, the radical nature of the proposed legislation is bound to accelerate the privatization process. Given the exact opposite trend of the judicial reform such 'unnatural' acceleration may seriously hamper the process' and outcome's quality, not to mention heavy social costs as well as a strong reluctance from regional elites.

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<sup>3</sup> Type and degree of such government participation is to be determined by the President.

<sup>4</sup> I.e. unlike on unitary enterprises the government carries a subsidiary responsibility on *kazennye* enterprises perhaps that was the reason why such forms of state ownership never took off in Russia. As of 2002 out of 9393 federal unitary enterprises only 33 were *kazennye*.

<sup>5</sup> Ministry for Economic Development is due to submit appropriate legislation for consideration.



Finally, it is important that the government continues with a management reform of the property under its control. Such reform can be based on a simple inventory recount, which also has to include clear delineation of authority between various level of government over its particular holdings.

Efficiency problems of using Russian property abroad are just one area that would benefit enormously from such reform. Ever since the start of the privatization process, Vitsovpetro has been the only revenue source of all Russian state property situated abroad. The Russian accounting chamber reckons that Russian agencies, various enterprises and organization that own property beyond Russia's borders knowingly present inaccurate data to the Ministry of Property. Similarly, information on government stakes in foreign-registered entities that belong to Russian organizations is also understated. The Russian government in the meantime is loosing, as some sources claim, about \$1 billion in dividends a year. It has to be said that about 80% of all Russian state property abroad belongs to Russian embassies, consulates and other such diplomatic structures.

The following two measures would especially be relevant for addressing the need for better management of Russian property abroad:

- creation of a complete up-to-date registrar of all federal property abroad
- establishment of clear rules and principles for dividend payment policy on Russian assets in foreign entities

In the past few years there virtually has been no disagreement on the need for a law on nationalization, in the very least for detailing appropriate articles in the Constitution and the Civil Code. A fairly high degree of political sensitivity of the subject and existence of few alternatives ensured that the process for creating such law has been rather slow.

The Ministry for Property prepared a draft of it's called a Law on Turning Private Property to that of the State (in short, nationalization), which underwent Duma discussions on October 21, 2002. This Ministerial draft gives two reasons for invoking the law: ensuring defense abilities of the state and national security.

According to the proposed draft, the government would each year specify the country's needs in strategic goods and services necessary for ensuring national security in one of the classified articles of the budget and set aside funding for their purchase and/or production. If the government finds itself unable to purchase these strategic goods on a market or find a state-owned enterprise that is able to produce these strategic goods, the government has then a right to nationalize an enterprise that has an ability to produce the strategic goods. In these cases, the government upon consultation with the President makes a list of assets subject to nationalization and retains a valuator for determining a market price of these assets. If an owner of an enterprise marked for nationalization disagrees with the government's decision he/she has a right to appeal in court.

### **4.3. State property management**

#### **General approaches**

In the course of development of privatization along with contraction in the volume of government property in Russia over the '90s, the problem of an operative and strategic management of public enterprises (shares) has become increasingly pressing. The whole sectors of

the economy needed solutions to that (fuel and energy and defense, transport, communications, among others).

It was governmental Resolution # 1204 of September 9, 1999 on approval of the Concept for management of government property and privatization in the Russian Federation (below referred to as the Concept) that launched a new stage of property relations reform in Russia. Notably, apparently it has become the first attempt since 1992 to put the problem of state property management higher in the priority hierarchy than a formal change of property form. A drastic downfall in prices for enterprises and their stock packages after the Rub. depreciation naturally determined in 1998-99 the shift of the federal center's focus of attention towards boosting non-tax budget revenues by means of using government property. That in turn automatically required an introduction of a greater clarity to the relationship between different tiers of the government.

In the meantime, it can be argued that it is the implementation of the action plan aimed at improvement of the existing government property laid out in the Concept that forms an urgent task in the public property management area for the years to come. The document cited state unitary enterprises and economic entities with the government participation in their capital among other main objects of the property policy. The document emphasized a gradual qualitative contraction in the number of the objects in parallel with the implementation of the action plan on improvement of their management.

The Concept forms a perspective guidelines document and proceeds from the need of concluding strict contracts with managers, which will hold them responsible for 'their' enterprises' performance, as well as carrying out a constant economic monitoring, and the need in a register of economic efficiency that would specify future performance of an enterprise or a company.

To address these tasks, one needs to implement long-awaited measures: to introduce standard reporting forms for government representatives in open-end joint-stock companies (OAO) (October 1999); to pass a decision on establishment of a register of economic performance indicators of federal state unitary enterprises (FSUE) and OAO whose shares are owned by the federal government (January 2000); transition to an annual approval (for FSUE and OAO with the federal government share over 50%) of economic performance indicators and control over observance with them and the use of property, identification of the share of FSUE's profit subject to transfer to the budget, the recommended volume of dividends to be voted for by RF representatives in OAO boards (February 2000), the regulation of procedures of appointment of governmental representatives and their interaction with the Ministry of Property Relations and the respective sectoral agencies depending on the size of the government package, including timelines for notifications, submission of proposals, and provision in writing directives and reports on their participation in enterprises' governing boards (March 2000).

The measures undertaken under the Concept over the past three years have already brought about some results. The period between 2001- 2002 has been notable for a qualitative shift in the structure of the federal budget revenues from privatization and the use of the federal property (see Section 1).

Some general matters that concern managing both unitary enterprises and economic agents with the government participation are worth a separate analysis.

First, as long as the state property management is concerned, it is the governmental staff policy that becomes especially important. Nowadays, in addition to a higher qualification of



those who carry out managerial procedures, it is the staff selection and a resolute battle against corruption that remains very urgent. Whilst putting the possibility of using the civil and criminal law provisions aside, one can offer a range of fairly visible measures to address the above:

- introduction of the provision on a mandatory expulsion in the future from the state property managers community those who were dismissed from their duties because of their unfair performance (with a detailed description of such abuses and a respective penalty), along with the creation of a database to store complete information on all the staff ever representing the government interests in the property management area (directors of FSUE, governmental representatives in AO, trust managers);
- introduction of the provision of a compulsory information by directors of FSUE and governmental representatives in AO of their income and property as a variant of adoption of a special law on labor compensations for heads of public companies or amendments to the tax law. The enforcement of this particular measure with regard to heads of economic agents with the government share in them is under discussion (and can be related to the size of the government share).

Secondly, there exists a serious challenge in the unitary enterprises management area that fall under the RF Subjects' property and municipal unitary enterprises (as of late 1999, their overall number made up some 65,000) as well as economic companies with the local governments' share in their capital presents.

The problem is it is FSUE and AO whose shares constitute the federal property that falls within the purview of practically the whole legal base developed over 1999-2001. The exception is RF Government Resolution # 23 of January 11, 2000 "On the register of economic efficiency indicators for federal state unitary enterprises and open-end joint-stock companies whose shares are in the federal property". The document *recommends* executive agencies in RF Subjects to organize the work on creation and conduct of registers of economic efficiency of state unitary enterprises owned by RF Subjects (as well as of open-end joint-stock companies, whose stock belong to RF Subjects).

It is evident that the priority mission is to spread all the management patterns and mechanisms emerged over the past three years onto the property of RF Subjects (in analogue to the federal property objects). This should concern, at least, the enterprises the federal center is going to assign to local governments. The respective Government resolution (# 1366 of December 9, 1999) relates the assignment of such FSUE=s to the ownership of RF Subjects just to decrease in the amount of funds the federal budget transfers to regions. Enterprises with arrears on compulsory payments to the federal budget and state off-budget funds, as well as backwages, outstanding over 3 months were bound to submit a business plan. The latter should provide for a liquidation of such arrears over a certain period of time (with concrete sources of funding of necessary measures), among other things. At the same time, the respective standard Framework Agreement and Assignment Deed approved by the Ministry of State Property with its Decree # 2-p of May 23, 2000, were not registered by the RF Ministry of Justice. So, the matter has been suspended so far.

The launch of the process should be preceded by a detailed examination of the actual state of affairs in the property relations area in a specific region, including the situation at the enterprises that have earlier been assigned to local governments. It would be appropriate to conjoin the possibility of assigning the federal property to the RF Subjects with the size of the

existing regional property (including stock packages), efficiency of privatization procedures and local property managers' performance over the prior period, and to include all the above in official documents on interbudgetary relations.

Third, there exists a group of questions associated with the rate and quality of economic growth. It is not accidental then that the Concept regards encouraging production and its diversification, improvement of such enterprises' financial and economic performance, attraction of investment, optimizing managerial costs, implementing institutional transformations in the economy as independent objectives in the state property management area.

The above objectives can be reached by the following means: the use of state-owned stock packages to secure credits and investment; capitalization of enterprises' debts to the budget and an contribution with their land sites to AO=s' authorized capital, with the consequent sale of, or trusting the newly issued stock; establishment of vertically-integrated corporate structures; enterprise restructuring with a separation of the property complex needed to solve problems of the national scale, and sales of other assets; and, finally, the use of various privatization procedures.

The nature of the above instruments and a well - known fact of the transition of a main mass of attractive enterprises to the non-government sector show that the above processes to a greater extent concern companies with the government share in their capital, while to a less – unitary enterprises.

At the same time, one should take into account that any job on enterprise restructuring that implies separation of any production should involve a great deal of cautiousness and is time-consuming. That can be explained by the need of a thorough account of the whole set of related circumstances and primarily of evaluation of the possibility of downsizing the objects that once were built as a single technological complex. As well, it should imply studying into technical aspects of the problem. The task to create competitive holding structures with the governmental participation poses a serious challenge, too, as the account of the technical aspect of the problem (compatibility, inter-relation and mutually complementary functions of such integrated enterprises) is complemented by demand for concentration of government-owned assets to the extent allowing exercise an efficient control with minimal managerial costs involved.

Obviously, these problems can be solved and visible results can be achieved only in the long run (within 5-7 years), when both unitary enterprises and companies partly owned by the state demonstrate a steady and qualitative implementation of their functions set while fixing them in the government ownership and a considerable increase in non-tax receipts to the budgets of all levels is ensured. By that time, by and large, a sound management system of state-owned assets in unitary enterprises and mixed companies should be built. The system should be based on an individual approach towards each such object and a program-targeted principle that implies a mandatory identification of objectives of the state participation in the given enterprise's capital and, consequently, a strict formulation of tasks and a documentary fixing of means of influence on the given object, providing existence of efficient control instruments.

Naturally, the implementation of all the aforementioned measures, along with a sound staff policy pursued by sectoral and functional management agencies, does not guarantee absolute protection of the state acting as a principal from potential offensive acts of the manager as an agent. This notwithstanding, it appears that such measures can considerably lower an integrated risk of bankruptcy of unitary and mixed enterprises, inhibit stripping them off assets and eventually lower costs in the public entrepreneurship area.



In all fairness, it should be noted that such negative effects caused by the functioning of an economic institution as poor current performance indicators, stripping an enterprise off its assets, false bankruptcy, etc. in principle appear characteristic of economic agents of other organizational and legal forms, too. For instance, in Russian economy, many privatized companies do not perform as expected, nor they proved to be manageable even under new, private owners. This manifests a universal nature of difficulties arising in the relationship between managers and owners in the transitional conditions.

With all their similarity, the processes of improvement of management of unitary enterprises and economic companies with the government participation and the legal regulation of the state property rights towards these different kinds of objects have their own specifics<sup>6</sup>, which allows better understanding of the nature of challenges facing them.

Overall, one should recognize that currently the 1999 Concept needs a serious update, primarily from the perspective of shaping a single public property (asset) management system, which would allow to ensure a material provision of implementation of public functions and optimization of the federal property's structure. The idea of shaping such a single system basing on a classification of the federal property and improvement of new mechanisms of managing federal property objects should become a core one in the course of furthering the legal base of privatization and public property management.

## Unitary enterprises

It was in 1999 (in the frame of the Concept) that unitary enterprises along with government-owned stock packages (shares) in economic companies (primarily AO=s) and real estate were for the first time singled out as a separate object of the government policy. Accordingly, it was for the first time ever that the number of FSUE=s became known – 13,786, which was roughly twice lower than as of January 1, 1998 (29,666). By summer 2000, there were 11,200 unitary enterprises, as of September 1, 2001 – 9,855, and as of January 1, 2002 – 9,394 (or at some 32% less than stipulated in the Concept)<sup>7</sup>. Such a decline in the absolute number of FSUE=s is explained by the implementation of a complex of measures provided by the Concept. They are aimed at contraction in their number (reorganization, privatization, liquidation), while at the moment it is impossible to unambiguously argue that in the future the vector of quantitative dynamics of FSUE=s will be heading steadily for a decrease in their number.

The data in *Table 3* (though its covers different dates) clearly show differences between the federal unitary enterprises on the one hand, and regional and municipal ones, on the other.

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<sup>6</sup> Obviously the problems related to management of budget institutions (reforming the budget network in the social sphere sub-sectors), natural monopolies reform (associated with antimonopoly regulation, encouragement of competition, and corporate governance), restructuring the bloc of law enforcement and military agencies and sales of property freed due to that (associated with the military reform) also bear their great functional specificity, which is related to the nature of the respective agencies' operations. However, the present paper does not deal with them.

<sup>7</sup> The process of creation of the Register of Federal Unitary Enterprises has been far from completion. This can be attributed primarily to the absence of a distinct division of powers and rights for a certain property between different tiers of the government and, in a number of cases, to the fact that regional administrations and unitary enterprises there are keen to avoid the application of accounting and control procedures on the part of federal agencies. For example, according to the Department for Accounting the Government Property of the RF Ministry of State Property, by mid-2000 in 69 Russian regions there were found 1,232 legal entities having the status of federal enterprises in the region but not included into to the respective federal agencies' lists.



They both prove to be very closely associated with the level and limits of the respective government tiers' competence.

As concerns the structure of regional and municipal unitary enterprises, it is the housing sector that has the greatest proportional weight (27.6%), followed by trade and public catering (25.2%). As long as all economic agents of this particular organizational and legal form are concerned, the overall proportion of both sectors stands nearly 53%. By contrast, their share in the group of federal unitary enterprises is just 11.4%, while the proportional weight of agrarian and forestry sectors is notably big there (14.6% vs. 5.4% in the group of regional and municipal unitary enterprises), followed by sectors for transport and communication (11 vs. 4.9%). However, it is 'other' sectors whose respective rate is especially great (almost 33% vs. 12.2%), of which almost 2/3 falls on science and scientific services. The proportional weight of industrial and building sectors in the group of federal unitary enterprises (some 30% in all) does not bear a fundamental difference from the respective proportion of these sectors in the group of regional and municipal enterprises (24%).

Under a detailed disaggregating of the sectoral FSUE structure, it becomes evident that as of early 2002, it was the proportion of science and scientific services that was the greatest one (15.2%), followed by agrarian sector and forestry (14.6%), transport and communication (11%). An absolute number of enterprises in these particular sectors exceeds 1,000. This group is closely followed by the construction sector (10.5%) and trade and public catering (9.7%) that currently comprise 988 and 909 FSUE=s, respectively. As concerns the industrial sector whose share in the overall number of existing FSUE=s roughly accounts for 1/5, it is machine engineering and metal processing whose share is the largest (some 48%, or 9.4% of the overall number of FSUE in the economy), followed by enterprises dealing with material and technical supply and sales (7.4%), while the proportional weight of all other sectors does not exceed 2.5%.

The number of FSUE in a certain sector to a great extent mirrors the level of the pre-reform production concentration on the one hand, and the level of the given sector's attractiveness for outsider (and not only foreign) investors and the quality of the government property management policy over in the past, on the other. In this regard, a very insignificant (up to 50) number of FSUE=s can be found in the fuel and energy sub-sectors, metallurgy and the sector or chemicals that due to technological reasons would have a high level of production concentration yet in the conditions of the centralized economy. With the outset of market reforms, their export-oriented production plus a compulsory integration of a great number of the former public enterprises into holdings at the pre-privatization stage raised such a great interest in them on the part of private capital that pursuing its privatization program the government practically abandoned these most attractive sectors, though maintained some property in the form of shares in AO=s' capital. Thus, there are only 6 unitary enterprises survived in the oil sector, 1 in the gas sector, and none- in the oil and gas construction sector.

*Table 3*

**Sectoral structure of federal, regional and municipal unitary enterprises between 2000- 02**

Sectors	Federal state unitary enterprises as of January 1, 2002		Regional and municipal unitary enterprises as of January 1, 2000	
	Number	Proportion	Number	proportion
<b>Industrial sector, including:</b>	1844	19,6	6044	16,4
- machine engineering and metal processing (exclusive	879	9,4	...	...



of the sector for medical equipment)				
- forestry, wood-working and paper and pulp industries	229	2,4	...	...
- polygraphic	219	2,3	...	...
- light	153	1,6	...	...
- building materials	83	0,9	...	...
- food	64	0,7	...	...
- medical	59	0,6	...	...
- chemical	42	0,4	...	...
- fuel	35	0,4	...	...
- electricity	31	0,3	...	...
-non-ferrous metallurgy	27	0,3	...	...
- ferrous metallurgy	16	0,2	...	...
- microbiological	7	0,1	...	...
- milling and gruel and feeder	-	-	...	...
<b>Agriculture and forestry</b>	1368	14,6	2000	5,4
<b>Transport and communication</b>	1033	11,0	1818	4,9
<b>Construction</b>	988	10,5	2799	7,6
<b>Trade and public catering</b>	909	9,7	9627	25,2
<b>Housing</b>	162	1,7	10155	27,6
<b>Other, including:</b>	3090	32,9	4477	12,2
- science and scientific services	1431	15,2	...	...
- material and technical supplies and sales	692	7,4	...	...
- healthcare, physical culture and social security	226	2,4	...	1,0
- geology and sub-soil exploration, geodesic and hydrometeorologic services	218	2,3	...	...
- management	158	1,7	...	...
- culture and fine arts	155	1,6	...	...
- other kinds of activity associated with material production	140	1,5	...	...
- public education	60	0,6	...	0,4
- finance, credit and pension security	10	0,2	235*	0,6
<b>total</b>	<b>9394</b>	<b>100,0</b>	<b>36795**</b>	<b>100,0</b>

\*Finance, credit, audit

\*\* Subfederal and municipal unitary enterprises that submitted their financial accounts for 1996 and 1999

Source: the RF Ministry of State Property Homepage: [www.mgi.ru](http://www.mgi.ru); Kordyukova T., Galkin M., Eugel F. Unitary predpriyatia- potentsialny dokhod ili potentsialnye riski dlya regionalnykh I mestnykh administratsiy?// Credit Russia. An analytical bulleting of EA-ratings, the strategic partner to Standard and poor's, # 19-20 (56-47), October 2001; ACIS project "Povyshenie effektivnosti upravleniya gosudarstvennymi I municipalnymi unitarnymi predpriyatiyami" Materialy k seminaru of 7 December 2001 (draft). GBRW, EA-Ratings. Part 1.P.7.

The opposite pole is formed by a number of processing industries (primarily machine engineering) where the original level of concentration aggravated by the crisis in sales and the policy on 'atomization' of economic agents pursued at the initial stage of privatization allowed a great number of enterprises to stay out of potential investors' sight, thus retaining their public status.

The problem of *reforming unitary enterprises* is related primarily to deficiencies in the legal construction of the economic right. Its essence lies with an asymmetry of powers exercised by the subject of such a right and those granted to the government as a title owner. Article 296 of the Civil Code of RF grants the title owner with a strictly formulated circle of functions: 1) establishment, reorganization and liquidation of an enterprise; 2) identification of the subject and purposes of its operations; 3) appointment of its head (director); 4) control over the property assigned basing on the economic right; 5) the right for a part of its profit (without reference to concrete mechanisms of realization of such rights).

At the same time, enjoying its economic right, a unitary enterprise controls its property, except the real estate, while in compliance with p. 5 Art. 113 of the Civil Code, it meets its obligations with all its assets. In the absence of the law on government and municipal unitary enterprises, its heads would have a greater freedom of action with regard to incomes and

property, which they de-facto own and control. So, there emerges a possibility to burden SUE with debts and the risk that counterparts or creditors would seize the enterprise's property, which for the government means a great probability of losing it. More specifically, such obligations may arise, should a unitary enterprise participate in capital of various economic agents associated with the UE's head. Such companies are not limited by the necessity to coordinate their operations with an owner in the frame of special procedures, as it happens in joint-stock companies.

It is these particular circumstances that gave a rise to a strategic decision on reducing the number of unitary enterprises of all levels. It is intended to transform them in open-end joint-stock companies (OAO) in the medium run, with 100% of their stock owned by the government or a municipal administration, or to assign them to the Treasury. This allows not to use a special control mechanism – rather, delegating governmental representatives to the boards of such OAOs, which has become fairly ordinary means over recent years. The period between 2001-02 saw a preparatory work on incorporation of such enterprises. Some 2/3 of FSUE received proposals on their restructuring, including reorganization of 1,669 and liquidation of 531 of them.

The main ways of transformation of unitary enterprises were identified by the Government in its Resolution # 1438 of December 6, 1999 “On federal state unitary enterprises established on the basis of economic right”. The document provided the following situation under which the maintenance of the organizational and legal form of unitary enterprises based upon the economic right (as well as their transformation into treasury enterprises) is allowed:

- the use of the property whose privatization is prohibited, including the one needed to ensure the national security, functioning of the aircraft and fleet, and realization of other strategic interests of RF;
- carrying out operations aimed at solving social tasks, including sales of certain goods and services at a minimal price, as well as at organization and conduct of procurement and goods intervention for the purpose of ensuring the food security of the state;
- the development and manufacturing of single kinds of products falling into the sphere of national interests of RF and ensuring the national security;
- the production of single kinds of goods that are withdrawn from the civil turnover or the use of which in the civil turnover is limited;
- carrying out operations that the federal laws reserves exclusively for public unitary enterprises;
- carrying out single subsidized kinds of activity and unprofitable production;
- carrying out research and scientific-technical activity in the sectors related to ensuring the national security.

In addition to retaining enterprises in the form of unitary enterprises based upon the economic right, the government identified still 4 variants of transforming organizational and legal structure of such enterprises:

- reorganization, including their transformation into open-end joint-stock companies;
- creation of federal treasury enterprises on the basis of their property;
- their sales as property complexes; and
- liquidation.



It is liquidation of the institution of SUE that appears the most radical decision. At the same time, a low liquidity of their assets and specifics of their operations makes the scenario of a gradual bringing the number of state unitary enterprises into line with the state's managerial capacity (which implies retaining some 3,500 of them) more probable. In parallel with that, there should exist a complex of measures to improve their management, as stipulated in the Concept. The realism of such a scenario can be proved by the fact that the governmental medium-term program's projections that by 2001 the program of transformation of unitary enterprises into joint-stock companies should be complete, with the state owning 100% of their stock, have proved to be far from reality. Let us remember that in 2002 there were 9,394 FSUE=s and only 90 AO=s fully owned by the state. During three years after the enactment of the 1997 privatization law (i.e. in 1998-2000), it was just a sole AO created in 1998 on the basis of enterprises owned by the federal government.

Whilst considering the above, one has to admit that quantitative estimates quoted in the scenario-based forecast of privatization of the government property appear overly optimistic and radical. The proposed contraction of the public sector to 1,5-2,000 federal enterprises by 2004 implies privatization of some 3- 3,500 of them annually. By itself, such a figure does not seem significant, however, it would be appropriate to compare it with the number of privatized enterprises objects during the monetary privatization period (See *Table 1* of the Section "Dynamics of the privatization process").

The scenario-based forecast of the government property privatization conjoins the reduction in the number of public enterprises and institutions with the amount of the government funding (in the form of direct financing and payment for the state order), which cannot be considered correct. In developed market economies, state orders are placed with companies of all kinds of property - furthermore, for decades the private sector viewed them as especially profitable and went into a cut-throat competition to get them. The actual problem lies with the level of economic agents' maturity in Russia's non-governmental sector and their capacity to accomplish these or those tasks of the national scale and to relate such a mission to the overall strategy of the country's development. So, it is just single cases in which the approach that unambiguously conjoins the number of public enterprises and institutions with the government's financial capacity can be applicable.

It is also important to note that a mass and accelerated incorporation of public unitary enterprises inevitably narrows the room for the restructuring privatization, when an enterprise is sold as a whole property complex – production equipment together with facilities, buildings, the site (a popular privatization option in the former GDR). Should such enterprises be transformed into AO, it will most likely result in problems with splitting their equity into separate packages for sale and their appraisal. Naturally, one cannot exclude the option of implementing a restructuring scheme of privatization by means of liquidation of the given public enterprise and launching a new business basing on its facilities and equipment.

It is the government's impotence in carrying out its proprietor's functions that serves as an argument in favor of the most urgent transformation of public enterprises into AO=s. However, in the conditions of the national transitional economy where many privatized enterprises, even under new, private owners, do not meet expectations in terms of their efficiency and manageability, it is hard to expect that a mere change of an organizational and legal form in the public sector's frame would have an immediate positive impact on their state. To prove

this, one can cite numerous problems inherent in the largest joint-stock companies with the governmental participation<sup>8</sup>.

Using the 'survival and growth capacity' characteristics for the purpose of qualifying enterprises for the respective group and solving the problem of their privatization appears a profound error. The economic practice of the '90s proved that these were different criteria, to say nothing of such well-known things as an extremely insignificant volume of outside investment even in the most attractive Russian companies. As concerns enterprises that currently are fully owned by the state, such a prospect appears more than doubtful.

Overall, in the meantime one can argue that the government's organizational capacity for reforming unitary enterprises *has entered in a serious conflict with the quantitative restrictor – that is, the scope of the sector for SUE*. There also is a visible conflict between a radical orientation towards complete liquidation of SUE=s with the abolition of the right for economic performance as a whole and specifics of their economic operations related to the output of goods and services and completion of works whose main consumer is the state and the society on the whole, as well as a low liquidity of their assets. Finally, there is, though limited, a circle of state tasks (and public interests), the mandate on solving which can be delegated to SUE=s. However, this can be viewed as a sound option only if the respective regulation is improved.

The actual progress in privatization over the past 4 years, i.e. the period of the effect of the 1997 privatization law makes the scenario of a long existence of unitary enterprises most likely. Proceeding from this, it is the focus on a gradual contraction in the number of state and municipal unitary enterprises and a parallel implementation of a set of measures on improving their management laid out by the Concept that appears more grounded.

Retaining FUE=s as economic agents in Russian transitional economy in the foreseeable future makes it urgent for the government to focus on such a specific regulative matter in the property relations area as minimization of deficiencies generated by the right for economic activity.

In practical terms, this implies *minimization of commercial risks arising in the course of carrying out government entrepreneurship via unitary enterprises*. The list of the most evident and widespread commercial risks in this particular sphere comprises:

- the possibility of a partial alienation of the property the government assigned to FUE=s;
- a low probability of generating revenues from FUE=s' operations, which may be attributed both to their sectoral specifics (a low profitability and low asset liquidity rates, focus on state orders and the consequent problem of the government honoring its obligations) and to the possibility of outsider structures intercepting the respective financial flows;

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<sup>8</sup> The planned transformation of the federal railway transport under the auspices of the RF Ministry of Railway Transportation into joint –stock company 'Russian Railroads' at 100% owned by the state at least is unlikely to ensure a considerable effect. In this regard, one should refer to the respective experiences of the electricity and gas sectors that have passed the incorporation stage yet in 1992 and consequently been transformed into giant holdings (RAO 'UES Russia' and 'Gasprom'), with their control blocks owned by the state: these companies have failed to show a substantially greater efficiency compared to the railway sector, which in turn was carrying out its inner changes in the frame of natural monopolies reform program. These three sectors were bearing a great deal of similarity over the past three decades: non-transparent financial flows, cross-subsidizing, and the aging of capital assets being close to critical.



- the danger of aging of the production assets due to a non-targeted use of investment funds and ‘eating up’ profit;
- the risk of FUE=s’ bankruptcy and the government completely losing its property rights for the assets assigned to them to conduct economic activity.

The main remedies the government should seek in order to minimize the risks are:

- *bringing FUE=s’ operations* in line with requirements provided by the legal acts of the RF Government and the RF Ministry of State Property of 1999-2001: more specifically, they imply re-registering their renewed charter documents with the RF Ministry of State Property; appointing of enterprises’ heads on the contract basis; fixing in their charters the government’s right for a share of their profit; introduction of a new accounting and control system;
- *an efficient exercising by the owner of his powers in the frame of the effective law and the aforementioned requirements* (identification of the volume of powers; control over the use of property and attaining certain indicators of FUE=s’ economic performance; contributing to the non-tax revenues of the budget system by means of FUE=s regular transferring a pre-set share of profit from current operations; pursuance of staff policy through the respective rulings of attesting boards and cancellation of contracts);
- specification and organizational optimization of the governing impact of the state on FUE=s (creation of specialized FUE=s to manage a great volume of relatively small, dispersed assets; integration of unitary enterprises into holding structures; strengthening the governmental control functions in large FUE=s by means of establishment Supervisory Boards that would comprise representatives of all the government agencies controlling the given enterprise; as concerns FUE=s of strategic importance, they should be directly subordinated to the RF Government);
- continuation and completion of the work on inventorying the government property in the part of inclusion of public unitary enterprises in the Property Register of RF basing on a clear distinction drawn between federal, regional and municipal tiers (and preclusion of a situation when a federal unitary enterprise exists without clearly defined subordination to a certain agency).

It is also necessary *to amend the effective legal base* underlying unitary enterprises’ operations.

First, the urgent need to pass a special law to regulate their operations cannot be questioned. Though the need in such a law has become visible since 1995 (when the Civil Code of RF was promulgated), its final version was passed on November 14, 2002 (# 161-FZ ‘On state and municipal unitary enterprises’).

The mission of the law is to minimize drawbacks of the right for economic operations. The quintessence of the new law became a certain narrowing of the level of a unitary enterprise’s economic freedom (a strict definition of purposes of its creation and allowed kinds of operations, the volume of legal capacity), strengthening of regulatory procedures of its management by the state and protection of its property rights (regulation of entering in large-scale deals, transactions that involve interest, restriction of their rights for establishing daughter unitary enterprises, an assumption of the possibility of withdrawing a part of their property in favor of the state).

The list of major innovations that allow speaking about toughening the system of management of SUE=s comprises the following provisions, among others:

- Unitary enterprise may not establish, as a legal entity, another unitary enterprise by assigning a part of its property to that (the daughter enterprise), which effectively blocks organizational possibilities for stripping the parent enterprise off its assets;
- Unitary enterprises may become participants (members) of commercial and non-for-the-profit organizations where the participation of legal entities is allowed. The decision of the given unitary enterprise to participate in a commercial or non-for-the-profit organization may be made only upon the consent of the owner of the unitary enterprise's property. As well, managing the share (contribution) in the authorized (equity) capital of the newly established economic structure or partnership, as well as the stock belonging to the unitary enterprise, may become possible only upon the noted owner's consent;
- Unitary enterprises may not become founders (participants) of credit institutions (thus, the possibility for their heads to control financial flows is limited<sup>9</sup>);
- Unitary enterprises have no right to sell the real estate belonging to them, lease it, use it as a collateral, contribute with it to an economic company's (partnership's) authorized capital or otherwise manage the property without the owner's consent;
- Without such a consent, unitary enterprises have no right to exercise deals related to disbursement of loans, guarantees, receipt of banking guarantees and other charges, assignments, debt transfer, and to conclude agreements on society in participation;
- Establishment of a treasury enterprise is possible both on the federal (as provided by the Civil Code) and regional and municipal levels, though the list of grounds for their establishment is limited (only for the purpose of using the property whose privatization is prohibited, solving social tasks, and manufacturing products associated with the national security and defense or single kinds of products withdrawn from the turnover);
- Restrictions have been introduced for heads of unitary enterprises with regard of combining their position with commercial operations: it is just research and creative activity which is allowed for them in addition to exercising their immediate functions;
- All large transactions in excess of 10% of the given unitary enterprise's authorized capital or of 50,000 minimal salary rate have to be reconciled with the owner;
- Public enterprise carries out its operations following a revenue/expenditure estimate approved by the owner;
- The owner is granted with the right to transform a unitary enterprise into a public or municipal establishment;

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<sup>9</sup> In 2001, to inventory the governmental share (SUE=s) in commercial banks, a special interdepartmental commission was established. The Commission reported that the government owned shares in 424 banks (including control blocks in 62 banks). Some 600 SUE=s control 714 stock packages worth a total of some Rb. 2.5 bln. in 250 credit institutions. All the agencies were bound to assign their stock to the RF Ministry of Property until July 1, 2002. SUE first reacted by distorting the information on their participation in credit institutions, while some of them attempted to increase commercial banks' authorized capital to dilute the governmental share. Nevertheless, as of late October 2002, the Ministry has received some 90% of all the stock. An analogous attempt should be launched with regard to insurance companies and investment funds.



- The procedures have been specified of formation of an authorized capital of unitary enterprises founded upon the right for economic operations.

In compliance with the Civil Code of RF, the law defines the legal status of government and municipal unitary enterprises, powers and obligations of owners of their property, procedures of establishment, reorganization and liquidation of unitary enterprises. Commercial organization not granted with the property rights for the property fixed with it by the owner is not recognized as a unitary enterprise. It is only government and municipal enterprises that can be established in the form of unitary enterprises. The property of a municipal enterprise belongs, on the basis of property rights, to the Russian Federation, a Subject of the Russian Federation or a municipal establishment. However, *the most crucial defect* of this particular organizational and legal form is still there.

As well, one cannot help but note that the adopted law bears a whole range of other substantial deficiencies, such as:

- unsound provisions that identify cases of possible establishment of unitary enterprises and primarily an excessive number of grounds for establishment of public enterprises;
- the absence of the much-needed development of the respective provisions of the Civil Code that define a special legal capacity of unitary enterprises;
- an insufficient development of the provisions that concern changing the kind of unitary enterprises and reassigning its property to another owner of the public or municipal property;
- inconsistency between some provisions of the said bill with the Civil Code of RF, other effective laws (more specifically, the federal law 'On auditing activity' and inconsistency between the terminology applied therein with the one used in sub-acts, etc.)<sup>10</sup>

Second, the fact of enactment of the law 'On state and municipal unitary enterprises' should not imply refusal of the government policy aimed at strengthening its controlling impact on unitary enterprises by improving the effective legal base developed between 1994 to 2001, i.e. by means of further development of the Standard Chapter of FSUE and the Standard Contract with its head, improving the work of Attestation Commissions with the overall emphasis on enhancement of the level of maintenance of public property.

The main means to ensure the above is to introduce to the said documents provisions on restricting opportunities for heads of unitary enterprises to carry out certain kinds of operations without a prior consent of the owner's representative, extending the incentive system to encourage them honor already concluded contracts, including a range of grounds for their cancellation, consequent penalties, and labor compensations.

Third, as far as contracts are concerned, there may appear new items, such as, for instance, the obligation of heads of unitary enterprises not to combine their position with a paid job in commercial structures, entrepreneurial and political activity, not to take part in transactions involving interests, and to report regularly their personal income and property to their superior agencies. At the same time, the enterprise head labor compensation system should be modified, so that to ensure an interrelation between various bonuses designated for comple-

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<sup>10</sup> For more detailed comments on the law, see: Povyshenie effektivnosti budgetnykh raskhodov na finansirovaniye udghetnykh organizatsiy (uchrezhdeniy), upravlenie gosudarstvennymi unitarnymi predpriyatiyami. M., IEPP, 2003



menting a reasonable fixed salary and economic performance of their enterprises, the presence or absence of disciplinary punishments, and honoring terms and conditions of their contracts. One should also extend the circle of grounds for canceling their contracts at the owner's initiative (in certain cases along with paying off a compensation).

Fourth, from the perspective of organization of an efficient system of management of, and control over operations of heads of unitary enterprises and restricting their excessive freedom of action, a charter of such an enterprise has to comprise provisions on restricting opportunities for heads of unitary enterprises to carry out certain kinds of operations without a prior consent of the owner's representative. On 19 November 2001, the Ministry of Justice registered a joint order of the RF Ministry of Economic Development, the Ministry of State Property and the Ministry of Taxes and Levies which identifies the list of procedures of identification of the above indicators.

It will be transferring profit to the budget according to pre-set standards and the adoption and implementation of a program of development of unitary enterprises for a certain period of time, which should be reconciled with government agencies that should form indicators of success in the government's managing impact.

### **Economic companies with governmental participation**

The implementation of main provisions of the governmental Program with regard to economic companies with governmental participation, the majority of which is represented by AO=s, is capable to contribute to a better realization of the government's interests in the corporate governance area. However, in practice a lot will depend on concrete mechanisms, some of which are analyzed below.

In the medium run, the main question is a more precise specification of the governmental legal rights for property in different AO=s. It is based on a number of criteria, of which the most important one is the size of the governmental share in AO=s' authorized capital. As concerns majority packages, there should be formed a set of provisions and procedures that would allow the state as a strategic owner to exercise control functions. As far as minority blocks are concerned (under 25%), there should be a set of provisions and procedures allowing the state, among other owners, to exercise the respective control functions.

Today, specifying legal rights the state exercises as a co-owner in various AO=s requires addressing three particular tasks:

1. a greater level of clarity and regulation of operations of those individuals who represent the government's interests in AO=s by means of amending the effective legal acts on these issues (mostly beyond the frame of law-making processes in the Federal Assembly of RF);
2. introduction of elementary control mechanisms over financial flows and the process of at least simple reproduction of capital in mixed companies with the governmental participation in their capital and integration of such mechanisms in operational patterns of individuals representing state interests in AO=s;
3. inventory and ranging of the stock packages the government owns in regional-sectoral terms from the perspective of execution of the revenue part of budgets of all the tiers, completion of the much-needed institutional reform, not excluding pursuing a more pro-active structural and industrial policy in the future.

Let us remind that while being aimed at improvement of economic companies with the state participation, the aforementioned Concept for management of government property and



privatization in the Russian Federation generally lies in the frame of guidelines and principles analogous to those applied to unitary enterprises. This can be proved by similar reporting procedures for heads of FSUE=s and representatives of RF in open-end joint-stock companies, monitoring of operations of OAO whose stock is owned by the federal government, which is conducted along with unitary enterprises, by means of inclusion into the register of indicators of their economic efficiency, and transition to an annual approval of economic efficiency indicators both for FSUE and OAO (with the share of federal property over 50%).

It appears that further necessary elements of improvement the process of managing stock (shares) remained in the government's property could be:

- bringing the effective standard contract on representation of state interests (approved in May 1996 and not revised since that time) in consistency with the above documents;
- cancellation of the right of government representatives (both trustees and civil servants) for independent decision making on the circle of matters due for reconciliation, unless there are instructions of their superior governing bodies, in order to minimize manifestations of an opportunist and interest nature;
- to solve the problem of the mechanism of direct encouragement of the work of each of government representatives and trustees by granting them with a certain amount of dividend receipts from the state-owned packages (the Concept suggests allocating not less than 10% of dividends payable on the stock owned by the federal government to fund expenditures associated with managing the stock, however, it does not provide any concrete recommendations in this regard);
- provision of the representation of the state interests in the largest and most important AO=s by government executive agencies' staff, for whom such an activity should become a major one, along with the approval of the program of their annual operations by the Government (an introduction of the institution of the authorized government representatives). In this regard, an adoption of 'Regulation of protection of rights of the Russian Federation as an owner' may form a major innovation. The Regulation provides the transition of the said institution to a professional basis. Such a transition highlights two necessary components – that is, tougher requirements to those pretending to represent state interests in AO=s' boards and defining financial sources of their operations;
- improvement (setting limits of remuneration and compensation for costs incurred by a trustee, solving the problem of licensing trustees' operations proceeding from the law on securities market', along with the organization and conducting of a register of trustees), and a gradual extension of the practice of application of the trusteeship mechanism in the part of stock packages of enterprises of no strategic importance that are owned by the federal government (the most radical variant suggests a transition to this particular form of governance as a solely possible, though considering the effective legal base and current practices, this appears a complex issue);
- development of a set of responsibility measures, including the possibility of amending the Criminal Code of RF in the part of protection of state interests in the event of professional representatives dishonestly exercising their duties;

- a realization of an alienation strategy with regard to minority stock (up to 25%), except those in the largest and financially significant enterprises;
- a differentiated approach to evaluation of efficiency of government representatives' performance depending on the size of the state-owned stock and chances to exercise influence on the decision-making process.

#### **4.4. Sectoral Peculiarities of Unitary State Enterprises**

Federal unitary state enterprises have been reformed at the level of individual sectors within the framework of the Concepts of Public Property Management and Privatisation.

The most profound changes from the perspective of sheer numbers were made to the railway transport as part of preparation to reform the sector and establish RAO "Russian Railway". In 2001 the Ministry of Railway (MR) reorganised 396 enterprises depriving them of their legal entity status, of which the vast majority (395) were involved in primary operations, i.e. were part of the railway.

There were as much intensive changes in unitary state enterprises under the Ministry of Industry, Science and Technology. They reorganised 20 federal level enterprises of which one half (10) were liquidated as part of bankruptcy proceedings, 6 transformed into joint-stock companies and 4 passed over to constituent territories of the Russian Federation. 38 enterprises were under bankruptcy proceedings, 12 ceased to be operational (to be liquidated) while another 5 petrochemical engineering enterprises in the territory of Chechenya are in the process to be passed over to the Chechen Republic. The table below shows changes in the structure of enterprises under the Ministry of Industry across sectors in more detail.

*Table 4*

**Changes in Sectoral Structure of Federal Unitary Enterprises under the Ministry of Industry, Science and Technology, 2000-2001**

Sector	Number of Federal Unitary State Enterprises				
	Listed in Russian Government Resolution No. 813 dated October 12, 2000	Liquidated	Bankrupt and no longer operational	To be passed over to the Chechen Republic	As of late 2001



Ministry of Industry, Science And Technology (Minprom):					
- Mechanical engineering;	400	19	50	5	326
- Metallurgy;	153	7	21	5	120
- Chemical industry;	40	-	5	-	35
- Medical and biotechnological industry;	43	2	4	-	37
- Wood and timber complex;	51	2	4	-	45
- Defense industry;	55	7	10	-	38
- Light industry;	28	2	3	-	23
- Intersectoral enterprises	14	-	3	-	11
	16	-1*	-	-	17

\* One federal entity was transformed into a unitary state enterprise.

Table 4 demonstrates that 60-70 percent of liquidated, bankrupt and non-operational unitary state enterprises are part of mechanical engineering and wood/timber complex.

At the same time changes in the composition of federal unitary state enterprises again confirmed that the process of improvement of the governance system will reveal new and previously unaccounted for enterprises to be added to the list of subordinated enterprises. In 2001 41 unitary enterprises associated with the State Construction Committee and 28 associated with the Ministry of Industry were identified.

*Efforts to harmonise charters of unitary state enterprises with new requirements.* The first priority task of sectoral management agencies in implementing measures to improve management of unitary state enterprises envisaged in the Concepts of Public Property Management and Privatisation was to perform Russian Government Resolution No. 104 dated February 3, 2000 as regards harmonising charters of subordinated entities with the effective law. Given below are data describing this process as of early 2002 (Table 5).

Table 5

**Harmonising Charters of Federal Unitary State Enterprises with New Requirements**

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Enterprises with new charters:					
		approved		to be agreed		other status (refined etc.)	
		Unit	%	Unit	%	Unit	%

**RUSSIAN ECONOMY in 2002**  
trends and outlooks

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Enterprises with new charters:					
		approved		to be agreed		other status (refined etc.)	
		Unit	%	Unit	%	Unit	%
Ministry of Transport (Mintrans):	834	134	16,1	176	21,1	524	62,8
- Road network;	396*	30	7,6	97	24,5	269	67,9
- Automobile transport;	236	70	29,7	10	4,2	156	66,1
- Airlines;	146	8	5,5	57	39,0	81	55,5
- Sea transport;	36	14	38,9	9	25,0	13	36,1
- River transport	15	12	80,0	3	20,0	-	-
Ministry of Railway (MR)	459	...	...	...	...	...	...
Ministry of Industry, Science and Technology (Minprom):	326	180	55,2	87	26,7	59	18,1
Ministry of Natural Re- sources (MNR):	290	113	39,0	89	30,7	88	30,3
- Geological services;	193	83	43,0	53	27,5	57	29,5
- Forestry;	83	29	34,9	25	30,1	29	34,9
- Environmental protection service;	8	-	-	7	87,7	1	12,5
- Water service	6	1	16,7	4	66,6	1	16,7
State Construction and Utilities Committee (Gosstroy)	174	103	59,2	46	26,4	25	14,4
State Fishing Committee (Goskomrybolovstvo)	40	...	...	...	...	...	...
State Metrology and Standards Committee (Gosstandard)	39	...	...	...	...	...	...
Precious Metals and Jewels Agency under the Ministry of Finance	33	-	-	23	69,7	10	30,3
Federal Weather and Environmental Monitor- ing Service (Rosgydro- met)	6	6	100,0	-	-	-	-

\* Documents of the Russian Road Service (Rosavtodor) contain other assessments of the number of associated unitary enterprises (314, 368 and 433\_).

The above data suggest that the process of harmonising charters with new requirements was the most successful at the Federal Weather Service where all 6 enterprises had their charters agreed with the Ministry of Public Property and approved by the sectoral management agency by early 2002. This work is drawing to a close at the Federal River Transport Service (under the Ministry of Transport) where 12 out of 15 enterprises had their charters re-registered. The State Construction Committee and Ministry of Industry were also performing adequately, with 50-60 percent of enterprises having their charters re-registered. This work



was completed at the Ministry of Communications and apparently at the State Standards Committee.

This situation is contrasted by the majority of divisions under the Ministry of Transport, with 50-70 percent of enterprises yet to start re-registering their charters. The majority of departments under the MNR also have a large amount of work to do but, unlike the Ministry of Transport, most enterprises have their charters in the process of agreement. The Ministry of Nuclear Energy (Minatom) was expected to complete the work to approve charters of its enterprises by mid-2001 but we have no information whether this process has been completed. Efforts to harmonise charters with new requirements are still under way in the MNR, Precious Metals and Jewels Agency under the Ministry of Finance, and the Federal Land-Surveying and Cartography Service (Roscartography). We do not have any information on the process of harmonising charters in the MR, Ministry of Agriculture (Minselkhoz) and State Fishing Committee.

*Staffing policies.* In implementing the Russian Government's decisions to improve management of unitary state enterprises (Resolution No. 234 dated March 16, 2000), many ministries and agencies have set commissions to organise tenders for management positions with these enterprises and certification. In particular, these commissions were set up at the MNR (Ordinance No. 367 dated October 9, 2000), State Construction Committee (Ordinance No. 79 dated April 16, 2001). At the same time the procedure of these measures, list of issues and tests were defined. Thus, the Ministry of Agriculture issued Ordinance No. 1075 dated December 27, 2000 to approve the procedure of tender for position of the manager of unitary state enterprises and the certification procedure.

Certification of directors in 2001 suggests that the process was formal, the maximum share of managers acknowledged incompatible with their position being only 4 percent (in the Ministry of Industry). At the same time we have no information on certification commissions being set up and certification being held in the majority of departments under the Ministry of Transport, MR, Minatom, Ministry of Communications, State Fishing Committee as of early 2002.

With regard to the staffing aspect of improving management of federal unitary state enterprises, one should mention tenders for vacant managerial positions and employment contracts.

We have this information only for two agencies: Ministry of Industry and State Construction Committee. By early 2002 the former held 19 tenders, with 18 managers acknowledged as the best bidders (i.e., covering nearly 5.5 percent of all subordinated enterprises as of late 2001, with 7 tender yet to be held), the latter – 11 tenders in 2001 (i.e., covering nearly 6 percent of subordinated enterprises or 8 percent if not counting the enterprise which became associated with this agency in late 2001).

*Table 6*

**Certification of Managers of Unitary State Enterprises in Line with New Requirements**

Ministry (Agency)	Total enterprises	Number of enterprises with managers
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	as of late 2001 – early 2002, units	to be cer- tified	made their presentations	decisions was made on their compliance with their position	
				people	% of presenta- tions
Ministry of transport (Min- trans): - Road network	433*	419	361**	354	98,1
Ministry of Industry, Sci- ence and technology (Min- prom)	326	230	221	212	95,9
Ministry of Natural Re- sources (MNR)	290	...	147	144	98,0
State Construction and Utilities Committee (Goss- stroy)	174	...	13	...	...
State Standards and Metrol- ogy Committee (Gosstan- dards)	39	...	...	...	...
Federal Weather and Envi- ronmental Monitoring Ser- vice (Roshydromet)	6	5	5	...	...

\* Data of the Labour, Wages and Personnel Department in the road network of Rosavtodor.

\*\* Not counting 58 directors whose certification was postponed until 2002.

Moreover, the Ministry of Industry documented 205 additional agreements to effective contracts with managers of unitary state enterprises including 147 agreements which enhanced their responsibilities in line with requirements defined in Government Resolution No. 234 dated March 16, 2000.

The State Construction Committee entered 15 contracts with managers, with 7 more to be coordinated with the Ministry of Public Property. Taking this into account, the share of subordinated unitary state enterprises with new contracts entered with managers will be 12.6 percent.

*Financial and economic position of federal unitary state enterprises as influenced by ministries and agencies.* Financial and economic position of these enterprises is ambiguous. Given below are data describing financial and economic position of enterprises subordinated to specific sectoral agencies.

*Table 7* shows that a part of federal unitary state enterprises is in a critical condition but their share is relatively small, if one is to believe reports of ministries and agencies. In any event, it is considerably smaller than the share of loss-making enterprises across the economy (37.9 percent in 2001).

Enterprises associated with the Precious Metals and Jewels Department under the Ministry of Finance were in an especially bad position. Positive performance in 2001 was shown by the Weather Service where all unitary state enterprises were making profits and by the Ministry of Interior with less than 8 percent of loss-making enterprises in 2000.

Despite satisfactory financial and economic position of many enterprises, the problem of transferring part of their profits to the federal budget is yet to be addressed. Thus, the Ministry of Nuclear Energy was expected to develop and implement deduction ratios from profits



of its subordinated enterprises to the federal budget as late as in the IV quarter of 2001. No profit was transferred by enterprises under the Weather Service and Cartography Committee.

Table 7

**Financial and Economic Position of Federal Unitary State Enterprises Subordinated to Specific Sectoral Agencies**

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Number of enterprises with					
		no economic operations		negative or small-value net assets		conservatorship or bankruptcy proceedings	
		unit	%	unit	%	unit	%
Ministry of Industry, Science and Technology (Minprom)	400*	12*	3,0	8**	2,0	38*	9,5
State Construction and Utilities Committee (Gostroy)	174	18	10,3	12	6,9	6	3,4
State Standards and Metrology Committee (Gosstandard)	39	...	...	...	...	3	7,7
Precious Metals and Jewels Department under the Ministry of Finance	33	...	...	...	...	10	30,3

\* Enterprises associated with the Ministry of Industry in line with Government Resolution No. 812 dated October 26, 2000, bankrupt enterprises and no longer operational enterprises from this list.

\*\* Enterprises with authorised capital less than the minimum required by law.

In 2001 only a few ministries and agencies adopted regulations on this issue.

It is worth mentioning the MNR which issued ordinances No. 351 and 353 dated April 24, 2001 to define the following deduction ratios from profits to be transferred to the federal budget as proprietor's income in 2001:

- 10 percent for enterprises allocating less than half of profits at their disposal to finance capital expenditures for primary operations;
- 20 percent for enterprises allocating minimum 40 percent of profits at their disposal to finance capital expenditures for primary operations;
- 30 percent for enterprises allocating minimum 30 percent of profits at their disposal to finance capital expenditures for primary operations;
- 60 percent for enterprises allocating less than 30 percent of profits at their disposal to finance capital expenditures for primary operations.

Moreover, enterprises allocating minimum 90 percent of undistributed profits at their disposal to finance capital expenditures for primary operations were fully released from any transfer of proprietor's income to the federal budget.

On the basis of economic performance of unitary state enterprises associated with the MNR in 2000 it was established that enterprises allocating minimum 90 percent of undistributed profits including previous years' undistributed profits at their disposal to finance capital expenditures for primary operations were released from any transfer of proprietor's income to the federal budget.



The share of profits to be transferred to the federal budget as proprietor's income including any previous years' undistributed profits was generally 50 percent. Where undistributed profits were the security for the enterprise development under the capital expenditure programme for primary operations approved by the MNR, the share of profits to be transferred to the federal budget was 10 percent of undistributed profits including previous years' undistributed profits.

It was established that regional departments of natural resources should ensure:

1. Approval of capital expenditure programmes for primary operations;
2. Control over transfer of resources by enterprises to the federal budget as proprietor's income;
3. Control over efficient use of resources allocated by enterprises as capital expenditures for primary operations.

The State Construction Committee issued Letter No. IZ-2025/14 dated April 19, 2001 to define deduction ratios from profits of subordinated enterprises to be transferred to the federal budget on the basis of performance in 2000 taking into account the nature of the sector and their operations.

A year later Ordinance No. 65 dated April 26, 2002 defined the following deduction ratios from net profits received in 2001 and left at the disposal of enterprises (line 190, form No. 2 of 2001 Profit and Loss Account):

- 15 percent for construction (installation) entities, scientific maintenance entities, utilities sector maintenance entities and state farms;
- 10 percent for manufacturing entities, surveying entities etc.;
- 7 percent for research and design entities, entities of engineering protection of territories.

Enterprises allocating minimum 40 percent of profits at their disposal to finance capital expenditures for primary operations and compensate for previous years' losses, and also "Radon" special radiation safety enterprises had zero deduction ratio from profits to be transferred to the federal budget on the basis of performance in 2001.

The deadline for full transfer of part of profits to the federal budget was June 15, 2002.

The public property department under the State Construction Committee was expected to ensure:

1. Control over transfer of resources by enterprises to the federal budget on the basis of performance in 2001;
2. Control over use of assets held by enterprises and analysis of efficiency of their operations
3. Review of capital expenditure programmes for primary operations;
4. Review of grounds to change deduction ratios from profits to be transferred to the federal budget on the basis of performance in 2001.

The Ministry of Communications agreed 10 percent ratio with the Ministry of Public Property with respect to performance in 2001.

This suggests that the sectoral management's approach to define deduction ratios from profits to the federal budget was largely based on taking into account the nature of operations of specific enterprises.



In its turn, this suggests that in practice deduction ratios for transfer of profits to the federal budget were defined for a narrow range of enterprises. Thus, the deduction ratio for profits to be transferred to the federal budget in 2001 on the basis of performance in 2000 was defined for only 170 unitary state enterprises of the Ministry of Industry (or approximately 52 percent of enterprises subordinated to with this ministry).

The Ministry believes that transfer of net profits to the federal budget was prevented by either their lack or negligible amount which owed itself to part of profits at enterprises' disposal being allocated to increase the authorised capital up to the statutory minimum, upgrade technical and production facilities, and open up new product lines.

Enterprises under the Ministry of Transport were touched by these proceedings to even lesser extent, with 10 percent deduction ratio defined for 3 out of 36 sea transport enterprises, 20 percent for 1 enterprise; 10 percent deduction ratio from net profits defined for 4 out of 15 river transport enterprises, 5 percent for 2 enterprises. No deduction ratio from profits was defined for road and air transport enterprises (including the Air Traffic Control Department).

This owed itself to extensive wear of fixed capital which, given scarce budget financing, required allocations for investment to maintain the operational infrastructure of air (airports) and river (ports, canals etc.) transport, and mobilisation readiness of road transport (formation of numbered army-type columns). Entities providing services to water transport and central offices of the respective agencies (advertising, communication, computing entities, sectoral printed media, maintenance and health entities) do not have available profits at their disposal either. Weather forecasting and environmental monitoring enterprises are in a similar plight. In stating the lack of deductions from profits as a compensation for using federal property in 2001, the Russian Weather Service indicated that the profits at the disposal of enterprises were used to maintain their facilities.

At the same time one needs to underline that sector-specific nature of unitary state enterprises, for instance, scientific research, does not indicate that they fail to generate enough profits to be transferred to the budget. Thus, 3 out of 6 river transport enterprises covered by deduction ratios in 2001 were research institutes and design offices. 3 more were associated with provisioning and foreign economic activities.

Plans for 2002 adopted by a number of agencies (Precious Metals and Jewels Department and Russian Weather Service) envisaged, apart from defining economic performance benchmarks, approving ratios and amounts of profits to be transferred to the federal budget, something that was lacking in the previous years.

The most important aspect of sectoral management's operations to comply with the Russian Government resolutions to improve management of unitary state enterprises was setting up balance sheet commissions or commissions for review of performance and management reports to:

- define the economic position of subordinated enterprises;
- assess the efficiency of use of federal property;
- define and approve economic performance benchmarks for subordinated enterprises, and define deduction ratios from profits to be transferred to the federal budget.

An example of approval of economic performance benchmarks is the following specific values approved by the MNR for 2002:

- Proceeds from sale of goods, products, services (minus value-added tax, excise taxes and other mandatory payments) – at least 2001 benchmarks times 1.12.
- Net profits – on the basis of general performance indicators:
  - – minimum 12 percent for enterprises involved in geological prospecting;
  - – minimum 9 percent for other enterprises.
- The amount of net profits to be transferred to the federal budget is defined as the amount of net profits minus part of net profits allocated to finance capital expenditures for primary operations times 1.5 provided that depreciation deductions in the reporting period are fully used to finance capital expenditures for primary operations. Moreover, deduction ratios from net profits to be transferred to the federal budget are minimum 10 percent and maximum 90 percent.
- Net assets – at least within the amount defined in the enterprise charter.

The MNR's Department for Subordinated Enterprises was required to:

- maintain the sectoral database of approved benchmarks and actual economic performance of enterprises;
- submit for approval any capital expenditure programmes for primary operations, to be provided to the MNR together with annual reports, and opinions on such programmes;
- define a share of profits to be transferred to the budget and absolute values of economic performance benchmarks for each enterprise.

At the same time the management reporting procedure and methodological recommendations to organise and perform economic performance analysis were approved and made available to federal unitary state enterprises.

Thus, the Ministry of Industry issued Ordinance No. 88 dated November 2, 2000 to approve the Procedure for defining economic performance benchmarks for subordinated enterprises. Actual performance under the benchmarks were assumed as reference values for commissions to define targets for the period following the reporting period, to be used in maintaining the register of economic performance indicators of enterprises. Targets were used by enterprises in drafting their development programmes. The Ministry sent to the Ministry of Economic Development its proposals to monitor financial and economic operations of subordinated enterprises under the Monitoring and Operational Planning Programme whose development is under way. The proposals, in particular, included special criteria for assessment of operations of the scientific sector's enterprises, which make up nearly half of subordinated unitary state enterprises (sectoral science and scientific support).

In 2001 managers of 262 enterprises (nearly 80 percent of enterprises subordinated to the Ministry of Industry) made presentations at commission meetings. Operations of 232 out of 262 were acknowledged as satisfactory. This was approximately in line with the share of enterprises, which reported to the Ministry of a regular basis (277 out of 326 unitary enterprises associated with the Ministry). The available reports were analysed, generalised and used by commissions in their work.

Moreover, it should be noted that a profound analysis of financial and economic operations of enterprises would in many cases invite auditing. Unfortunately, the reports of ministries and agencies on improvement of management of unitary state enterprises had very little information on actual audits of subordinated enterprises. The only exception was the Ministry of Industry which reported audits of 57 out of 72 enterprises to be audited under Government



Resolution No. 81 dated January 29, 2000 on the basis of their performance in 2000. Audits of another 15 engineering and timber enterprises were delayed until late 2001 due to the high cost of auditing services.

*Settlement of property issues.* Settlement of property issues was part and parcel of efforts of ministries and agencies to improve management of federal unitary state enterprises. This primarily involves building an inventory of federal property and its legal documentation (making it part of the Public Property Register of the Russian Federation), and focusing on any construction in progress.

*Table 8*

**Intermediate Results of Sectoral Management to Build Inventory of Subordinated Federal Unitary State Enterprises**

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Enterprises with assets registered with the federal property register	
		units	% of available
Ministry of Transport (Minstrans):	834	...	...
- Road network;	396	...	...
- Road transport;	236	...	...
- Airlines;	146	...	...
- Sea transport;	36	...	...
- River transport	15	...	...
Ministry of Railway (MR)	459	361	78,6
Ministry of Industry, Science and Technology (Minprom)	326	311	95,4
Ministry of Natural Resources (MNR)	290	200	69,0
State Construction and Utilities Committee (Gosstroy)	174	132	75,9
State Fishing Committee (Goskomrybolovstvo)	40	...	...
State Standards and Metrology Committee (Gosstandard)	39	39	100,0
Precious Metals and Jewels Department under the Ministry of Finance	33	...	...
Federal Weather and Environmental Monitoring Service (Rosgydromet)	12*	11	91,7

\* Taking into account 6 enterprises set up in the first half of 1990s without coordination with the Russian Weather Service by separating pilot production units from research institutes.

*Table 8* shows that inventory in the majority of federal ministries is not expected to be completed soon. From 20 to 30 percent of enterprises associated with the Ministry of Railway, Ministry of Natural Resources and State Construction and Utilities Committee have not yet received certificates of registered assets. The situation was better at the State Standards and Metrology Committee, Ministry of Industry (considering only actually associated enterprises) and the Federal Weather and Environmental Monitoring Service. There is no data available on the enterprises associated with the Ministry of Transport, Ministry of Communications, Minatom, Precious Metals and Jewels Department under the Ministry of Finance, Ministry of Agriculture and State Fishing Committee.

Also, it should be noted that lack of certainty regarding the assets of unitary state enterprises is acting as a brake on harmonization of new charters and new requirements. The charters of 13 enterprises under the State Construction and Utilities Committee are being under reworking due to lack of attachments, which requires from the enterprises to settle the issues of documents specifying their right to assets or settlement of property disputes in court. In specific cases, the issues of previous illegal privatization or assignment of the constituent territories or municipal units arise. Likewise, property issues of 19 enterprises under the Ministry of Industry are settled at territorial agencies.

Throughout 2001 many ministries and agencies carried out inventory of construction-in-progress objects owned by enterprises and institutions subordinated to sectoral management agencies. Propositions were designed on their involvement in economic operations, which normally included the following options:

- Construction completion with specifying of sources of financing (core capital and borrowed funds, federal budget funds);
- Privatization (joint-stock companies, selling by tender under investment conditions, auction under conditions of further utilization);
- Assignment to constituent territories and municipal units;
- Leasing.

This work resulted in registration of 185 objects (by 99 organizations) under the Ministry of Railway, 97 units (by 46 organizations) under the Ministry of Industry, 12 units under the Federal Weather and Environmental Monitoring Service, 8 units under the State Standards and Metrology Committee, 5 units (only major ones) under the Ministry of Communication.

It should be noted that the majority of the organizations with construction in progress are non-profit units rather than unitary state enterprises. This specifies the nature of proposals on involvement of these objects into economic operations in which completion of construction is essential and financed mostly with the federal budget.

Specifically, of 185 objects of the subordinate organizations, the Ministry of Natural Resources suggests to write off 12 units (including 10 units of unitary state enterprises), assign 8 units (including 2 units of unitary state enterprises) to regions and municipal units, sell 7 units (including 4 units of unitary state enterprises), and lease 2 units (including 1 unit of unitary state enterprises). Thus, even without regard for the objects, which have not been mentioned, about 80 percent of the objects with construction in progress need investments for completion. Only in two cases construction can be completed by financing with the core capital of the enterprises.

Of 12 of the construction-in-progress objects under the Federal Weather and Environmental Monitoring Service, 2 units are suggested to be completed by extrabudgetary financing and partial selling by tender under investment conditions, 1 unit is suggested to be financed with the budgetary funds. No suggestions have been made with regard to other objects.

Of 8 objects under the State Standards and Metrology Committee, 5 units (including 3 units of unitary state enterprises) are suggested to be completed by financing with budgetary funds, 2 units by financing with the funds of institutions (Standards and Metrology Centers) generated from authorized economic operations, 1 unit is suggested to be written off (by assigning the site to local administration).



The State Construction and Utilities Committee has collected a data bank on the objects with construction in progress as part of the assets of the subordinated enterprises. Actual changes in the structure of these assets were represented in legal documents and balance sheets of the enterprises. This resulted in a significant downtrend of the construction-in-progress objects.

Table 9

**Preliminary Proposals of Agencies of Sectoral Management on Reorganization of Unitary State Enterprises**

Ministry (Agency)	Total enterprises as of late 2001 – early 2002, units	Reorganization methods proposed							
		I	II	III	IV	V	VI	VII	VIII
Transport (Minstrans): - Road network;	396	...	...	30	...	...	...	...	...
Ministry of Industry, Science and Technology (Minprom)	326	12	...	60	...	8	...	...	...
Ministry of Natural Resources (MNR):	290	1	68	48	15	39	1	49	87
- Geological services;	193	1	68	29	15	8	1	37	52
- Forestry;	83	0	0	17	0	30	0	11	25
- Environmental protection service;	8	0	0	0	0	0	0	1	7
- Water service	6	0	0	2	0	1	0	0	3
State Construction and Utilities Committee (Gostroy)	174	8	9	16	1	...	...	...	...
State Standards and Metrology Committee (Gosstandard)	39	3	-	-	3	1	-	-	32
Federal Weather and Environmental Monitoring Service (Rosgydromet)	6	-	2	-	-	-	-	-	4

Note: methods of reorganization are designated by figures as follows:

I – acquisition; II – merging; III – privatization and incorporation; IV – assignment to constituent territories; V – liquidation (including enterprises with negative net assets on which no decision has been made yet); VI – reorganization into federal agencies; VII – exclusion from the subordinated enterprises register; VIII – maintained as a unitary state enterprise.

*Methods of the ministries and agencies aimed at further reforming the unitary state enterprises in various industries.* On the basis of the requirements of the Ordinance No. 1348, dated December 6, 1999, of the Government of the Russian Federation, throughout the period of 2000-2001 of sectoral management agencies had been involved in development of proposals and reorganization of the unitary state enterprises. The data specifying the quantitative part of the issue are presented in Table 6.

In addition, we can refer to privatization of 4-5 unitary state enterprises, reorganization of 3 enterprises by acquisition and 2 by merging, as scheduled by the Ministry of Communi-

cation for 2002-2003. The Federal Land-Surveying and Cartography Service has scheduled to maintain the previous legal form of its organizations.

Table 6 shows that the work on development of reorganization plans is being in full pride. Only the Ministry of Natural Resources, the State Standards and Metrology Committee and the Federal Weather and Environmental Monitoring Service have a final view of their future.

In spite of different approaches at various agencies, it should be noted privatization unitary state enterprises by incorporation is accepted only for 15-20 percent of the total: 18.4 percent at the Ministry of Industry, 16.5 percent at the Ministry of Natural Resources and 9 percent at the State Construction and Utilities Committee. Assignment of the enterprises to constituent territories looks even more unlikely. The Ministry of Natural Resources is expected to use this option for about 5 percent of the enterprises, the State Standards and Metrology Committee for about 8 percent.

In general, one may state that the reorganization plans developed by the sectoral management agencies tend to maintain the existing organizational and legal form unchanged or changed (after acquisition or merging) for the majority of the enterprises.

This is often substantiated by the following:

- considering an object or type of operation as an exclusive federal property;
- ban on privatization;
- manufacturing and service provision related to the national security, withdrawn from or restricted for business;
- participation in federal programs and provision of unique technological processes;
- registration with the Federal property Register.

To date, the procedures of reorganization of the unitary state enterprises by restructuring of their assets through separating various units with their further isolation and integration with educational institutions (to create scientific and educational establishments) are being developed or tested as pilot projects.

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In summarising the work performed by the federal executive agencies over the last few years regarding improvement of management of unitary state enterprises, we may note a significant progress in terms of asset inventory and harmonisation of the charters of the enterprises and new requirements at the majority of the ministries and agencies. However, lack of data on a series of sectoral management agencies (Minatom, Ministry of Agriculture and State Fishing Committee) and on the majority of structural units of the Ministry of Transport suggest that these agencies are at the initial stage of implementation of a package of measures provided for by the Concepts of Public Property Management and Privatisation.

In addition we have to state that a token character of certification of managers along with poor advancement of practice of competition for vacancies and conclusion of contracts limit a positive effect of the measures provided for by the Concepts. A certain positive experience has been gained at the Ministry of Industry and the State Construction and Utilities Committee.

Lots of efforts will have to be made to resolve the issues of allocating a part of the profit to the federal budget (so far, only the Ministry of Natural Resources and the State Construction and Utilities Committee have been leading in this respect) and preparing sound proposals on fu-



ture reorganisation of the unitary state enterprises. At present they are strictly conservative and tend to maintain previous organisational and legal form and receive budgetary financing for completion of construction in progress.

It should be taken into account that the foregoing analysis is far from being complete. The data presented by the ministries and agencies cover less than a quarter of the total of 9.4 thousand enterprises as of early 2002. Specifically, the analysis has not covered almost the entire military-industrial complex under specialised government agencies as well as enterprises under power ministries (State Customs Committee, Ministry of Internal Affairs, Ministry of National Emergency, Ministry of Justice, Federal Information Agency, Federal Security Service), whose operations are strictly specialised. A good example is the Ministry of Internal Affairs which includes, for instance, specialised instalment and operation enterprises involved in instalment, operation and introduction of technical means of traffic control (traffic lights, road signs, etc.), which are considered for assignment to the executive agencies of constituent territories of the Russian Federation.

#### **4.5. Certain Trends in the Corporate Sector Development**

Among basic tendencies that are typical of the corporate sector development in 2002 it is noteworthy to single out both the continuing process of share capital concentration, amalgamation of enterprises and reorganisation of already existing business-groups and a whole series of new tendencies related to intracorporate programmes of a number of the largest companies (groups). It is essential that an analysis of reorganisation changes in 2002 allows us to reveal different strategic motives – depending on the groups' "maturity"<sup>11</sup>.

The development of corporate governance standards within a company is directly connected with its reorganisation and long-term strategy. Peculiarities of the latter, judging by the experience of 2002, are also defined by potential views of group's owners on the features of its international expansion in the nearest years.

##### **Concentration, amalgamation and merger of corporations**

In oil, coal and metal branches in 2002 *the intensive process of redistribution of property was to a great extent finalised* (due to the fact that the last government share holdings got privatised and spheres of influence between the largest industrial groups got distributed). A further development in the redistribution processes in these sectors is primarily defined by transactions connected with reorganisations of large holdings, optimisation of their assets (withdrawal of non-profile assets), or alliances among groups.

In this way the control in ferrous metallurgy is performed by 7 largest groups, which in its turn does not exclude the possibility of their further consolidation. At the end of 2002 leaders of the metallurgical works in Novolipetsk (NLMK) and Magnitogorsk (MMK) announced about a possibility of their companies' amalgamation. Though at present stage a "mild" amalgamation with the aim of joint investments and saving of their resources is most probable, establishing of a unified holding structure is also possible, which can give

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<sup>11</sup> When choosing concrete examples to give the analysis objectivity the author made a point of using only undeniable facts or several sources that in their aggregate show opposite tendencies. In addition to the author's own data there were used data from WEB-sites of the issuers, SKRIN and other Internet resources, periodicals of publishing house "Commerzant", "Finansovaya Rossiya", "Vedomosti", "Expert", "Finansovye Izvestiya", "Companiya", "Zhurnal Dlya Aktzionerov", "Rynok Tzennykh Bumag" and a number of others.



grounds to place the new holding among ten largest world producers in the branch. It is worth noting that also other might-have-been variants of amalgamations of the largest metallurgical companies were announced previously (an alliance between OAO "Severstal" and the MMK versus an alliance between NLMK and "Eurasholding" with sales of government shares in the "Kuzbassugol" company, a non-commercial partnership established by the NLMK and "Eurasholding" with "Russkaya Stal"). As will also be shown below, at present stage the branch is to a greater degree characterised not by amalgamations but by restructuring and assets consolidation programmes within the framework of already existing ones that have the branch under their control.

In the copper industry the market is controlled by 3 companies, in the aluminium industry in 2002 only two holdings were left. In the aluminium branch as a result of the fact that OAO "SUAL" (the second largest in the branch) amalgamated the aluminium assets of "Sevzapprom" (the managing company of aluminium works in Volkhov and Volgograd, Pika-lyovsky GZK and a number of others) the SUAL-holding company has actually divided this market with "Rusal" and controls now 25% of production of aluminium and 60% of production of alumina. The owners of OOO "Upravlyayuschaya Compania (managing company) "Sevzapprom" got 18% of the shares of OAO "SUAL".

An indication that rather stable influence spheres are being formed in the branch can be the insignificant at first glance transaction with the shares of Nadvoitzky aluminium works (NadAZ), which is significant first of all for the development of SUAL. In 2002 65% of NadAS's shares were bought by the SUAL-holding, and 32% by "Russkiy Aluminiy". It was rather evident that a joint management of this enterprise by the two rivals in the branch could hardly be promising and was fraught with a lengthy confrontation within the corporation, that is why the situation was decided in a civilised way at the end of 2002, when SUAL bought 32% of the above shares. Though the transaction conditions are unknown, it is easy to suppose that "Russkiy Aluminiy" got a considerable premium on its renunciation of the joint management.

An institutional result of the military-industrial complex reform in the nearest years shall become the appearance of a rather limited number of large holdings controlled by the government. Pursuant to the government programme adopted in May 2002 in the aircraft industry there shall be established 5 integrated structures by 2004, including 2 multi-profile holdings that will produce both military and civil products: in March 2003 the shares of VASO, MAK "Ilyushin" and Ilyushin aircraft complex will be unified and holding OAO "Corporatziya "Ilyushin" with a 51% government share will be established; by the beginning of 2004 "Tupolev" corporation will be established.

In autumn 2002 legal registration of the process of consolidation of telecommunication companies within the framework of "Svyazinvest" holding was finalised. The result of this process was establishment of 7 inter-regional companies (Tzentrtelcom, North-West Telecom, Uralsvyazinform, The Southern Telecommunications Company, SibirTelecom, VolgaTelecom, Dalsvyaz) on the basis of 72 telecommunication operators. The formal consolidation, no doubt, envisages an even more labour-intensive subsequent stage – actual consolidation of inter-regional subsidiary companies, a tougher management control on the part of the holding, and a capitalisation growth programme.

Concurrently in 2002 subsidiaries of "Svyazinvest" company with the help of bounded debts in roubles attracted 2.5 bln roubles. In 2002 inter-regional subsidiaries plan to float bonds for 3.2 bln roubles. (OAO "VolgaTelecom", "SibirTelecom", "The Southern Tele-



communications Company". A considerable part of the acquired means shall be used to go on with the policy of assets consolidation: by OAO "VolgaTelecom" to buy 50% of shares of mobile operator ZAO "Nizhegorodskaya Sotovaya Svyaz", and by "SibirTelecom" also to buy two mobile telephone companies.

At the same time a certain stabilisation in the sphere of property interests (in a certain sense - a post-crisis fixation of property interests' spheres) creates prerequisites for a new phase of hostile absorptions. Both the deficit of "available" takeover objects and gradual exhaustion of available financial resources give ground to suppose that the takeover style in the nearest years will to a considerable extent be "administrative", using debt schemes, actions at law about insignificance of previous transactions, etc.

On the other side in a number of branches that possess a considerable growth potential and/or relatively scattered assets *intensive concentration (takeover) processes and glaring corporate contradictions persist*, the latter being typical of unstable institutional structures.

A concentration process of relatively scattered assets in the meat industry started in 2002, which was initiated to a considerable degree by agricultural sub-holdings belonging to large oil and metallurgy groups. On the whole the tendency of interest growth on the part of largest Russian groups to the agricultural sector has been characteristic for the past 3 years, which is connected both with the effective demand outlooks in this branch and the possibilities to legalise capitals.

In contrast to the meat industry, where in spite of the starting consolidation no corporate conflicts have been registered so far, the "timber" war will in all probability persist also in 2003 (including in London arbitration tribunal). Though in 2002 the court decisions retained the rights of "Ilim Pulp Enterprises" on shares of pulp and paper mills in Kotlas and Bratsk, its major rival "Continental Management" (a subsidiary of "Bazovy Element") is hardly going to refrain from its struggle and its further expansion in the branch. It is evident that in this property conflict of two largest companies in one of the most attractive branches in Russia's economy the real confrontation will be happening between the largest extractive groups that are diversifying their assets. According to assessments most effective in this kind of conflict turned out to be takeover methods traditional for the past years – made to order bankruptcies, tampering with registers and the "administrative resource". One should also take into the consideration that according to the assessments as of the end of 2002 all in all 12 independent structures are present in the branch, they form both vertically and horizontally integrated holdings (structures belonging to the Alpha-group, OAO "Severstal", and others).

Among other known conflict of 2002 one can name the failed attempt by "Alpha-Echo" to take over the metallurgical works in Taganrog that turned for help to the MDM-group, seizure of a block of shares of Krasnoyarsk coal company, paralleled stockholders' meetings of "Dalvostokugol", suits by minority shareholders of "Rosneft" about transfer price formation in the holding, tampering with registers of a fat-and-oil factory in Nizhny Novgorod and NPZ in Moscow<sup>12</sup>, a multi-layer conflict around "Severnaya Neft", a clash between officers of justice and "employees" of "Moskomplektmebel", and others.

A parallel process of getting rid of non-profile assets and diversification allows us to speak about moving of financial resources between branches that started in the past two years

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<sup>12</sup> An analogous procedure (seizure of the register pursuant to a court decision and its transfer to another registrar with follow-up "changes" in the list of shareholders), as far as we know, was used to shift the control of the timber factory in Ust-Ilimsk, metal works in Taganrog, etc.

and is being serviced by the absorption market. Meanwhile, two basic features are typical of the recipient branches: lack of strategic (controlling) owners and an acceptable (higher than the average) level of profitability. The acuteness of corporate conflicts persistent in the majority of branches also testifies to the effect that hostile takeovers (including those containing specific Russian features – usage of the “administrative resource”<sup>13</sup>) keep being the predominant method of share capital concentration. For the nearest years (taking into consideration the plans to privatise state-owned enterprises and turn them into joint-stock companies) one can also forecast corporate conflicts connected with shift of control at these enterprises prior to and in the course of privatisation transactions. Nevertheless, the results of 2002 allow us to speak about certain quantitative changes.

As is well known, single instances of using classical takeover methods were typical of the initial privatisation stage (post-privatisation stage since the middle of the 1990s until the crisis of 1998). If privatisation deals are taken into account, it is this very period that can clearly be characterised as “takeovers through privatisation”. This method was both used as an independent mechanism and within the framework of expansion strategies of the first financial and industrial groups (first of all non-formal ones, originating in banks).

The second stage (the post-crisis boom) was typical of the period from the middle of 1999 until 2002, when specific reasons that caused a wave of amalgamations and takeovers in Russia became particularly apparent. Nevertheless, due to peculiarities of the methods used, some analysts prefer not using the “amalgamation and takeover” notions to describe them, restricting themselves to a more regular word-combination “redistribution of property”. In this period the expansion of industrial groups was combined with a growing process of assets consolidation.

The third stage (reorganisation “slump”) starts in all probability at present. It can be characterised by a certain decrease in the existing groups’ expansion tempo slowdown, finalisation of consolidation processes and a transfer to restructuring of groups and legal reorganisation (first of all legalisation of amorphous holdings and groups)<sup>14</sup>.

### Restructuring Programmes

It should be noted that restructuring concepts are visibly varied in different surveys (a detailed analysis of these is not included in the present research). They agree only in the part of a most general approach to restructuring, when it is defined as “changes in operations, in-

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<sup>13</sup> The “administrative resource” notion (materially motivated decisions of courts, federal and regional authorities, etc), which is so wide-spread at present and being rather evident in its essence, is at the same time difficult to be interpreted and even more difficult to be legally proved (which was spoken of with confidence in one of his interviews by the president of “Alpha-Bank” and leader of one of the most aggressive Russian groups in the sphere of corporate absorptions M. Friedman). The president of “Sibneft” Y. Shwidler stated for example that each of oil companies in the course of its development got its share of the administrative resource and it is namely this fact that defines the real competitions at the oil market (Kommersant-Vlast, 2003. January 20-26, p. 25). It is noteworthy that according to the original version of the same source, the standardisation and the mass character of using the procedure of the “administrative resource” in 2002 led to a reduction of its price and simultaneously caused a situation when rivalling parties use same methods (balanced support actors) and are most often incapable of bringing their cases till final victory of one of the parties. In such a situation expenditures that correspond to the corporate conflict become comparable to the real price of the assets and civilised negotiations become more economical.

<sup>14</sup> For more detail about theoretical and legal aspects of this problem see in *Radygin A., Entov R., Shmelyova N. Problemy Sliyaniy I Pogloscheniy V Korporativnom Sektore*. Moscow, IET. 2002.



teractions (interplay) and motivations in the direction of reaching success in the changing market situation”<sup>15</sup>. In practice the traditional meaning of “restructuring” both in Russia and in the West is “improvement of enterprise’s activities”<sup>16</sup>. On the whole the restructuring process, being a multidimensional concept, includes the following components:

- restructuring as a legal matter (the subject of it is solely reorganisation of a juridical person (company) as a subject of the law, including amalgamation and joining in Russian law-terms);
- restructuring of a group of companies (legalisation of a holding and its owners);
- restructuring as a matter of production, that is changes in the production and technical structure of an enterprise, restructuring of an enterprise as a subject of company’s property (object of restructuring here is the property used for business undertakings as subject of law);
- restructuring of the owner or restructuring of a company as a subject of property of its owners, including shareholders (only at the initiative of owners themselves), including amalgamation and joining;
- restructuring of the system of daily management;
- restructuring of financial flows;
- restructuring with respect to employees.

There exist also other approaches based upon Russian peculiarities: the major problem of restructuring Russian companies lies in the fact that when they are being restructured there is made a redistribution of shadow business, when there is no credence attached to one’s partners; in the majority of cases restructuring of Russian companies does not sue any economic purposes, but political ones, it is not done to optimise company’s activities, but to withdraw money flows from it, and finally, restructuring today is a mere continuation of privatisation and a subsequent redistribution of property<sup>17</sup>.

It is rather evident that the goals pursued within the framework of restructuring programmes are to a considerable degree defined by *concrete development stages of enterprises (groups of enterprises)*.

Table 10

**Formation of formal standards for corporate governance in the oil sector and some of their related characteristics**

	Lukoil	Yukos	Surgut-neftegaz	TNK	Sibneft**	Tatneft
Withdrawal of non-profile assets	2001	1998*	-	-	1997	2002
US GAAP reporting	1998	2001	2002	-	1998	2000
Dividends at least 10% to the profit (“western” analogues – from 30 to 70%)	1993 (about 15%)	2001 (about 15%)	2-5%	-	2001 (about 15%)	2-5%

<sup>15</sup> Ericson R. Restructuring in Transition: Concept and Measurement. Comparative Economic Studies, 1998, 40. P. 103–108.

<sup>16</sup> Blake E., Levis F. Mify O Restrukturizatsii V Rossii / Rynok Tzennykh Bumag, 1998. #6. p. 24-27.

<sup>17</sup> See materials of conferences arranged by the Publishing House “Commersant”: Restructuring of companies, alliances, merger, take-over. Moscow, October 2000. Successful restructuring of enterprises. Problems and practical solutions. Moscow, October 2001. To describe general processes of changes at enterprises (within groups) we will further on use notions “restructuring”, “reorganisation” and “transformations” of enterprises (groups) as synonyms, meaning not only legal aspects, but also economic and first of all “property” aspects of the process.

## RUSSIAN ECONOMY in 2002 trends and outlooks

Independent directors	2002	2000	-	-	1998	-
Code (charter, principles) of corporate governance	-	2001	-	Draft in February 2003	1998	-
Presence of a corporate governance committee in the board of directors	-	2000	-	-	1998	-
ADR issues	1996	2001	-	-	2000	1998
Disclosure of data about the property structure	-	2002	-	-	-	-
Withdrawal of major owners (shareholders) from the management	-	-	-	-	1996	-
Share of free float shares, in % to the authorized capital stock, December 2002	52-54 (>25 after 2000)	20-25	N/a	10-15	15	N/a
Possibility for minor shareholders to influence the level of income (compensation) of the managers and to obtain corresponding information	2001	-	-	-	-	-
Equality of market's subjects with respect to the issuer (ban to use insider information at purchase of shares by employees (affiliated persons), ban to transfer not published information of vital importance to private persons and organisations)	-	-	-	-	-	-
Option programmes	-	2001	-	-	-	2001
Place in the corporate governance rating (IKPU), in all 25 companies, 3 <sup>rd</sup> quarter (2 <sup>nd</sup> quarter) 2002	7(9)	5(5)	17(19)	20(20)	6(7-8)	21(22)
**SKRIN-Naufor popularity rating, 50 issuers, January 2003 (January 2002)	1(1)	7(10)	4(4)	16(18)	14(15)	17(14)

\* At the end of 2001 – beginning of 2002 (prior to privatisation of the remaining government owned shares) the problem of assets withdrawal from “Yukos’s” subsidiary VNK was discussed, though it never got a univocal interpretation. The problem of acceptable economic and legal limits (conditions) for withdrawal of assets and transfer price formation acceptable from the viewpoint of minority shareholders is typical of the majority of holdings (groups), though.

\*\* The company’s reports in 1998, as well as its “independent directors” called for a whole series of criticisms on the part of analysts. It was quite evident that 90% of the profit paid out in 2001 as dividends could not be interpreted in the context of standard goals of a dividend policy.

Source: companies’ WEB-sites; “Commerzant – Neft I Gaz”, 2002. # 114; assessments by the author.

Finalisation of institutional formation (consolidation) processes of stable business groups in the oil branch by the beginning of the 2000s does not exclude a further expansion in oil and other industries. Nevertheless, the current restructuring programmes for the largest oil companies are rather similar and in the first place are aimed at an optimisation of property assets, lower per barrel cost prices in oil production, raised oil production and increased exports of oil products, development of the gas producing sector.

Programmes of oil companies “Yukos”, “Sibneft” and since 2002 of “Lukoil” include also a set of standard measures to increase the companies’ capitalisation: US GAAP reports, withdrawal of service and non-profile structures, inclusion of independent directors in their boards, dividend policies, etc (*table 10*). For example “Lukoil” that has lost its leading position in the branch recently plans sales of 206 non-profile companies, shutdown of ¼ of non-commercial wells (about 5000), staff reduction. The board of directors consisting of 11 member at the annual shareholders’ meeting in 2002 got 3 independent directors (in “Yukos” the board of directors elected in 2002 in addition to two top managers of the company includes 9 independent directors or directors at least not directly connected with the company). Never-



theless, the existing complicated structure of the holding and the level of transparency do not quite correspond to the task of increasing the company's capitalisation. On the contrary, one of the major corporate events of 2002 was the fact the "Yukos" disclosed its data on the structure of the group's property, which also had an effect upon capitalisation growth (an incentive for it was listing by the New York stock exchange and floating of ADR of the 3<sup>rd</sup> level).

It is evident that capitalisation growth that from the viewpoint of the investors automatically testifies to a high effectiveness of assets management gives the company a whole number of advantages – an effective participation at the stock market, good image and enhanced prestige of its managers, accessibility of credits on the security of its shares, profitable sale of the company and its merger, realisation of compensation programmes for its employees, etc. At the same time (and this is not just a Russian trait, which is testified to, for example, by the case of Enron) capitalisation does not necessarily reflect the dynamics of the basic showings, but can be connected with the inertial "fashion" for already overestimated securities in conditions of a limited market (due to insufficiency of traded securities) and an effective information support (PR, positive financial reports by analysts, etc).

To give an example, according to estimates "Surgutneftegaz" is one of the most effective companies in Russia that has a substantial basis for its growth (production increase, volumes of extracted resources) supported by large investments. At the same time the company's policies are characterised by privacy of data, it ignores interests of minor shareholders and has much smaller dividends compared to its rivals. In 2002 "Surgutneftegaz" published its financial reports for 2000-2001 according to US GAAP meaning to publish quarterly reports in future and to develop a programme of a better corporate image. Nevertheless, the company plans to hold the annual stockholder' meeting as early as in March, not at the end of spring – beginning of summer 2003 as is usual in other companies, which can be viewed as an indirect evidence that the company will continue to pursue the above policies also in 2003. The reason for that in all probability is a possibility that soon there will be made amendments to the Law "On Joint-Stock Companies", which will give a more precise definition to the "net profit" notion. Using the current, not defined by the law approach there is an opportunity to interpret the net profit as profit after deduction of taxes, investments and amortisation, while the new amendments (1<sup>st</sup> reading on December 25, 2002, 2<sup>nd</sup> reading on February 14, 2003) give a clear definition to the net profit as profit after deduction of taxes. For establishing preferred dividends, which shall be at least 10% of the net profit, this makes a great difference.

State-owned "Rosneft" in 2002 also published its financial reports for 2000-2001 based on US GAAP. Nevertheless, from the point of view of property relations that are being established in the holding the company still lags behind its rivals. When the latter have actually finalised their processes of consolidation of subsidiaries and went over to single shares at the end of the 1990s – beginning of the 2000s, the consolidation policy in "Rosneft" is far from being finalised. One of the problems in this respect is the pattern of its property in its subsidiaries – 51% in equities, but only 38% in the authorized capital stock (should "Rosneft" fail to pay preferred dividends it will thus lose control, which already happened in 1997). "Rosneft's" clear final goal is achieving a qualified control over its subsidiaries with a follow-up transfer to single shares. This becomes even more pressing for the company taking its conflicts with minority shareholders in 2002 about transfer price formation in the holding into consideration.

Many events connected with "Lukoil's" activities in 2002 (denunciation of the Iraq contract within the framework of the production sharing agreement (PSA) on "Western

Curna-2" field, its withdrawal from Azeri-Chirag-Gunashli Consortium, sales of the tanker fleet of the ice class, taking out of bonds that can be converted into "Lukoil's" shares started by British Petroleum in advance in January 2003, cancellation of its application to participate in privatisation of "Slavneft", etc) cannot be unambiguously interpreted with respect to assessments of the company's development. At the same time as distinct from the overwhelming majority of the largest oil producing companies in Russia "Lukoil's" freely floated shares at the market as of the beginning of 2003 according to assessments can account for 52-54% of its authorized capital stock. This free float figure alongside with the transparent property pattern, information openness and the profit shares in dividends are of decisive importance for portfolio investors (with respect to assessment of the issuer's and its affiliated structures' capabilities to manipulate the market). In comparison with "Lukoil" free float of TNK amounts only to 10-15%, "Sibneft" – 15%, and "Yukos" – 20-25%. One more potential advantage of "Lukoil" are its investments into petroleum refineries and sales companies in Eastern Europe, which allows the company to feel to a certain degree comfortable in cases of crude oil price falls.

Also rather indicative – in the context of consolidation as a general tendency and corresponding outlooks for Russia's equity market – is the negative position taken by TNK with respect to floating its shares on the domestic market after its consolidation. Among reasons for the company's actually closed character and its unwillingness to publicly float its shares are named the following: a minimal number of minor shareholders, fears of scandals and corporate blackmailing that can harm the company's reputation, its disinclination to use "cheaper" internal price quotations.

The policies of corporate image enhancement and artificial "pumping" of capitalisation can in particular be an evidence of preparations for sales or an international parity merger. Should all other conditions persist appearance of foreign co-owners in some of Russian oil companies (in different organisational forms) is being assessed as only a matter of time, which is conditioned in the first place by Russian companies' reaching a certain level of their correspondence in price to their foreign counterparts if their value is recalculated taking into account their oil stocks, and secondly by presence of other alternatives to invest proceeds into the Russian economy<sup>18</sup>.

In 2002 a number of large holdings (groups) embarked on restructuring programmes aimed at tightening control and consolidating the management of the purchased assets, thus following the example of the oil sector. The two main aspects of such a restructuring are as follows.

Firstly, it is *the strategy of asset regulation* (getting rid of the companies that are not in the main line of business (non-specialised assets) that was typical not only of the oil sector but also of the majority of large, relatively organised groups in 2002.

The restructuring programme of OAO Obyedinennye Mashinostroitelnye Zavody (OAO OMZ) is not related to asset consolidation; it provides for establishing in 2003 six business following divisions within OMZ, without legal independence at the first stage, but with independent balance-sheets and budgets: Mining, Nuclear, Metallurgy, Oil and Gas Equipment, Special Steels and Shipbuilding. It is possible that subsequently the divisions will be transformed into independent companies and sold. OAO Severstal started a similar programme of

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<sup>18</sup> Used assessments by investment company "Tzentrinvest", IC "Finans-Analytic", The Institute of Financial Research, IC "NIKoil", IC "Prospect", IC "Aton", surveys at RusEnergy.com.



asset restructuring in 2002. It is assumed that three holding will be formed (the metallurgical company OAO Severstal, car-building company OAO Severstal-Avto and mining company OAO Severstal-Resurs) under the control of ZAO Severstal-Group. The purpose of such a restructuring is to clear the Group's main business, steel production, of non-specialised assets and increase its capitalisation so as to enter the US stock market subsequently.

RAO Gazprom's policy of asset regulation seems much more complicated, in particular due to the need to return to the company some of the previously stripped assets that belonged to its core business. The control regained over SIBUR in 2002 is not enough for efficient management, and Gazprom needs to increase its share to qualified majority. It should also be noted that in 2002 control was regained over the companies Zapsibgazprom, Purgas, Vostokgazprom, the South Russian Deposit and others. At the same time, non-specialised assets are being sold (the revenues in 2002 were RUR 7 billion and expenses of returning the core business assets cca. RUR 9 billion). Still, it is obvious that Gazprom's status of a federal natural monopoly prevents one from regarding these processes as a restructuring programme. More serious reforms in Gazprom must have been frozen at least for the next 18 months.

Secondly, *the tightening of management and property control*; this is typical both of the groups that have completed their expansionist programmes and of the groups that are continuing the corporate formation. In contrast to the relatively widespread Western practice of consolidating only the management, in Russia management consolidation usually follows property consolidation and is never considered sufficient (or only provisionally, at the phase of gaining control over property).

The creation of industrial sub-holdings of the MDM group has been practically completed. According to group officials, the concluding deal was the acquisition of 80 percent of AO Azot by the Mineral and Chemical Corporation Evrokhim. The first step of the restructuring, like in a number of other groups, is vertical tightening of the asset management structure. In the first place, the holding's representation in the boards of the main companies has been strengthened. In the second place, management functions are being consolidated: instead of general directors appointed and dismissed by the boards of directors or general meetings of shareholders companies should be locally governed by executive directors appointed by the holding and acting on the basis of a power of attorney.

The next logical step would be to transfer each of the holdings (MCC Evrokhim, the Tube and Metallurgical Company, Baikal-Ugol) to a single share (creation of a single legal entity that would include all the companies under control as divisions), transform it into a public company and enter the stock market (IPO in 2003 or 2004). As a result of the restructuring, the MDM Group core may also subsequently decentralise its subholding management.

Tougher strategies of control over group companies have also been introduced in the Russian Aluminium (under parity control by Sibneft through Millhouse and by O. Deripaska's group). The issue of creating a subsidiary company OOO Rusal - Upravlayushaya Kompaniya, a single management body for the holding's eight companies, was considered in early 2002. It was proposed that the companies belonging to the group's main specialisation (the main assets) should remain legally independent and all auxiliary assets should be centralised. According to that proposal, the former directors of the holding's companies would lose their general director status and would carry out their functions by proxy as executive managing directors working in a close-end company. But as soon as in the autumn of 2002 consolidation of the holding's 27 companies into six business areas and transfer to a single share gained greater priority (at least, according to official statements). While there is a number of legal



issues that need to be solved (obtaining the permission of the RF Ministry for Antimonopoly Policy to purchase more than 20 percent of shares, the procedure for transformation of open-end companies into close-end companies for a number of companies, forced exchange / buy-back of minority blocks in an acquisition / merger), OAO SUAL carried out a similar acquisition of the works under its control in January 2001.

Interestingly, the restructuring started in 2002 in the car-building plant GAZ controlled by Bazovy Element is going in the opposite direction – from a single company to a classical holding – and is in fact selling off structural units into subsidiaries. Such subsidiaries can be established on the basis of the Mold and Press Form Works, Gearset Works, Car Bridge Works, Foundry Works, Passenger Car-Building Plant and Lorry-Building Plant, etc. Besides cutting production costs, the plan is to establish joint ventures on the basis of the subsidiaries.

The industrial holdings going through the forming period and continuing asset expansion are introducing tight control over the newly purchased assets.

An expansion example in the food industry is Gosinkorholding, which is currently forming a horizontally iterated confectionery subholding on the basis of the blocks of shares of Rot Front, Krasny Oktyabr and nine regional candy factories. The plan for 2003 is to acquire five more candy factories and gain full control over Babayevski. Starting from 2003 general management of the holding has been transferred to the management company United Confectioneries (Obyedinyonnye Konditery) and sales and marketing have been centralised in the trading house Obyedinyonni Torgovy Dom that have been established for these particular purposes.

The continuing expansion of the Ural Mining and Metallurgical Company (UGMK) is related to the forming of a vertically integrated copper holding that comprises, through a system of off-shore assets, over 20 companies in the mining and non-ferrous metallurgy sectors. At the same time UGMK acts as the Management Company. At present the task is to ensure 'legally clean' control over a number of companies that are already involved in the Group (it is necessary to obtain a permission of the Ministry for Antimonopoly Policy to acquire large blocks of shares of the Gaisky Ore Mining and Processing Enterprise, Uralelectromed and others). The next logical step in the process of legalising (increasing the transparency of) the system of the Group's assets would be to transfer the controlling blocks of the Group's member enterprises from off-shore companies to UGMK, then convert to a single share and float the shares of the consolidated public company on foreign stock markets. Still, experts believe that the Group's acquisition strategy has not been completed yet.

Further restructuring of Evrazholding implies transition of the holding's steel-casting enterprises (the Novosibirsk, Kuznetsk, West-Siberian and Nizhny Tagil Metallurgical Enterprises) to a single share by 2005; however, a precondition for such an operation is the potential problems relating to management of the enterprise (obtaining the powers of an executive body) should be regulated. In particular, it is planned that the holding should obtain the status of a management company in relation to the North-Siberian and Nizhny Tagil Metallurgical Plants (this requires at least 75 percent of votes in a shareholder meeting). It should be noted that liquidation of the general director's functions and transfer of executive powers to a special management company (and this implies qualified control) has the indisputable advantage of limiting the top management's ability to act in an opportunistic manner (the extreme case: control take-over in agreement with the management). Thus, the current phase of reorganisation can be aimed only at defence; however, the strategies purpose, like in some other companies, may be to enter the stock market or to sell the company.



It should be noted that the issues of tightening the control over the top management's activities have been considered in state-owned holdings, too: one may refer to the Government's Decree No. 1512-r of 29 October, 2002 "On Introducing Changes in the Charter of the Federal Unitary State Enterprise Rosspirtprom" as an example. According to this decree, the holding's right to borrow independently, put the election of boards of directors and executive bodies on the agenda of the companies whose shares have been transferred in the Enterprises charter capital and terminate the authorities of the subsidiaries is withdrawn. From now on all such operations may only be carried out with the permission of the Government that would make recommendations on the amount dividends to shareholder meetings of the said companies and decide on changes in their constituent documents and charter capitals. Appointments of the general directors of subsidiaries and of deputy general directors and the chief accountant of the holding itself will be co-ordinated with the Ministry for Agriculture of the Russian Federation. Previously Rosspirtprom's limitations related only to additional share issues and the conversion of shares into bonds. The main reason cited by the Government for such a step is the necessity to cut the number of deliberate bankruptcies in the alcohol production sector.

Moreover, several relatively *new trends* related, as we have mentioned above, to inter-group programmes of a number of the largest companies were typical of 2002. Besides the above-mentioned tightening of management control, the following trends are of interest.

Firstly, the restructuring and consolidation processes in 2002 were distinguished by the clarity of interim purposes, in particular, the task of entering the Russian and international stock markets. Such purposes have been cited by the industrial subholdings of the MDM Group, UGMK and Severstal; it is also highly probable that Evrazholding, Rusal and a number of machine-building enterprises will embark on such programmes. According to estimates, in the next one to two years, as a result of the concentration of capital in the machine-building sector continuing against the background of a growing appeal of machine-building company stocks, a number of the sector's largest holding structures and groups (Russian Machines, Power Machines, Severstal-Avto) will enter the stock market. Several large companies in the agroindustrial sector have also declared their intent to enter the stock market: the agroindustrial enterprise Cherkizovsky (the blocking stake worth cca. US\$ 150 million will be placed on NYSE in 2003), agroindustrial farm Rusagrocapital (the blocking stake worth US\$ 25 to 30 million will be sold in 2005) etc.

Obviously, the consolidation of property and management control is a condition that is indispensable but not sufficient. It is just as crucial to create the image of transparency for prospective investors. In this connection one may predict a growth in real demand for new corporate governance initiatives related to information disclosure and corporate financial accounts.

At the same time, it would be wrong, from our point of view, to overestimate these prospects. On the one hand, just like in the past, the Russian stock market cannot carry out the redirection of investment flows. Although the RTS index has grown almost 35 percent in 2003, approaching its maximum pre-1998 values, market capitalisation does not exceed US\$ 90 billion and ten companies account for 90 percent of turnover (and out of these, two companies – Lukoil and RAO UES – account for 45 percent). It is quite obvious that the overall prospects of realisation of the bank reform and of the possibilities to grant bank loans to small and medium companies have considerable impact on the Russian financial market. The forecast for international financial markets do not give cause for optimism, either, despite the rise of Russia's credit ratings and of the interest to Russian securities in 2002 on the side of for-

eign institutional investors that operate with longer term investments and use corporate fundamental indices as a benchmark.

On the other hand, the fact that IPOs are few and far between does not one allow to join in the celebrations of many analysts (especially their interpretation of 2003 as 'the IPO year' that will replace 2002 as 'the year of corporate RUR bonds'). It is significant that the relatively successful placements relate so far to the companies that have been private from their inception and have well-known brands, and their buyers are financial institutes, not strategic investors. It is also important that the IPO procedure is only very briefly described in the Russian legislation, so each project requires by far more consultancy and legal expenses than it would be the case if there existed standard detailed regulations. Usually, potential benefits of an IPO (such as low cost of the obtained funds, as compared with other funding methods, growth of capitalisation, liquidity etc.) exceed total expenses (on information disclosure, fees of advisors, legal experts, underwriters etc.) only at a relatively mature stage of a company's development. E.g., empirical tests carried out on the basis of the life cycle theory demonstrate that during the past 20 years companies performed the IPO at an average age of seven (if one does not count in the dotcom boom of the late 1990-s).

The experience of foreign IPOs is rather modest: Vimpelcom (1996, US\$ 100 million), Mobile TeleSystems (2000, US\$ 300 million) and Wimm-Bill-Dann (2002, US\$ 200 million) at floated their stocks at NYSE. Besides the above-mentioned enterprises, the following companies plan to float their shares in the USA in the next years: Kalina concern (cca. 25 percent of shares, upon publication of an IAS report), MefaFon (cca. 20 percent of shares) and OAO Baltika Brewery (upon integration of the holding's subsidiaries into a single structure).

OAO Rosbusinessconsulting Information Systems was the first Russian entity to carry out an IPO in Russia (at MICEX and RTS, 16 percent of shares). In January 2003, the drug-store network Aptechnaya Set 36.6 floated 20 percent of its shares. In both cases the placement price was lower than the initial estimates by the underwriters (still, this is not typical of the Russian market), and no forecast are made in respect of active secondary circulation.

Corporate Ruble bonds remain so far the only instrument – at least, due to the lack of an adequate alternative. Nevertheless, according to certain estimates, the interest to shares as a financial instrument is going to grow in the course of the next two years<sup>19</sup>. This means, inter alia, that many issuers can (as an easier alternative to an IPO) convert their privileged shares into ordinary shares. And, the other way round, the debt instruments will be of interest to the relatively limited circle of investors (and these will not compete with the investors interested in placements in Russian shares). As regards the IPO, the future placement will be most probably divided into two segments: the external segment for large companies and the Russian segment for small and medium companies (i.e., in fact, the Small Caps market will be created in Russia). For instance, development of the latter segment is fundamentally important for the transition to classifying Russian companies by capitalisation and not by liquidity.

Secondly, the trend towards legal 'closing' of a number of companies has been expressed more clearly.

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<sup>19</sup> *K. Lynch* 2002: the corporate bond year. 2003: the IPO year/ *Securities Market*, 2002, Issue # 5, pages 60-62; Interview with P. Helloran, Chairman of the Board of Directors of IC Aton./ *Securities Market*, 2002, Issue # 9, pages 48-50; *V. Petrov, P. Suprunov, O. Petrova*, Is Russia expecting an IPO boom? / *Securities Market*, 2002, Issue # 20, pages 20 - 26.



In the 1990-s oil holdings were transforming their subsidiaries into close-end companies by exchanging their shares for the shares of the holding. In 2000 - 2001 the most consolidated of the companies started to consider the issues of transforming into a non-public single consolidated company. In 2002 the Russian Aluminium considered transforming open-end joint-stock companies comprising the holding into close-end joint-stock companies. IN November 2002 the issue of transforming open-end joint-stock companies comprising the holding into close-end joint-stock companies was, for the first time, regarded in practice: Uralkali included it on the agenda (Uralkali: the largest potash fertiliser producer, over 70 percent of shares belong to the controlling shareholder, 10,000 shareholders, IAS accounting since 1996, listed at RTS since 1999). Taking into account the company's characteristics, it is not quite clear what the reason for the possible transformation is: 1) the management was trying to neutralise minority shareholders and stop the attempts at collecting the blocking stake (like in the Russian Aluminium, in which the presence of a lot of open-end joint-stock companies in the group is regarded as a significant problem); 2) fixing the established structure of ownership that, following the reorganisation, would be difficult to question in court (including the privatisation deals); 3) speculating for the fall of the open-end joint-stock companies' shares (without real reorganisation purposes) so as to consolidate a block exceeding the qualified majority with lesser expenses; 4) according to the version proposed by the company: the necessity to transform into close-end joint-stock companies corresponds the companies business purposes since de facto, from the viewpoint of ownership, it is a close-end company not interested in outside investments.

This issue has a wider aspect, too. For many medium-sized Russian companies that have been forced to become open-end in the course of the mass privatisation and are highly concentrated from the point of view of the shareholder capital structure there is a number of advantages. Still, such transformation is possible on a large scale only in case there would be created the necessary conditions or, to be more precise, obvious incentives for transforming from an open-end joint-stock company into a close-end joint-stock company<sup>20</sup>.

One of self-contradictions in the Russian law is that operations of public companies are not sufficiently regulated while the companies with a close-end organisational and legal forms (non-public) are burdened with excessive regulation. E.g., from the viewpoint of the Ministry for Economic Development of Russia, it would be expedient to introduce such novelties for close-end joint-stock companies as eliminating the requirement on the constituent agreement (which often is a duplicate of the charter but is necessary in the course of different voting procedures), introducing the possibility of unlimited member walkout (in accordance with the charter), registering members in the state register etc.

Thirdly, in 2001 - 2002 a number of companies developed option programmes, thus undertaking another innovation. Granting to the company's management options for its shares has been traditionally regarded an efficient tool of boosting capitalisation and the management's interest in the company's development strategy (although the Enron case introduced a pessimistic note into the generally accepted idea and put the issue of tightening the corresponding regulation on the agenda).

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<sup>20</sup> In other words, the policy of 'squeezing' companies into other forms by means of a system of incentives and legal limitations seem reasonable. A similar approach (already legally fixed in 2002) has been envisaged for unitary state enterprises.

In Russia certain rules were introduced on 9 January, 1997, when the regulation of the Federal Securities Market Committee ("On an Options Certificate and Its Application and on Approving the Standards for Issuing Options Certificates and their Prospectuses"). The first issue of options certificates, for the shares of OAO Tatneft, was registered in May, 2001. In August 2001 RAO GAZ prom approved a programme of granting options for the company's shares. The board of directors of YUKOS approved in April, 2001, an incentive programme for the remuneration of personnel that envisaged using options for shares and granting shares free of charge. The total amount of shares that may be transferred to the staff in the course of the next three years should not exceed 85 million, or 3.8 percent of the total number of the shares issued by the company. In doing so, the company does not contemplate any additional issues to realise the programme. In October, 2002, a long-term programme of "remunerating the best employees with the company's shares" (by means of an agreement of gift) was announced.

A programme of options for the personnel (the management of subsidiaries and dependent entities) of power industry sector companies was envisaged as part of the overall reforms of RAO UES. The scheme approved by the board of directors in June of 2002 envisages that the management of parent companies of RAO UES would be granted an option right to one percent of the shares of RAO UES and the management of AO-energос would be offered from 0.5 to five percent of the shares of AO-energос. At the same time, general problems of restructuring the joint-stock company, including the relationship between the management and minority shareholders, complicates such schemes considerably.

As far as the companies that were private from their inception are concerned, similar programmes are being developed at Vimpelcom (a system of participation in profits for the staff and a system of options for top management). Undoubtedly, it would be possible to assess the efficiency of such schemes only three to five years after they commenced. Still, just like in the case with the IPO, the existing legal norms require considerable detailed elaboration and revision (despite the amendments to the Law "On the Securities Market" that came into force in January 2003). Likewise, it is possible to apply such schemes at a certain stage in a company's development. It is obvious that, in addition to the considerations of capitalisation, option schemes may be applied in Russia as part of consolidation of corporate control and legalisation of the management's income.

Fourthly, the new development trend typical of established Russian holdings that have exhausted the internal resources for expansion is that they are entering the international market. It is not a purpose of this survey to discuss the exact definitions or concepts of the development of multinational corporations<sup>21</sup>, however, certain fundamental differences are important, above all the motives behind and the type of internationalisation.

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<sup>21</sup> See, e.g., works by S. Heimer, C. P. Kindleberger (the monopolistic advantage model), R. Vernon (the product life cycle model), J. Galbright (technological model), J. Casson, J. McManus (internationalisation concept), S.P. Muggy (appropriation theory), J. Dunning (eclectic model), the materials of the UN Centre Multinational Corporation etc. It should also be noted that the applied definitions are relatively conventional: companies that are similar in their features may be termed 'international concerns' in Germany, 'multinational corporations' in the countries of the Anglo-Saxon tradition etc. And similarly, there is no standard criterion for the international nature of a company (presence of at least one branch or a certain portion of business operations (assets) abroad, a certain amount of export-import operations, foreign shareholders, capitalisation, the share of free float on international markets etc.).



In addition to the traditional motives (first of all, the advantages of vertical or horizontal integration that vary subject to the country and sector specifics), the following motives typical of the Russian holding can be pointed out at the present stage:

- increase in the 'physical' power and search for an integration model that would allow to reach a level of international competitiveness that is commensurate with the foreign analogues;
- restoration and development of the supply and sales structure that was established in the times of the USSR and Council for Mutual Economic Assistance and has retained its economic importance for Russian companies;
- business diversification (within the main specialisation of the Group) so as to protect oneself against changes in the global commodities markets;
- the wish to support the company's reputation and ensure the most favourable conditions from the viewpoint of attracting foreign investments (in case powerful outside strategic partners become group members);
- political insurance against internal Russian risks.

Transfer pricing - this classical know-how of international companies - obviously deserves special attention. According to P. Lindert's definition, 'transfer pricing is an artistic form of evading the corporate income tax that may be applied by any accountants operating with assets or products that cross national borders'<sup>22</sup>. Considering the discussion of transfer pricing going on in a number of Russian federal bodies, the forming of a foreign network of subsidiaries and branches can become a preventive measure against possible tightening of the approach.

The above-named features of the present stage of reorganisation in many Russian holdings are obviously directly connected with the owners' strategic ideas on the prospects of their further transformation. Consequently, two development scenarios are possible in the context of the groups' business globalisation.

1) The forming, on the basis of consolidated Russian assets, of really *multinational* corporations (lack of a single base country, registration of the parent (holding) company outside Russia, broad international membership of influential shareholders).

In future it will evidently be possible to contemplate creating a consolidated international industrial group (members: SUAL International, coal assets of Access Industries in Russian and Kazakhstan, tantalum works in Mozambique and ferronickel works on Cuba owned by Fleming Family and Partners and FFP's investment liabilities worth cca. US\$ 3 billion). From the point of view of SUAL, such an alliance significantly increases the efficiency of the group's access to international stock markets (the IPO will presumably take place in two years) and means, in particular, real internationalisation of the company. In fact, the new company is created on the basis of SUAL-International, and FFP's share should in future achieve 25 percent. Contrariwise, the Russian Aluminium, SUAL's direct competitor, does

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<sup>22</sup> Lindert P.H. International Economics, IRWIN, 1986. E.g., a company overprices products or services delivered from a country with beneficial taxation to its branch in a country with a high level of taxes. As a result, the net amounts of taxes paid by the multinational corporation are reduced. It is assumed that it is possible to prove the tax evasion by comparing intercompany prices and market prices but there are ways to disguise the transfer pricing. In the 1980-s a single tax was introduced in a number of states (California, Montana.); according to this tax, a the portion of total declared profits received by a multinational corporation on the territory of the state equals the portion of its total assets, paid salaries and sales falling to the share of this state; profit statements presented by the corporations were *a priori* recognised inadequate.

not consider entering international stock markets and / or selling a share of its business; obviously, it counts on its internal economic and political reserves.

It is quite possible that a number of Russian oil companies boosting their capitalisation and creating a favourable corporate image can take this road in future, too. According to a number of estimates, some of the companies do not position themselves in their statements as Russian companies any more<sup>23</sup>. In our viewpoint, this development scenario is not going to be widespread (even when other Russian companies, now at the stage of asset consolidation and tightening of management control, have 'matured').

2) The *multinational expansion* version (the headquarters are in Russia, foreign assets are acquired as part of vertical or horizontal integration of the group's companies, group assets are transferred to foreign profit centres etc.) was typical of many Russian industrial and extractive sector companies and groups already in the 1990-s. Numerous examples include the Russian Aluminium (alumina processing plants in the Ukraine, in Guinea etc.), Lukoil, YUKOS, Norilsk Nickel, the MAIR Group etc. This is also true for the companies that have been private from their inception. E.g., in 2002 it was announced that Mobile TeleSystems would purchase 57.67 percent of the Ukrainian mobile communications operator UMS (deal amount: US\$ 194 million).

Thus, on the whole, one may say that in 2001 - 2002 the largest Russian groups started to look for their place in the system of international economic relations. Still, the fundamental issue that we rose back in 2001 (to what extent will the current reorganisation of the big Russian business correspond to the aim of achieving its competitiveness at the international level<sup>24</sup>) has retained its vital importance. Whether the selected strategy is appropriate depends to a large degree on the owners' aims (strategic development of a competitive group or going out of business with fixation of profits) and can be confirmed only in future.

These processes have to a certain extent been reflected in the discussion on the aims and principles of the potential industrial policy in Russia that livened up in 2002. The gist of the discussion lies in talks over two fundamental interconnected aspects: 1) more general alternatives of Russia's long-term economic development: either preserving the status-quo<sup>25</sup> or rejecting the orientation towards production of raw materials, tightening export taxation so as to level profitability in the raw materials and in the processing sectors; 2) absolute government support to 'integrated business-groups' (according to the Russian Union of Industrialists and Entrepreneurs) or 'limiting the absolute power of national financial-industrial groups'.<sup>26</sup> However, in reality, at the present time the notion of industrial policy represents a mutating symbiosis of lobbying efforts by the largest industrial and financial groups, on the one hand, and ambitious statements by political groupings, on the other hand. Obviously, for the indus-

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<sup>23</sup> Tremasov K., Industrial Policy. Why there are No Investments. // Vestnik NAUFOR, 2002, Issue # 3, page 9.

<sup>24</sup> See: Russian Economics in 2001, Moscow, IET, 2002, Volume 2.

<sup>25</sup> An extremely clear position has been formulated in an economic report by Brunswick UBS Warburg, one of the leading broker firms in Russia (published 31 January, 2003): "In a post-industrial world, a nation's prosperity is determined by the country's integration in the global economy by concentrating on its relative advantage. Such an advantage for Russia is exports of raw materials and energy carriers (as opposed to capital- and labour-intensive industrial products)".

<sup>26</sup> Mau V.A., Results of Year 2002 and Specific Features of Economic Policy in the Election Year/ Kommersant, 2003, Issue # 15, Page 20; Tremasov K., *ibid.*; etc.

As regards the issue of oligarchic capitalism against the background of decreasing rates of the economic growth and a sharp deceleration of structural reforms, see also: E.T. Gaidar's Speech at the Council of the Party "Union of Rightist Forces" on 22 December, 2002. ([www.iet.ru](http://www.iet.ru)).



trial policy to be really efficient it requires not just a formal document of general nature, but a series of concrete measures based on clear aims in the field of tax policy, economic concentration (according to the definition of the Ministry for Antimonopoly Policy, stock market, enforcement and the foreign policy of Russia.

And, finally, one can point to certain rather *contradictory changes in the market's approach to corporate governance issues* on the whole.

The 're-decoration' started in many large corporations relating to the improvement of corporate governance ('codes of corporate governance', 'independent directors', 'departments of shareholder relations', ensuring 'transparency' etc.) will hardly be able to delude anybody. Obviously, this renovation is predominantly a re-decoration that does not affect the system of relations established in the Russian corporate sector in the 1990-s. This has been caused, above all, by lack of serious conditions for fundamental improvements in this field (especially within the context of equal treatment of all shareholders and of shareholder rights) – lack of serious conditions in the structure of ownership and control, in the field of funding sources and business organisation charts, in the outside environment (taxes, politically engaged selective enforcement etc.)<sup>27</sup>.

In this connection, it would hardly be wise to take seriously declarations made in 2001 - 2002 by a number of large Russian companies on the problems that the business faces due to the lack of civilised ethical business norms. Such declarations partly expressed in the so-called Charter of Corporate and Business Ethics of the Russian Union of Industrialists and Entrepreneurs adopted on 25 October, 2002. The advocates of 'generally accepted moral rules and ethical norms' that put their signatures on the Charter include participants of the notorious 'loans for shares' deals of the mid-1990-s and initiators of many corporate conflicts and scandals of the late 1990-s - early 2000-s. The Slavneft deal in December, 2002, does not inspire any optimism in this connection, either.

At present there exists one more factor that supports the above statement. In reality, initial interest in corporate governance appeared only upon the mass privatisation of 1992 - 1994, although a number of economists had recognised the importance of its long-term nature for Russian companies earlier. The Law "On Joint-Stock Companies" (No. 208-FZ of 26 December, 1995) became a legal landmark, but one can contend that the discussion on corporate governance (or, to be more precise, on the discrimination of outsider rights) shifted into the sphere of practical application against the background and as a result of the stock boom in 1996 - 1997. The most notorious conflicts of that period (Noyabrskneftegas, YUKOS, Yuganskneftegas, Samaraneftegas, Sidanco, Nosta, Varyeganeftegas, Chernogorneft, the Vyksun Metallurgical Plant, Magnitogorsk Metallurgical Enterprise, Baltic Shipping Company, Leningrad Metallurgical Plant, Akron, numerous telecommunication and power industry companies etc.) became a joint signal testifying to the problem's mass and chronic nature. The discussion was to a large extent initialised by foreign investors not yet accustomed to the Russian corporate standards. The financial crisis of 1998 brought about another wave and created new tools of property redistribution, which made the discussion only more intense. This occurred primarily owing to and in the course of strengthening of the management's property positions and to appearance of new shareholders that bought out

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<sup>27</sup> For details see: *Radygin A.* Corporate Governance in Russia: Limitations and Prospects // *Voprossy Ekonomiki*, 2002, Issue # 1, Pages 101 - 124; *Radygin A., Sidorov I.* Russian Corporate Economics: One Hundred Years of Solitude? // *Voprossy Ekonomiki*, 2000, Issue # 5, PAGES 45 - 61.



property positions and to appearance of new shareholders that bought out blocks of shares in the post-crisis period at a low price.

While in the mid-1990-s the calls for reforming corporate governance norms were generated rather by Western portfolio investors, at present the factor of 'pressure from the West' is losing dwindling.

Let us take the survey of investment fund managers carried out in 2002.<sup>28</sup> While several years ago the p/e ratio was a reason enough to buy the shares of a Russian company, at present to make an investment decision it is necessary to perform an independent due diligence by such significant parameters as the company's management profile, presence of independent directors on the Board, ownership structure (preference is given to investments in companies with foreign strategic investors and no government share), transparency (business plans, management accounting, IAS / GAAP financial accounting, listing at RTS or MICEX). Most of the largest Russian companies interested in capitalisation growth already formally comply with these requirements.

Apparently, at present one may speak of *adaptation* of the Western business community to the specifics of corporate relationship organisation in Russia: above all, conducting business through a groups of formally unconnected companies reporting to one owner or a number of partners, and the corresponding structure of financial flows<sup>29</sup>. Thus, one could assume that many Western partners have found creation of a formal image of the company (group) with elements of civilised corporate governance standards sufficient and taken the fundamental system of business organisation (including non-dividend sources of income and transfer pricing) as a matter of course.

Undoubtedly, there are a number of objectively positive trends in the development of corporate governance standards applied by Russian issuers. According to the Institute for Corporate Right and Governance (ICRG), corporate transparency has been increasing in the course of the past year (information is disclosed in greater detail and quicker, in particular, in issuers' quarterly reports and on the web-sites), the contents of the companies' constituent and internal documents have considerably improved.<sup>30</sup> These shifts are reflected, in particular, in the ICRG corporate governance ratings. E.g., during the 12 month-period (Quarter II, 2001, to Quarter II, 2003) out of 23 companies that account for 90 percent of capitalisation of the Russian stock market, corporate governance improved in 18, deteriorated in four and remained unchanged in one. The data for Quarter III confirm this trend, too. Certainly, the companies in question are the largest Russian companies, therefore it is so far impossible to speak of large-scale changes in the corporate sector in relation to the corresponding standards. The new revision of the Law "On the Securities Market" ought to have a positive influence on the quality of corporate governance in Russian companies. In particular, the Law introduces new requirements as to the contents of information disclosed in the form of quarterly reports (on financial and administrative operations, on members of the management, on the issuer's members, on transactions involving interest etc.)

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<sup>28</sup> Criteria for Investment Decisions. 2002 Fund Manager Survey on Russian Investment. Ernst & Young, Moscow, 2002.

<sup>29</sup> E.g., I. Rozinski gave this assessment of the present situation at the conference of the Higher School of Economics "Modernising the Russian Economy: Results and Prospects" (Section 2, "Institutional and Structural Reforms"), 3-4 April, 2002.

<sup>30</sup> E.g., in a number of cases the authorities of the general director signing the deals had been illegally extended. It is quite obvious that the possibility of declaring such a deal void increases shareholder risks.



Although legal novelties in the field of corporate law proper (protection of shareholder rights) had, to a considerable extent, achieved their limit from the point of view of the existing economic conditions, the prospects for the improvement of the existing norms are quite good. This regards both the fundamental law "On Joint-Stock Companies" and the more specialised fields, such as reorganisation, acquisitions, groups of companies, affiliates, insider deals, information disclosure, reporting, bankruptcy and others. It is also apparent that it will be impossible to develop the methods used to protect shareholder rights any further without adequate general measures in the field of enforcement and changes in the law of procedure.

#### **4.6. The Banking Sector**

The year of 2002 was a good period for Russian banks: the overall sector's growth continued with assets in real terms increasing by 20%, loans to non-banking sector by 26%, deposits by 27%, including an encouraging 39% growth on deposits from individuals.

On an equally inspiring note, Russian banks have also stayed away from devoting too much of their funds to securities, which, as of December 1, 2002, constituted only 14.9% share of banks' overall assets with only non-Treasury bonds registering a small rise.

The year of 2002 was particularly favorable for banks investing in Russian Treasury foreign currency-denominated (FCD) bonds, whose rise throughout the year allowed banks to book healthy profits in ruble-terms. Despite such good performance, the number of Russian banks investing in their country's sovereign FCD debt remains limited with usual suspects, Sberbank and Vneshtorgbank holding largest portfolios.

In 2002, as in the past, Russian banks continued to act as main investors in the Federal ruble-denominated debt, although its concentration in the banking sector has slowed down somewhat. The end-year data also show that in 2002 an average Russian bank has reduced its FCD assets in favor of ruble-denominated instruments.

#### **Credit to the Real Sector**

In 2002 crediting the non-banking sector (NBS) continued its 2001 trend to *relative growth*<sup>31</sup> (i.e. outpaced growth of banks' other assets). Thus proportion of loans to NBS in the bank's overall assets notched up to a 48.9% level from a 46.7% a year before, although in inflation-adjusted terms the 2002 pace of growth was somewhat lower than in 2001. Loans to NBS at the start of 2002 made up 44% of overall assets and by the end of the year this figure rose to 48%. For 11 months in 2002 the growth of banks' aggregate loan portfolio constituted 17.4% (18.9% in annual terms) against a 25.4% level in 2001. And although proportion of overdue loans have risen somewhat from a 1.7% in the start of the year to 1.9% in the last month, their share remains at a very low and stable level (annual average of 1.8%).

However, while proportion of NBS loans has risen relative to banks' other assets, it has to be noted that this base (i.e. funds made available to banks) has declined from 31.4% to 29.8% within 11 months. Again, without Sberbank in the picture the reduction is even more pronounced – from 38.8% at the start of the year down to 34.4% by December.

About 94% of country's banks are engaged in NBS loan activity. With 30% of all NBS loans outstanding, Sberbank is by far the largest creditor with Alfa Bank, its closest rival, holding five times less. Sberbank, in general, holds a leading position for all ruble-denominated loans. As of December 1, 2002 it controls 37.2% of the market. Sberbank's grip

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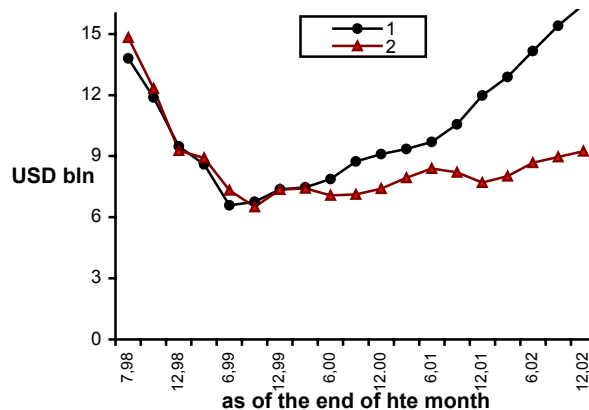
<sup>31</sup> Here and further throughout the text without regard of ARCO-managed banks

is less deadly on foreign-currency denominated loans where its 14.8% market share is not too far ahead of Vneshtorgbank's 9.9% share, although this gap is greater if only loans to resident-enterprises are taken into consideration.

In contrast to 2001, in 2002 growth of foreign-currency denominated loans outpaced that of the ruble loan portfolio. Thus foreign currency segment of the NBS loan market has grown in the year from 32% to 34.3%, while the proportion of ruble loans has declined from 68% at the onset to 65.7% by the end of the year. Excluding Sberbank figures, the share of foreign currency denominated loans has gone up from 39.5% to 41.3%. It has to be noted that the changes in the correlation between ruble and FCD loans were happening against backdrop of expansion in both of the segments.

For loans in foreign currency, the banks in 2002 had to rely more on local demand (enterprises and private individuals' resources) (see *Fig. 1*). If prior to 1998, banks' liabilities before non-resident customers exceeded banks' foreign currency loans extended to non-banking resident clients, by the end of 1999 those figures leveled and by the end of 2002 banks' liabilities before non-resident customers amounted to only 58% of the loans proffered to resident non-banking clients.

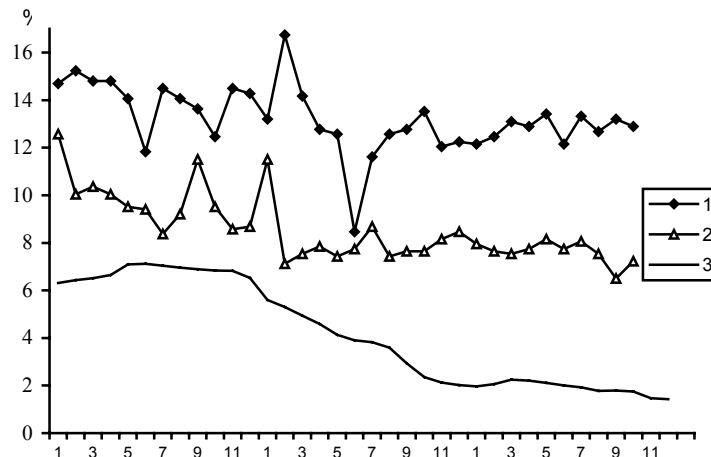
One of the important factors behind the growth of foreign currency loans was the increase in the time foreign currency-denominated deposits from private individuals, which in 11 months of the year has grown by 49% in dollar terms.



1 – loans to resident enterprises  
2 – liabilities before non-residents

*Fig. 1.* Foreign Currency Loans to Resident Enterprises vs. Banks Liabilities Before Non-Resident Clients (in US\$ millions)

Unfortunately, the reality of Russian banks' inability to attract adequate funds from world's financial markets translates into higher lending costs for Russian economy. As *Fig. 2* demonstrates, interest rates paid in 2002 on 6 months to 1 year deposits from individuals fluctuated within 6.5%-8% range, while 6-month LIBOR rate for the same year hardly exceeded 2.5%



1 - weighted averages of interest rates charged on foreign currency loans with .5-1 year maturity  
 2 - weighted averages of interest rates offered on foreign currency .5-1 year savings deposits from individuals  
 3 - weighted averages for LIBOR .5 year rates  
 Source Russian Central Bank and Finmarket data

*Fig.2. 2000-2002 Weighted Averages of Rates Charged on Foreign Currency Loans with 6 month-1 year maturity vs. Rates Offered On Foreign Currency Individual 6 month- 1 Year Savings deposits (as %, including re-investing)*

Another 2001 trend that did not continue in 2002 was the proliferation of short-term loans, number of which has fallen from 23.4% in the start of the year to 22%. At the same time, the market saw an increase in mid-term (more than a year) loans both in the ruble and foreign currency segments (see *Table 11*).

*Table 11*

**Time Structure of Loans to the non-banking sector (NBS) in 2000-2002**

Type of NBS Loan	In Proportion to Base Loans (%)			
	Jan 1, 2000	Jan 1, 2001	Jan 1, 2002	Dec 1, 2002
<b>All NBS Loans</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
up to 90 days	17.8	16.9	23.4	22
90-180 days	10.8	15.7	14.2	14.6
180 days- 1 year	33.2	34.4	31.1	28.7
More than 1 year	38.2	33	31.3	34.7
<b>Foreign Currency NBS Loans</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
up to 90 days	9.5	8	10.7	9.3
90-180 days	9	8.4	10.7	12.1
180 days- 1 year	25.1	28.1	28.6	24.8
More than 1 year	56.3	55.4	50	53.8
<b>Ruble NBS Loans</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
up to 90 days	24.5	21.7	29.3	28.5
90-180 days	12.2	19.6	15.7	15.9
180 days- 1 year	39.8	37.7	32.3	30.7
More than 1 year	23.5	20.9	22.7	24.9

Source: computed basing on STIiK's data

*As to lender profiling*, 2002 data show that banks are giving more loans to private individuals. In 2000 their category accounted for a little over 5% of all banks loans, while by the

end of 2002, that number has grown to 8.2% (see *Table 12*). This general tendency could be seen both at Sberbank and other private banks. For 11 months of the year Sberbank has increased loans to private individuals by 65.6, while other banks by 47.3%.

Bank financing for government and public enterprises has reversed its 2001 decline and has also seen an increase, albeit, of a less significant nature.

*Table 12*

### NBS Loans by Lender Type

Type of Loan	Loan Break-up in % terms*			
	Jan 1, 2000	Jan 1, 2001	Jan 1, 2002	Dec 1, 2002
Loans to Government and Public Enterprises	5.8	1.7	1.3	1.6
Loans to Resident Enterprises	82.8	88.1	87.8	86.9
Of those state-owned	8.4	8.1	5.6	5.9
Of those Private	74.4	80	82.2	81
Loans to Non-Resident Enterprises	6.1	5	3.9	3.4
Loans to Private Individuals	5.3	5.2	7	8.2

\*Includes overdue loans.

Source: data from STI&K consultancy.

Entrepreneurs accounted for a fairly large percentage of *all loans issued to individuals* (19% as of late 2001 and 21% as of late 2002). Another 1-2% was issued to non-resident individuals with the remaining three quarters taken out as consumer loans. At the end of the year the latter category amounted to RR113.3 billion, a half of which was issued by Sberbank alone. Most of these consumer loans were issued in rubles (80% for all banks and 70% for all banks excluding Sberbank). Sberbank leading position for this category of loans comes in especially strong for consumer loans with re-payment term of over a year. Conveniently, most consumer loans are taken out for periods of over 3 years.

Other banks, unable to compete with Sberbank's massive branch and product structure, try to beat the rival by offering a quicker service. Russkii Standard Bank and First O.V.K., for instance, advertise 'express loans' when a loan can be issued within the day of the application. The catch is that due dates for these 'express' loans rarely exceed 1 year, while interest and service fees are higher than those offered by more conservative banks.

*Table 13*

### Consumer Loans Term Structure

Type of Loan	All Banks		All Banks, except Sberbank	
	Jan 1, 2002	Dec 1, 2002	Jan 1, 2002	Dec 1, 2002
Consumer Loans Total	100	100	100	100
Overdraft	.5	1	.6	1.7
Up to 90 days/recall date	6.6	5.3	11.1	9.4
90 to 180 days	2.8	2.9	4.6	5.1
180 days to 1 year	17.8	18.5	27.9	29.5
Over 1 year	72.3	72.3	55.8	54.3
Including loans over 3 years	50.6	51.5	31.7	28.2

Source: data from STI&K consultancy

### Banks' Role in Market for Government Debt

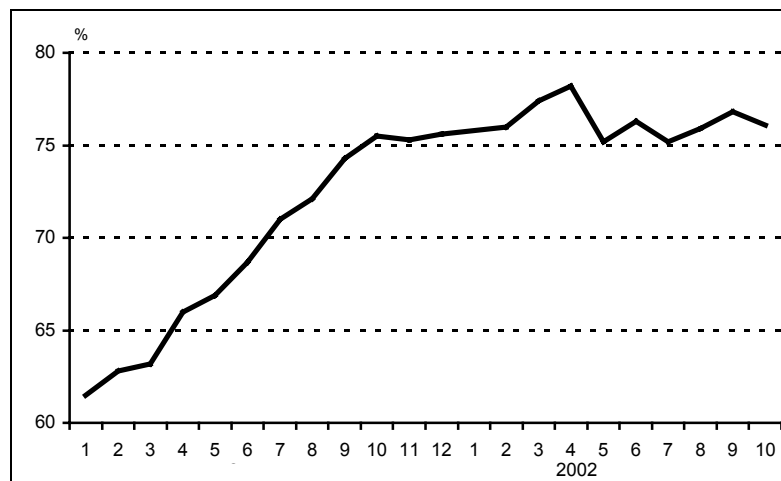
As mentioned, in 2002 banks have stayed away from significantly increasing their securities portfolios. In fact, their levels barely nudged from 13.9% of banks total assets in January to 14.9% by the end of the year. Even then, this 1 percentage point rise was mainly achieved by an increase in non-government securities. Whereas holdings of government bonds did not rise, they did undergo a change in denomination terms, with banks now preferring ruble-denominated instruments (up to 4.9% from 4.2%) to foreign-currency debt (from 7.8% down to 6.9% of all assets).

### Ruble Denominated Government Bonds

Russian banks remain large holders of Russian Government ruble denominated debt. In 2002, however, the process of further concentration of government issued ruble debt in banks was somewhat halted. In 2001, banks' share of the debt grew impressively from 61.5% to 75.6%. In 2002, however, after a brief rise up to 78.2% in February-March, banks' holdings of government debt plummeted down to 2001 level and by the end of the year amounted only to 76.1%.

A conventional explanation attributed this halt in concentration to the 2002 launch of a savings element of the Russian pension system, which allowed investing earned insurance premiums into *GKO-OFZ*.

A closer look at the dynamics of banks' share of government debt, however, does not necessarily point to such an easy explanation. Rise of banks' share of government debt had already showed signs of softening in the fall of 2001 (please see Fig. 3), a good few months before first premiums for the new pension system were collected. While investing these premiums since April 2002 have not yet caused banks to reduce their holdings of government debt as compared with December 2001.



Source: Russian Central Bank

Fig 3. Banks' Share of Government Debt in the Aggregate *GKO-OFZ* Portfolio in 2001-2002.

Unfortunately, data on government debt published by the Central Bank does not differentiate between holdings of the Central Bank itself and those of commercial banks. In this

case, commercial banks' balance statements are the only sources for establishing the amounts of government debt held by banks.

As of January 2002, out of a total number of 1,300 existing banks, only 500 had investments in government ruble-denominated bonds. By the end of November that number has further dwindled down to 434. At the same time, total value of government bonds in banks' possession has risen in 11 months of 2002 by 38% (from RR114.1 billion up to RR158.3 billion). Curiously enough, Sberbank's share of government debt grew at a slower pace than at the rest of the banks (34.2% vs. 58.7%), which lead to an annual reduction in Sberbank' total holdings of government debt (from 81% to 79%).

In 2001, on the other hand, things were different. Banks' share of government debt grew at a much slower pace (10.8%), most of which was achieved by rises in Sberbank's holdings. Its portfolio of government debt rose from RR63.4 billion at the start of 2001 to RR92.9 billion by the year's end, a staggering annual rise of 46.5%. While other commercial banks were undergoing a reverse process and reduced their government securities holdings from RR39.5 billion to RR21.2 billion in the year, a staggering annual decrease of 46.4%.

In 11 months of 2002, Sberbank' holdings of *GKO-OFZ* have increased somewhat (11.5% to 12% of total assets). The same insignificant rises of *GKO-OFZ* were seen at other commercial banks (from 1% to 1.3% of total assets). As of December 2002, government ruble-denominated bonds made up 45% of Sberbank total assets. For commercial banks that figure was much lower, and at the end of last year stood at only 25.5% of total assets.

Number of banks involved in *GKO-OFZ* transactions has had wide fluctuations throughout the year. Thus in December 2001, turnover for that particular instrument surfaced in balances of 378 banks, in September the figure rose to 384 and in November it dropped to 285. In absolute terms, cumulative turnover of all existing Russian banks has had somewhat different dynamics. In December 2002, the turnover amounted to RR51.4 billion, by September it declined to RR31.2 billion and in November it rose again to RR54 billion, the latter change, perhaps, being a reflection of a general vibrancy experienced by the secondary market in the last quarter of 2002. Sberbank participation in that market, on the other hand, was fairly stable throughout the analyzed period.

In general, *GKO-OFZ* market elicited only a lackluster interest and monthly turnover values on corresponding accounts (calculated as sum of sales and purchases per month) were lower than account balances. For comparison, in pre-crises months of 1998, turnover value exceeded account balances by 2-3 times. In November 2001, ratio of turnover to balances was 54.8% (87% if Sberbank figures are excluded). Whereas in November of 2002 the same ratio stood at 153% (283% exclusive of the data on Sberbank).

*GKO-OFZ* trading takes place on 8 Russian trading floors, with MICEX in the lead. Most of participants in the market for secondary trading of the government ruble bonds are banks. At MICEX more than 90% of the dealers represent various banks.

The following is a detailed account of banks, major participants of *GKO-OFZ* market. Data for this analysis is based in MICEX-compiled lists, which include market dealers with largest trading volumes for secondary transactions, which includes both the operations dealers undertake for themselves and on behalf of their clients. Thus for November 2001 and 2002, the list included 22 banks. Data for the market behemoth, Sberbank were clearly outliers and therefore excluded for the purpose of avoiding distorted average values.

November 2002 cumulative turnover for banks, leading participants in the market for ruble denominated government securities at MICEX (excluding Sberbank), amounted to



52.3% of the total cumulative turnover for *GKO-OFZ* operations of all existing banks (excluding Sberbank), a 1.5 times increase over its November 2001 level.

In absolute terms, both the turnover and balances on government ruble-denominated bonds accounts at leading banks were on the rise during the year, although at a varied pace. Thus, turnover growth was rising at almost twice the pace of balances growth.

Between November 2001 and November 2002 the turnover value for *GKO-OFZ* operations rose by 44.6% (from RR10.6 billion to RR15.6 billion in current prices), whereas, balances on these accounts in the same period grew by only 21.3% (from RR10.9 billion to RR13.8 billion). Thus the ratio of turnover to account balances on transactions for government ruble debt at largest banks had an annual increase from 97.6% to 116.4%.

The situation is reverse for average mid-size Russian banks, where (excluding Sberbank) turnover values for government debt operations remain below the balances on these accounts, with the ratio falling from 91% to 87% in the last year.

In general, the proportion of government ruble-denominated securities to other assets is higher at banks with leading positions at MICEX than the industry average (1.9% vs. 1% in December 2001 and 1.8% vs. 1.3% in December 2002).

In contrast to 2001, a rift between a strategy for government ruble bonds pursued by banks- MICEX leaders and average Russian banks grew larger in 2002. From December 2001 to a year later, trading volumes of government ruble-denominated bonds for MICEX's leading players, in absolute terms, rose by 21% (from RR10.9 billion to RR13.2 billion). The same figure in the analogous period for all Russian banks (Sberbank and ARCO-managed banks excluded) stood at only 3% (from RR32.7 billion to RR33.7 billion).

Similarly, average value of assets at a leading MICEX bank-participant, as of November 2002 stood at RR34.4 billion – a considerable difference over RR2 billion, estimated asset value of an average bank in the same period.

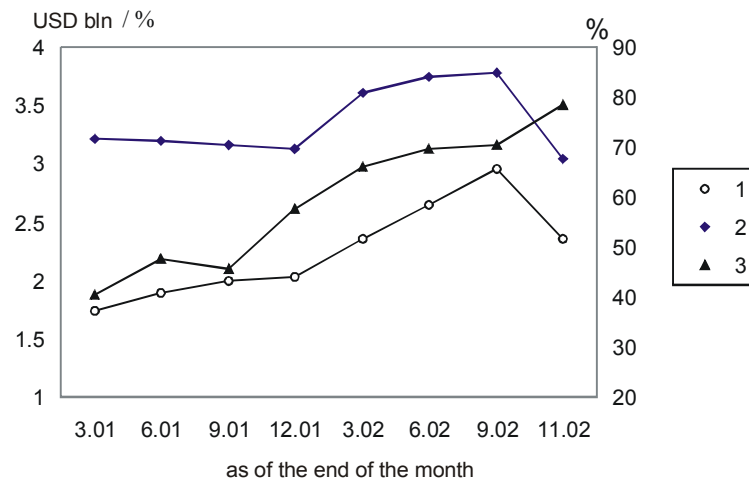
Contrary to dismissals that low participation in markets for government ruble-denominated bonds is nothing but a sign of the instrument's low returns, profit margins for banks, MICEX's largest participants provide no such evidence. For the past 11 months of 2002, banks with large positions on MICEX posted significantly higher profits than an average Russian bank, with ratio of returns on assets for the former standing 4.4% against an average bank's ratio of 2.9%.

### Government Foreign –Currency Denominated Bonds

Largest portfolios of government foreign currency-denominated (FCD) debt belong to Sberbank and Vneshtorgbank, which as of December 2002, accounted for 70% of all FCD bonds at Russian banks. From the start of the year, their share declined by 3.2 percentage points.

To get other banks' views on the attractiveness of FCD debt instruments, let's compare absolute values of FCD bonds in US dollars and their proportion to banks' other assets. Until November 2002 (please see Graph 4), the cumulative portfolio of FCD bonds was expanding in parallel to their price increases (due to the lack of investment indexes on *OVVZ* and Russian Eurobonds, we chose Fed-30, the largest volume bond in circulation as our price indicator). Data on proportions of FCD bonds to banks' other assets appears more complex and does not easily lead to unambiguous conclusions.





*Fig. 4. Government FCD Bonds in Russian Banks Portfolio (except Sberbank, Vneshtorgbank), 2000-2002*

By December 2002, the number of banks with holdings in FCD bonds has declined from a January high of 237 down to 208. Considering that the total number of banks with licenses for this sort of activity is 1000, the current number of participants appears very small. Oddly enough even the incredibly favorable price dynamics for the product in 2001-2002 has failed to amend that situation.

On average, for banks with holdings in FCD bonds, the latter share in proportion to banks' other assets is 9.2%. In addition, there are 20 banks, in which FCD bonds take up in excess of 15% of their total assets. Below is a more detailed analysis of banks with leading positions in holdings of FCD securities. Since Vneshtorgbank and Sberbank figures are clear statistical outliers in that batch, their data will be excluded from this analysis. With the two giants out of the picture, the average proportion of government FCD securities holdings to banks' total assets is 49%.

To be included in the analysis banks had to satisfy the following criteria:

- as of December 2002, share of government FDC bonds in a bank's total assets was above the industry's average (average value calculation excluded Vneshtorgbank and Sberbank);
- in the period from December 2001 to November 2002, a bank had non-zero balances on its account for FCD bonds operations, and was actively engaged in transactions for FDC bonds, i.e. reported non-zero turnover values on that account.

Overall 51 banks satisfied the above criteria and were chosen for the analysis. To begin with, the concentration in the group turned out to be very high. Thus just 4 top banks held a half of the group's entire FCD bond holdings, while 20 top banks covered 90%.

Let us now compare data on this select group of FCD debt 'leaders' against average Russian banks. First we have to note that only large banks are currently engaged in an active trading of FCD bonds. The average value of total assets for the select group, as of December 2002 was RR9.6 billion, while the average Russian bank analogue stood at only RR1.9 billion. Proportion of FCD bonds to overall assets for the select group of banks amounted to 11.2%, which exceeded the industry's average value by 3.7 times. Surprisingly enough, the



select group's figure has not increased much during the year even despite higher market valuations of the product.

During 11 months of the past year, prices for most issues of *OVVZ* and Russian Eurobonds were rising faster than their share in banks' portfolios. Thus, prices for *OVVZ* in that period, depending on the issue rose within the range of 9.2 to 39.5%, and Eurobond prices changed within the range of -2.7 to 39.2%, also depending on the issue.

In addition, the select group of banks has a higher than the industry average of foreign-currency deposits from corporate clients, however there is no statistically valid relationship between the amount of a bank's foreign currency deposits and value of its government FCD bond holdings.

As to profitability, for 11 months of 2002 the select group of banks' ratio of returns on assets did exceed the industry's average, but fairly insignificantly (2.6% vs. 2.4%).

Curiously enough, banks in this particular group of the most active FCD bond-players appeared to have smaller capitalization than their more average counterparts, with the ratio of balance capital to assets for the former group at 11.8% vs. industry average of 18.5% (although these particular figures for two groups are not quite comparable due to large difference in asset values). Having said that, both groups are showing a tendency for a decrease in the ratio of balance capital to assets. For select group of banks, assets growth, in 11 months of 2002, was outpacing that of capital balance by a factor of 1.5 (32.3% vs. 21.3%). Average banks' gap in growth was smaller and for the same period assets grew by 25.3%, while balance capital at 22%.

*Table 14*

**Some Balance-sheet Statistics for Banks with Leading Positions in FCD Bond Holdings (in % terms of total assets; end of month data; exclusive of Sberbank and Vneshtorgbank)**

Balance Statistics to Assets (in %)	Average Banks*		Banks with High Share of FCD Bonds	
	Dec 01	Dec 02	Dec 01	Dec 02
<b>Assets in Foreign Currency</b>	40,8	38,7	51,7	49,6
<b>Funds in Banking Sector</b>	39,4	34,5	37,1	31,9
Including those in foreign currency (FC)	19,0	15,3	20,5	14,7
<b>NBS Loans</b>	44,0	47,8	39,0	42,4
Including those in FC	16,3	18,6	17,3	20,4
<b>Bonds and securities</b>	6,5	8,9	15,4	18,8
Incl. Those in FC	3,6	4,1	11,9	12,7
<b>Government Bonds</b>	4,2	4,4	12,5	13,6
Incl. Those in FC	3,1	3,0	11,1	11,2
<b>Funds of Non-Resident Banks</b>	6,7	7,5	8,6	9,0
<b>Accounts of non-financial clients</b>	27,6	25,1	27,9	27,7
Incl. Those in FC	5,1	5,6	6,6	6,6
<b>Deposits</b>	21,5	21,9	27,5	28,2
Incl. Those in FC	14,7	13,8	20,9	20,1
Corporate Deposits	12,8	10,1	19,5	16,0
Incl. Those in FC	9,3	6,7	15,5	13,2
Individual deposits	8,7	11,8	8,0	12,3
Incl. Those in FC	5,5	7,2	5,5	6,9

Balance Statistics to Assets (in %)	Average Banks*		Banks with High Share of FCD Bonds	
	Dec 01	Dec 02	Dec 01	Dec 02
<b>Balance Capital</b>	19,0	18,5	12,8	11,8
<b>Profit</b>	2,0	2,4	1,9	2,6
For reference: The average size of assets of the banks of the sample, as Rb.blm.	1,5	1,9	7,2	9,6

\*All existing banks, except Sberbank, Vneshtrogbank and ARCO-managed banks.

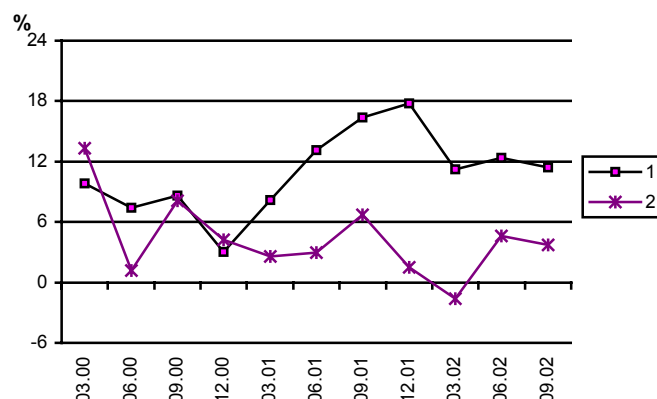
Source: STI&K consultancy

### Private individual's Deposits

The year of 2002 made up for a lively year in this segment of banking services. If in the aftermath of the 1998 crisis, number of private deposits was slashed by a half (excluding Sberbank) and by the of 1999 fell to a measly 5.6% of banks' liabilities, then by the end of 2001 the number recovered to 8.4% and by October 2002 has grown further to 10.9%. If we consider only banks that purposefully attracted individual deposits, the numbers become respectively 8.6% for the end of 2001 and 11.3% for October 2002. in constant prices, for 9 months of 2002, a total value of individual deposits attracted by banks (excluding Sberbank) grew by 39% (a bit lower than 42.4% growth achieved in 2001). In general, from the end of 2000, private deposits grew faster than banks' assets (please see Graph 5). The above facts all point to a conclusion that banks slowly but surely are restoring back to the pre-crisis individual deposits level.

Against this dynamic picture seen at most commercial banks, Sberbank deposit growth of only 18,7% appears rather modest. In fact, Sberbank's share on that segment of banking services has been contracting throughout the year and by October fell to 69.8% from a high of 73.5% it enjoyed at the start of the year (excluding funds linked to debit card accounts). At the same time, the decline was rather smooth (please see Graph 6). In other words, cuts in interest rates, which Sberbank undertook on both ruble and foreign currency accounts, had no discernable effect on its customers.

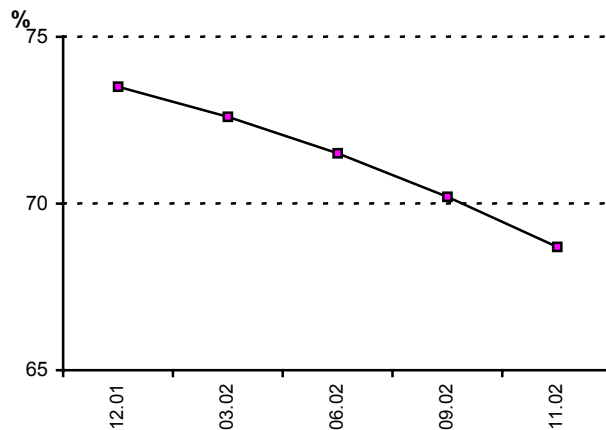
Sberbank aside, about 8% of all private deposits is at Alfa-Bank, another 5.6% is at Moskva Bank, which on the past 3 quarters managed to practically double the number of its private deposits.



1 – individual deposits

2 - bank assets

Source: STI&amp;K consultancy

**Fig. 5. Asset vs. Deposit Growth in Constant Terms, excl. Sberbank**  
 (% change over previous quarter)


Source: STI&amp;K consultancy

**Fig. 6. The 2002 Sberbank's Share in Total Number of Private Deposits**

Individual deposits are playing an even bigger role for regional banks (please see *Table 15*). There, deposits from individuals in the banks' liabilities make up twice the analogous figure at Moscow banks, and more than 90% of regional banks are actively pursuing private deposits while in Moscow that number is only 83%. However, since banks are heavily represented in Moscow, as of September 2002 Moscow-based banks accounted for 63.5% of all deposits in the country.

*Table 15*
**Individual Deposits Share in Banks Total Liabilities (as %)\***

	Moscow Banks				Regional Banks				Average Banks (excl. Sberbank)			
	Jan00	Jan01	Jan02	Oct02	Jan00	Jan01	Jan02	Oct02	Jan00	Jan01	Jan02	Oct02
<b>Individual Deposits</b>	4,7	4,7	7,0	9,2	9,6	9,2	13,6	18,0	5,8	5,8	8,6	11,3
<b>Incl. In FC</b>	3,7	3,7	5,4	7,2	4,2	3,8	5,6	7,4	3,8	3,7	5,5	7,3
<b>Incl. In Rubles</b>	1,0	1,0	1,6	2,0	5,4	5,4	8,0	10,6	2,0	2,1	3,1	4,0
Reference: Number of banks attracting individual de- posits	533	535	546	541	627	617	639	624	1160	1153	1175	1165
Average assets size in billion rubles	1,4	2,15	2,85	3,4	0,35	0,6	0,78	0,91	0,84	1,32	1,74	2,06

\*Start-of-a-month data for banks attracting private deposits

Source: STI&amp;K consultancy

In 9 months of 2002, Moscow banks have increased the total value of individual deposits by 55% (from RR110 billion to RR 169 billion). Regional banks have managed to raise the same figure by an equally commendable 52% (from RR69 billion to RR102 billion).

Moscow banks also differ from their regional counterpart in the currency type of their deposits. For years now, most of Moscow deposits (80%) come in foreign-currency, while the regions appear to be more patriotic and there foreign-currency deposits account for only 40%. In general, however, after a slump in 2000 and 2001, foreign-currency deposits (please see *Table 16*) are again becoming popular in 2002 (excl. Sberbank). For Sberbank, ruble deposits were growing at a faster pace than foreign-currency accounts.

*Table 16*

### Bank Deposits by Currency Type

Private individual's Deposits	All operating Banks, exclusive of Sberbank		Sberbank		All operating Banks, exclusive of Sberbank		Sberbank	
	bank	1, 2000	bank	1, 2001	bank	*1, 2002	bank	1, 2002
In FC	66.1	21.1	63.4	23.6	63.7	25.5	64.2	27.6
In Rubles	33.9	78.9	36.6	76.4	36.3	74.5	35.8	72.4

\* All Banks Excluding Sberbank

Source: STI&K consultancy

As to term type of deposits, 2002 saw customers continued preference for *savings* deposits and a continued decline in the number of settlement accounts. The latter's share has dropped in the past 3 quarters from 23 to 19% for all existing banks and 33 to 29% if Sberbank figures are excluded. A high number of settlement accounts in the Table 17 is associated with a generally high proportion of ruble settlement deposits at commercial banks.

*Table 17*

### Resident Individual Bank Deposits by Term Type\* (in %)

Individual Deposits	All Banks, incl. Sberbank				All Banks, excl. Sberbank			
	1.1.00	1.1.01	1.1.02	10.1.02	1.1.00	1.1.01	1.1.02	10.1.02
Current ac-accounts**	28,8	29,5	23,2	18,8	34,1	37,1	33,2	29,3
Incl, debit card accounts	2,6	2,2	1,6	1,0	8,7	9,6	5,1	3,1
Up to 3 months	8,9	6,3	4,8	3,7	14,8	9,8	7,6	5,4
3-6 months	49,2	41,4	32,8	29,6	19,9	21,7	21,6	18,3
6-12 months	8,1	11,4	14,7	17,6	17,0	21,6	27,3	32,5
Over 1 year	5,0	11,4	24,5	32,8	14,2	9,8	10,3	14,5
Total	100	100	100	100	100	100	100	100
In Foreign Currency								
Current **	28,0	25,4	22,1	18,8	34,7	34,5	28,2	23,9
Incl, debit card accounts	4,9	3,6	1,4	1,0	8,6	8,4	2,8	1,9
Up to 3 months	7,9	4,6	4,0	2,7	15,8	9,7	8,0	5,3
3-6 months	40,3	41,5	35,0	26,8	15,5	18,4	20,0	16,2
6-12 months	16,0	20,0	24,4	27,8	19,1	26,5	32,6	38,3
Over 1 year	7,8	8,5	14,5	23,8	14,9	10,9	11,2	16,3
Total	100	100	100	100	100	100	100	100



In Rubes								
Current **	29,1	31,4	23,7	18,8	33,1	41,2	41,1	38,4
Incl, debit card accounts	1,5	1,6	1,7	1,1	8,8	11,5	8,8	5,3
Up to 3 months	9,4	7,2	5,3	4,3	13,0	9,9	7,1	5,4
3-6 months	53,0	41,4	31,6	27,0	28,2	27,1	24,1	21,7
6-12 months	4,7	7,3	9,4	11,4	12,8	13,8	19,0	22,9
Over 1 year	3,8	12,7	30,0	38,5	12,9	8,0	8,8	11,6
Total	100	100	100	100	100	100	100	100

\*Share of bank deposits by non-resident individuals is less than 1% of the total individual deposits

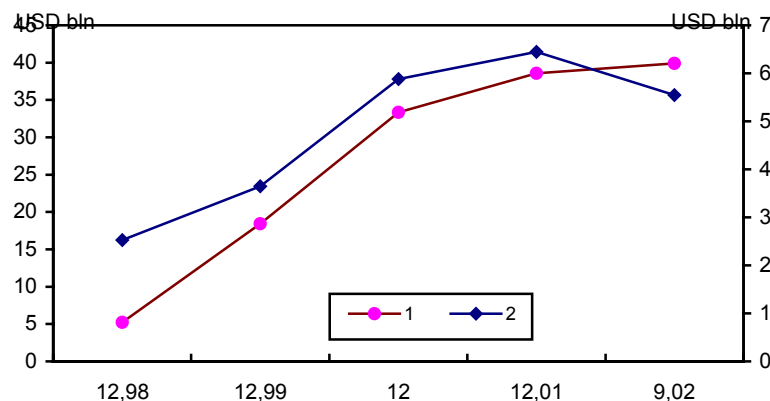
\*\*Settlement deposits also include funds linked to debit card accounts

Source: STI&K consultancy

As in 2001, Sberbank continued to attract more savings deposits with longer terms and most of its accounts carry terms of over 1 year. Sberbank numbers in this segment of banking services is so large that it affects the entire industry's average, i.e. making savings deposits with over 1 year term the most popular item in the account variety (32.8). If Sberbank data is excluded, then deposits with 6-12 months terms take up the leading position for both ruble and foreign-currency denominated accounts. Accidentally, this type of account is also a most popular service for Sberbank's foreign-currency deposits.

### Corporate Deposits

After a period of bubbly expansion in 1999-2000, 2002 was marked as a year of after-party calm and stabilization for this segment of the market<sup>3</sup>. At the start of the year, total volume of deposits from banks' corporate clients stood at almost RR270 billion<sup>4</sup>. By the end of the 3<sup>rd</sup> quarter that number waned to RR262 billion, which in percentage terms translated into a 3% annual fall.



1-ruble corporate deposits in early 1999 constant prices  
2-foreign-currency corporate deposits

<sup>3</sup> Corporate deposits do not include government agencies' ones

<sup>4</sup> here and below only operating banks, without regard of ARCO-managed banks, are considered

*Fig. 7. Ruble vs. Foreign Currency Corporate Deposits*

From the banks' balance sheet perspective, corporate deposits fell within the year from 9.4% to 7.6% as of banks' liabilities and from 11.4% to 9.1% as proportion of banks' total liabilities.

Although some firms, in addition to conventional deposits, place some of their funds as depositary certificates, their share accounted for less than 10% of the total amount of regular deposits and they therefore would be excluded from the analysis below. Similarly, deposits from non-resident corporate clients also make up less than 10% of the deposits total. Therefore, only figures for resident corporate deposits will be considered in this analysis.

For the 3rd quarter of 2002, a total value for corporate deposits has fallen, in current terms, by 2.6% (in constant terms, by 11.8%). The decline was caused by two opposing phenomena - a 4.1% fall in the number of deposits attracted by banks in our analysis sample (i.e. private commercial banks) and a 19.3% rise in corporate deposits attracted by Sberbank, whose figures we exclude on the basis of their strong statistical outlier influences.

#### Corporate Deposits' Currency Structure

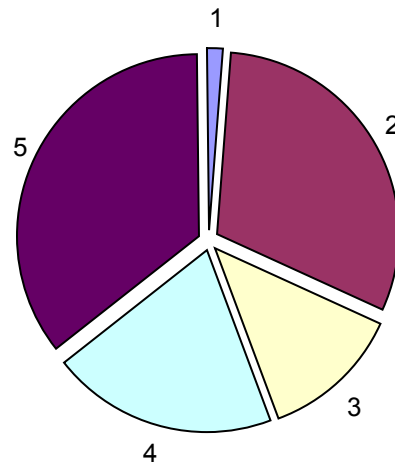
Most of corporate deposits in today's Russia are denominated in foreign currency. In 2002, however their proportion has declined from 69.3% to 64.7% and it is widely believed that this decline has attributed to an overall fall in the amount of corporate deposits. Ruble-denominated corporate accounts, on the other hand, have in the past 3 quarters risen in value by 12% and, in current terms, amounted to RR83.8 billion.

As in 2001, only two thirds of all existing banks (253, as of October 1) have been attracting corporate deposits in 2002. Both ruble and foreign-currency segments of the market remained fairly non-concentrated with leading positions often fluctuating between various banks. Thus, typically for the Russian banking sector, in the start of the year Surgutneftegas Bank with its 29% of all foreign-currency deposits enjoyed the leading position but managed to let Moscow International Bank (MIB) to claim the title later in the year. MIB's market share now exceeds that of its predecessor by 2.5 times. Market share of the segment's top three banks is less than 50%.

Concentration level for the ruble segment of the market, despite its relatively modest volume, is even lower. Cumulative market muscle for the three top banks, as of October 1, 2002, amounted to only 19.3% of the total. Sberbank, number one bank enjoyed only 9%.

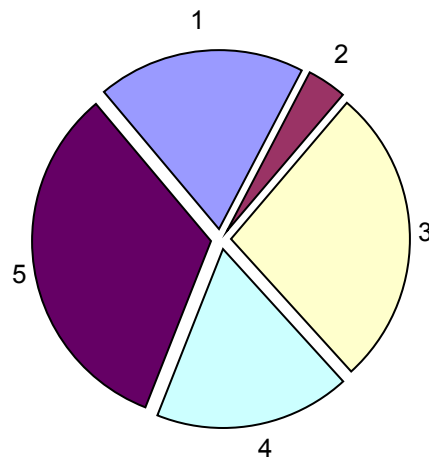
#### The structure of deposits by the term of attraction of funds

Term structure for corporate deposits in 2002 was vastly different from the situation we described for the individual segment of the market. If settlement deposits made up almost 19% of all individual accounts, its corporate counterpart stood at just 1.5% (please see Graphs 8 and 9). Similarly, for savings accounts of less than a year individual clients preferred savings accounts with 3-6 months term, corporations instead seemed to fancy shorter-term variants of up to 3 months. Though, more similarities between individual and corporate segments could be detected for savings accounts with terms of over 1 year.



1. Current deposits
2. Less- than- 3- month deposits
3. 3-6 month deposits
4. 6-12 month depositions
5. over- 1- year deposits

*Fig.8.* Resident Corporate Deposits by Term Type  
(as of October 1, 2002, including Sberbank)



1. Current deposits
2. Less- than- 3- month deposits
3. 3-6 month deposits
4. 6-12 month deposits
5. over- 1- year deposits

*Fig. 9.* Resident Individual Deposits by Term Type  
(as of October 1, 2002, incl. Sberbank)



Corporate savings ruble deposits with terms of less than a year saw some changes in 2002. If at the start of the year, most of these funds were deposited for 3 months or less (please see *Table 18*), then by the end of 3<sup>rd</sup> quarter deposits of 3-6 months and 6 months became more popular, which increased their weighted share by 33-36%. At the same time, share of less than 3 months deposits has declined on average from 40 to 28% in the year. While share of savings deposits with terms over 1 year has increased, particularly the deposit category of over 3 years.

*Table 18*

**Corporate Ruble Deposits by Term Type**

Term type	Share of Total Corporate Ruble Deposits in %	
	January 2002	October 2002
Settlement	2.7	2.6
Up to 90 days	40.2	28.1
91 days to 180 days	14.6	19.8
181 days to 1 year	15	19.9
Over 1 year	27.5	29.6
Incl. Those of over 3 years	14.6	16.4
<i>REFERENCE</i>		
Average Account Value (in current terms, RR billion)	3.4	4
Number of Banks	797	826

Source: STI&K consultancy

The shift towards longer-term deposits was brought about mainly by changes in strategy of Moscow banks. In other words, regional banks have not undergone the same changes with over 1-year ruble deposits registering only insignificant increase from 35.1% at the start of the year to 36.2% by the end of 3<sup>rd</sup> quarter. Moscow banks, on the other hand, have increase their share of corporate ruble deposits with over 1 –year term in the same period by 4.3 percentage points. Similarly, regional banks, unlike their Moscow counterparts have not to the same degrees been engaged in cutting the numbers of shorter-term corporate ruble deposits. Thus deposits of less than 3 months saw only a 26% annual decrease in regional banks, while in an average Moscow bank their number fell by 30% (from 51.4%to 35.7%). Capital and regional banks also differ on currency structure of their corporate deposits, with regions boasting twice the share of ruble deposits as compared with their Moscow counterparts. Though, both groups are now seeing a rise in ruble deposits from their corporate clients.

*Table 19*

**Term Structure of Corporate Ruble Deposits in Regional vs. Moscow Banks**

Term type	Share of Total Corporate Ruble Deposits in %			
	Moscow		Regions	
Current	3.8	3.7	1	1.1
Up to 90 days	51.4	35.7	24	17.8
91 days to 180 days	11.1	16.2	18.2	22.2
181 days to 1 year	10	16.4	21.7	22.7
Over 1 year	23.7	28	35.1	36.2
Incl. Those of over 3 years	16.3	18.6	14.2	16.7
<i>FOR REFERENCE:</i>				



Average Account Value (in current terms, RR billion)	4.43	5.01	1.03	1.16
Share of Resident Corporate Deposits in Banks' Liabilities	3.5	3.1	7.2	6.7
Number of Banks	333	354	462	471

Source: STI&K consultancy

In foreign-currency segment of the market, a clear decline in the number of short-term 90 days deposits was accompanied by various changes in share of longer-term deposits. Thus 3-6 months deposits rose by 2.5 percentage points while the next layer deposits of 6-12 months fell by 9.3 percentage points. At the same time, number of 1 year and over deposits practically doubled. To be fair, though, the latter increase came almost solely due to Moscow International Bank, which in 9 months of 2002 has increased its share of such deposits from 3 to 30 billion rubles. If MIB number are taken out of the picture, then the rise in the number of 1 year and over deposits, at 2.4 percentage points becomes far less spectacular. Clearly, it is too early to speak of any considerable industry-wide changes in the numbers of foreign-currency deposits from corporations.

As was the case with ruble deposits, foreign-currency deposits also differ in their structure between Moscow and regional banks. For instance, if an average regional bank has seen its corporate deposits of up to 3 months reduce by 23%, the same figure for an average Moscow bank has grown by 13%. Although to be accurate, a single regional bank, again, was responsible for decrease in this type of deposits. Surgutneftegasbank, a major regional bank accounted for 59% of all 3-month foreign-currency deposits attracted in the period. In addition, within the bank, these 3-month deposits made up over 80% of the bank's all foreign currency deposits from corporate clients. Obviously, when Surgutneftegasbank figures are excluded, the overall picture is rather different (please see *Table 20*).

*Table 20*

**Term Structure of Foreign Currency Corporate Deposits**

Term type	Share of Total Corporate Ruble Deposits in %	
	January 2002	October 2002
Current	7	.9
Up to 90 days	43.3	31.6
91 days to 180 days	5.6	8.1
181 days to 1 year	29.6	20.3
Over 1 year	20.8	39
Incl. Those of over 3 years	9.2	10.8
<i>FOR REFERENCE:</i>		
Average Account Value (in current terms, RR billion)	10.3	11.2
Number of Banks	230	254

Source: STI&K consultancy

At the start of the year, the segment of the market for 3-month corporate deposit did not vary significantly between Moscow and regional banks. However, throughout the year, growth in the number of this type of deposits was more pronounced at regional banks and by the end of 3<sup>rd</sup> quarter the gap in the number of these deposits between the regional banks and

their Moscow counterparts has reached 11.8 percentage points – a considerable increase from 2.7 percentage points in the start of the year (please see *Table 21*).

*Table 21*

**Term Structure of Foreign Currency Corporate Deposits  
Moscow Banks vs. Regional Banks**

Term type	Share of Total Corporate Ruble Deposits in %			
	Moscow		Regions	
	01.02	10.02	01.02	10.02
Current	1.1	1.2	0	0.1
Up to 90 days	20.7	23.4	19.5	35.2
91 days to 180 days	5.6	5.6	11.7	13.4
181 days to 1 year	41.9	22.7	41.2	17.1
Over 1 year	30.7	47.1	27.6	34.2
Incl. Those of over 3 years	15.6	14.2	5.8	5.2
<i>FOR REFERENCE:</i>				
Average Account Value (in current terms, RR bil- lion)	10.04	10.31	2.59	3.09
Share of Resident Corpo- rate Deposits in Banks' Liabilities	9.2	9.0	5.7	4.4
Number of Banks	127	147	100	104

*Note:* Surgutneftegasbank figures are excluded from the regional group

*Source:* STI&K consultancy

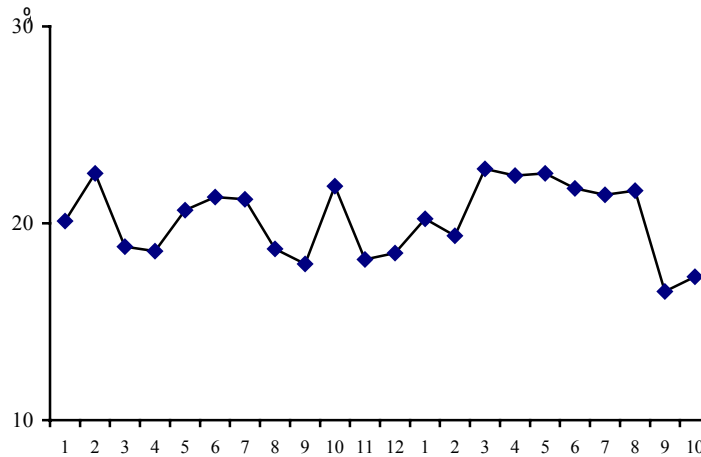
Similar changes occurred in the segments for 3-6 months and over 12 months corporate deposits. While the number of 3-6 months deposits has been stable during the year for Moscow banks, the regional banks have managed to increase their share from 2.4% to 16%. Likewise, corporate foreign-currency deposits of over 1 year have risen 1.5 times at Moscow banks and by almost 2.5 times at regional banks.

In contrast, 6-12 months deposits have significantly fallen in number both at Moscow and regional banks. If at the start of the year both groups had more or less similar positions on the market, by the end of September, the number of these deposits fell by 19.2 points for an average Moscow bank and by 24.1 points for its regional counterpart.

#### Banks' Operational Efficiency

Compared with the previous year, the returns on assets ratio (ROA) for three quarters of 2002 seemed to demonstrate that Russian banks were more efficient last year than they were in 2001. Thus returns on assets ratio for all existing banks (excluding Sberbank and ARCO managed banks) for three quarters in 2002 amounted to 3.3%, whereas in 2001 the figures stood at only 2.9%. 2002 gross operational income (the sum of net interest and net non-interest revenues) figures were also high relatively to assets (9.5% vs. 10.4%, see *Table 12*). The growth was achieved through increases in *net interest income* as banks managed to raise margin rate from 4.9% to 5.2%, while *net non-interest income* stayed at 2001 levels. An accelerated reduction in interest costs rather than an accelerated reduction in interest revenue has contributed to the rise in the *net interest income*. If interest revenues fell in 2002 by 0.9 percentage point (from 10.3 to 9.4%), then rate-based costs in the same period dropped by 1.2 percentage points (from 5.4 to 4.2%).

Rates on most popular type of corporate loans (6–12 months) continued to fall throughout 2001 and 2002, although their reduction did not proceed in a consistent manner.



Source: Russian Central Bank

Fig. 10. Profits on Corporate Ruble Loans with 6-12 Months Maturity Including Refinancing in 2001-2002 (in %)

In 2002 banks also appeared to be more efficient in their operations with securities. For 3 quarters of 2002, banks' net revenue raised from transactions with securities has grown from 0.8 to 1.1% - a pleasant reversal of fortunes from a dismal performance in 2001 during which banks' net securities revenue fell almost twice (from 1.9 to 0.8) on the previous year. The share of non-interest revenues did less well and their share in gross operational income for 9 months of the year has fallen a bit from 46.8% in 2001 to 45.3% by the end of 3<sup>rd</sup> quarter of 2002.

Table 22

### Banks' Costs and Revenues

Statistic (in % to assets)	2000	2001	3 <sup>rd</sup> Q 2002
Gross Operational Income	10.4	9.2	9.5
Net <u>interest</u> Income	3.3	4.9	5.2
<u>interest</u> Revenues	11.9	10.3	9.4
<u>interest</u> Costs	8.6	5.4	4.2
Net <u>interest</u> Income	7.1	4.3	4.3
Revenues from commission and fees, incl:	2.8	2.0	1.6
On financial market operations	2.7	1.5	1.7
Foreign-currency transactions	0.6	0.6	0.5
Gold and precious metals	0.1	0.1	0.1
<u>current operations</u> on Foreign-currency and deposits	0	0.1	0
operations with securities	1.9	0.8	1.1
revaluation of forex reserves and securities	1.0	0.6	0.6
revaluation of forex reserves	0.2	0.3	0.4
revaluation of securities	0.8	0.3	0.2
Leasing	-0.1	-0.1	-0.1

**RUSSIAN ECONOMY in 2002**  
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Other operational revenues	0.9	0,3	0,5
Administrative Costs	5.7	4.9	4.8
Incl. Wages and Social Security Payments	1.9	2.3	2.3
Depreciation deductions	0.3	0.2	0.2
Property Lease	0.5	0.4	0.4
Taxes, allowable for costs deduction	1.1	0.5	0.5
Net Operational Income	4.7	4.3	4.8
(-) Changes in reserves	2.6	1.6	1.8
Net result from occasional operations	0.3	0.2	0.4
Pre-Tax Profit	2.4	2.9	3.3
Pre-Tax Profit to Balance Capital	10.7	13.9	16.8

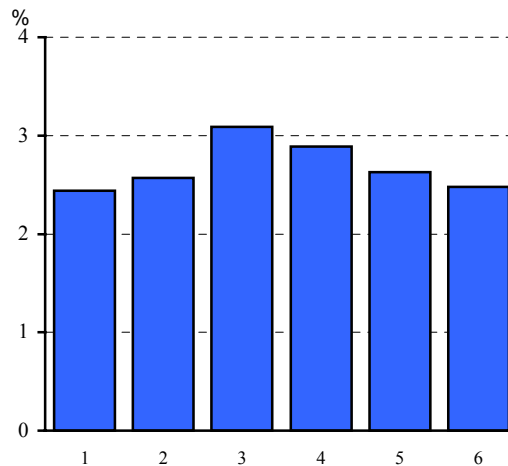
*Note:* Data for all current banks as of 3<sup>rd</sup> quarter 2002, excluding Sberbank and ARCOARCO-managed banks

*Source:* STI&K Consultancy

Thus, although banks 2002 profitability beats the previous year results, they still failed to match margins achieved in 2000. Administrative costs in 2002 continued to decline as a proportion of banks' assets, albeit at a slower pace than in 2001. If in 2001, banks managed to reduce administrative costs from 5.7 to 4.9% of assets, then in 9 months of 2002 the reduction barely made a symbolic 0.1 percentage points cut. Major reason for this belt-tightening was not so much focus on frugality on banks' part, but a change in rules governing assignment of certain tax payments to costs. For instance, in 2000, the value of tax payments that banks were allowed to book to costs amounted to 1.1% of the total costs, while in 2002 the figure stood only at 0.5%. Other types of administrative costs, except wages (which rose almost by a quarter), were cut as well. If in 2000, banks paid only 1.9% of their assets as wages, while in 2001 and 2002 that figure was raised to 2.3% of assets.

For the first time in several years, banks managed to raise (albeit only by 0.1 p. points) their net operational income. At the same time, more resources were designated towards reserves creation. For 9 months of 2002, reserves rose by 1.8% of assets, while in 2001 that figure amounted to 1.6%. Net results on non-regular operations in the same period almost doubled their share in relation to assets. Consequently, returns on assets ratio for 9 months of 2002 climbed up above the entire 2001 level by 16%. Pre-tax profits to balance capital ratio also rose and registered growth of 16.8%, but as was the case with administrative costs reductions, the changes for the better happened slower in 2002 than in 2001.

Interestingly, in 2002 the banks' performance proved to be just slightly dependent on the size of their assets (see *Fig.12*). In contrast, during 1998 crisis the size mattered, and it was the big banks that suffered heaviest losses, while smaller banks outside the top 50 managed to fairly quickly absorb the shock and adapt to a new environment. By 2002, convention of bigger means better seemed to prevail and the country's largest banks finally have visibly improved their profits to assets ratio of.



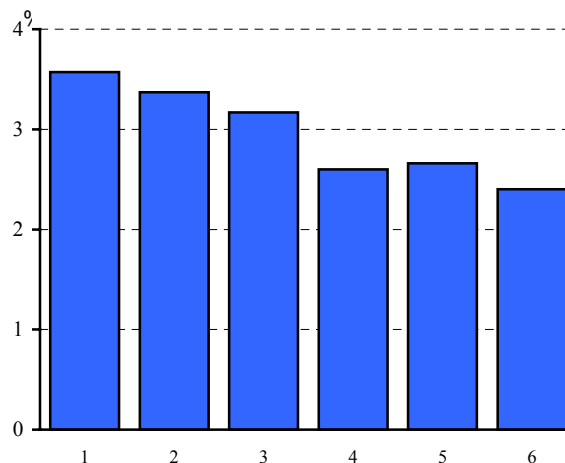
Banks Ranking Based on Assets Size as of January 1, 2002:

1. first 10 top banks
2. ranking 11-50
3. ranking 51-100
4. ranking 101-200
5. ranking 201-500
6. ranking 501- 1304

*Note:* out of currently existing 1304 banks data for only 1281 were included, because by the end of 2000 some banks have not yet commenced their operations. In addition, Imperial Bank was excluded from the 3<sup>rd</sup> group, because its data skewed the group's average by a factor of 2 (in 4<sup>th</sup> quarter the bank was engaged in heavy reserve creation)

*Source:* STI&K Consultancy

*Fig. 11. 2001 Returns on Assets Ratio of Banks Based on their Asset Size (except for Sberbank and ARCO-managed banks)*



Banks Ranking Based on Assets Size as of January 1, 2002:

1. first 10 top banks
2. ranking 11-50
3. ranking 51-100

4. ranking 101-200
5. ranking 201-500
6. ranking 501- 1304

Source: STI&K Consultancy

*Fig. 12. 3<sup>rd</sup> Q 2002 Returns on Assets Ratio of Banks Based on their Assets Size (except for Sberbank and ARCO-managed banks)*

## **4.7. The National Market for Housing in 2002 and up to 2003<sup>32</sup>.**

### **The general situation in the housing market and its dynamics in 2001-2002**

The previous analysis of this particular segment of the national economy<sup>33</sup> comprised a conclusion, as follows: having passed through the stage of decline and depressive stabilization, the housing market has entered the stage of stable growth, which was expected to end as early as in 2002.

In December 2002, results of the monitoring of the markets for housing in 9 cities of Russia and particularly Moscow oblast were concluded. The data showed that as of late 2002, the average proportional housing offer price (in USD equivalent) grew in all the cities of the sample.

Table 1 below cites price levels as of late 200, 2001 and 2002, a nominal increment in USD prices over 2001, the first half 2002 and 2002 on the whole, and an actual annual increment rate over the years in question. The actual increment in housing offer prices (IGS index<sup>34</sup>) suggests an account of the impact of inflation computed both in the Rb. and USD equivalent. According to Goskomstat, in 2001 the Rb. inflation accounted for 18.6 and 15.1% - in 2002, while the USD inflation in Russia (computed against consumer basket) – 10% and 8.8%, respectively. Table 1 also contains average weighted indices across the group of capital cities of the RF Subjects (hereinafter referred to as regional centers), except for Moscow and St. Petersburg. The weighting was done with account of the share of the given city's population in the overall number of population of all the group of cities.

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<sup>32</sup> The present paper is based upon the housing monitoring data compiled by a group of certified by the Russian Realtor Guild (RRG) analysis of the real estate markets as well as by those due to be certified. The latter represent the following organizations: Agentstvo expertizy investitsionnykh proektov (AEKSIP), Promyshlennostrahovaya kompania (PSK), RAN SAVVA, Kompania RMLS, Contact-nedvizhimost agency, Miel-nedvizhimost, NITSA, the sub-department of marketing of the Department of investment programs of building under the Moscow city Government (all from Moscow), Informational-publishing group Bulletin nedvizhimosti, Peterburgskaya nedvizhimost Corporation, real estate agency Itaca (all from St. Petersburg), the Realtor informational center under the Ural Real Estate Agency (Ekaterinburg), Vostochno-Sibirskaya pravda Agency (Irkutsk), Internet-laboratoria (N. Novgorod), Akropoland Kontinent-Sibir real estate agencies (all from Novosibirsk), the Perm league of realtors and appraisers, OAO 'Kamskaya dolina', Perspektiva Corporation (all from Perm), TITAN agency (Tver), ZAO Center nedvizhimosti" (Ulyanovsk)

<sup>33</sup> See: Rossiyskaya ekonomika v 2001 g. Tendentsi in perspektivy (Issue 23). M., IEPP, 2001. vol. 2, p. 169-89

<sup>34</sup> IGS was calculated according to the following formula:  $IGS = I_{pr}/I_{cp} = I_{pd}/I_{id}$ , где  $I_{pr}$  – the index of housing prices denominated in Rb.,  $I_{cp}$  – consumer price index,  $I_{pd}$  – the index of housing prices denominated in USD,  $I_{id} = I_{ipr}/I_{дрд}$  – the USD inflation index in Russia (relative to consumer price dynamics),  $I_{дрд}$  – the index of depreciation of the Rb. to USD



Table 23

**Dynamics of the average housing offer price level in 2000-2002 (in USD equivalent)**

City	The average proportional offer prices, as \$/ sq. m			Nominal housing cost indices			IGS		
	Dec. 2000	Dec. 2001	июнь 2002	Dec. 2002	Dec. 2001/ Dec. 2000	июнь 2002/ Dec. 2001	Dec. 2002/ Dec. 2001	2001	2002
Moscow*	720	940	977	1096	1,31	1,04	1,17	1,18	1,07
St. Petersburg	370	490	558	641	1,32	1,14	1,31	1,20	1,20
Moscow oblast**	352	471	515	602	1,34	1,09	1,28	1,21	1,18
<b>Regional centers (as a whole)</b>	<b>270</b>	<b>379,7# / 378,4</b>	<b>399</b>	<b>411</b>	<b>1,41#</b>	<b>1,05</b>	<b>1,09</b>	<b>1,28#</b>	<b>1,00</b>
Ekaterinburg	336	484	510	518	1,44	1,05	1,07	1,31	0,98
Novosibirsk	263	470	467	470	1,79	0,99	1,00	1,62	0,92
Irkutsk	...	365	412	422	...	1,13	1,16	...	1,06
Perm	287	390	371	394	1,36	0,95	1,01	1,235	0,93
N. Novgorod	280	301	354	365	1,075	1,18	1,21	0,98	1,11
Tver	203	260	307	311	1,28	1,18	1,20	1,16	1,10
Ulyanovsk	158	216	229	260	1,37	1,06	1,20	1,24	1,11

Notes:

\*computed basing on the data of RMLC, Miel-nedvizhimost, Kontakt-nedvizhimost;

\*\* computed as average weighted values across the data on 47 cities. The weighting was based on the share of objects of the given city in the total volume of offer;

#the average weighted value as of December 2001, without regard to Irkutsk: it was used to compute the respective housing price indices across the group of regional centers in December 2001 relative to December 2000, as the December 2000 data on this particular city is lacked (in order to ensure comparability).

The data above allows understanding that in 2002 it was St. Petersburg where the USD nominal price increment was the greatest one (31%), followed by cities around Moscow (28%). Prices were soaring at some 20% in N. Novgorod, Tver and Ulyanovsk, while remained unchanged in Perm and Novosibirsk (notably, the latter, with a 79% rise, was a leader in terms of housing price dynamics in 2001, while in Perm the respective index also grew fairly considerably). In 2001, in most of the cities of the sample the price increment (in USD equivalent) accounted for over 30%, while in Veliky Novgorod the growth made up moderate 7.5%.

It was, again, St. Petersburg where actual housing prices adjusted for the Rb. and the USD inflation levels in 2002 broke a record 20%, followed by Moscow oblast (18%), with the city of Moscow's increment rate lagging far behind with just 7%. Overall, prices remained unchanged across the group of regional centers, though housing prices plunged by 2-8%, while Irkutsk, Tver, N. Novgorod, and Ulyanovsk witnessed a 6%...11% price rise.

By contrast to a number of preceding years, 2001-02 saw changes in regularities on the housing market. More specifically, the factor of differences in market dynamics between groups of cities with different (Rb. and USD) price denomination has lost its significance. At the same time, there arose factors of post-crisis recovery rate and a normal effective demand. However, the data of Table 1 and charts below show that last year's forecasts of the situation on the national housing market were not accurate enough.

In the first half 2002, the nature of the housing price dynamics basically met expectations, i.e. it mirrored the transition from a steady growth in 2002-01 towards recession and



stabilization, except for N. Novgorod, Irkusk and Tver that had been lagging behind in terms of post-crisis price rise renewal. Between January to June 2002 the price increment in this particular group accounted for 13-18%, in the city of Moscow, Moscow oblast, Ekaternburg, Ulyanovsk – between 4 to 9%, while in Novosibirsk they fell by 1%, and in Perm - by 5%. At this point, the St. Petersburg housing market formed a contrast picture vs. the others, with a 14% increment and the price rise being stable rather than fading there.

Price dynamics in the late 2002 proved forecast estimates with regard to the group of regional centers, which cannot be argued about St. Petersburg and Moscow that demonstrated an unexpected growth over the period in question. The results of the 9 months of the year allowed conclusion about contrast price dynamics on different housing markets. All the cities of the sample can be divided into three different groups:

- regional centers, with stabilization being steady there;
- St. Petersburg, with the ongoing price rise; and
- the city of Moscow and Moscow oblast that experienced a new price rise in the late 2002.

### **The state of housing markets in the groups and single cities**

Let us depict the situation in each of the aforementioned groups.

As for the group of regional centers, the strengthening trend to stabilization allowed various scenarios of development of the situation (see *Fig. 1*)

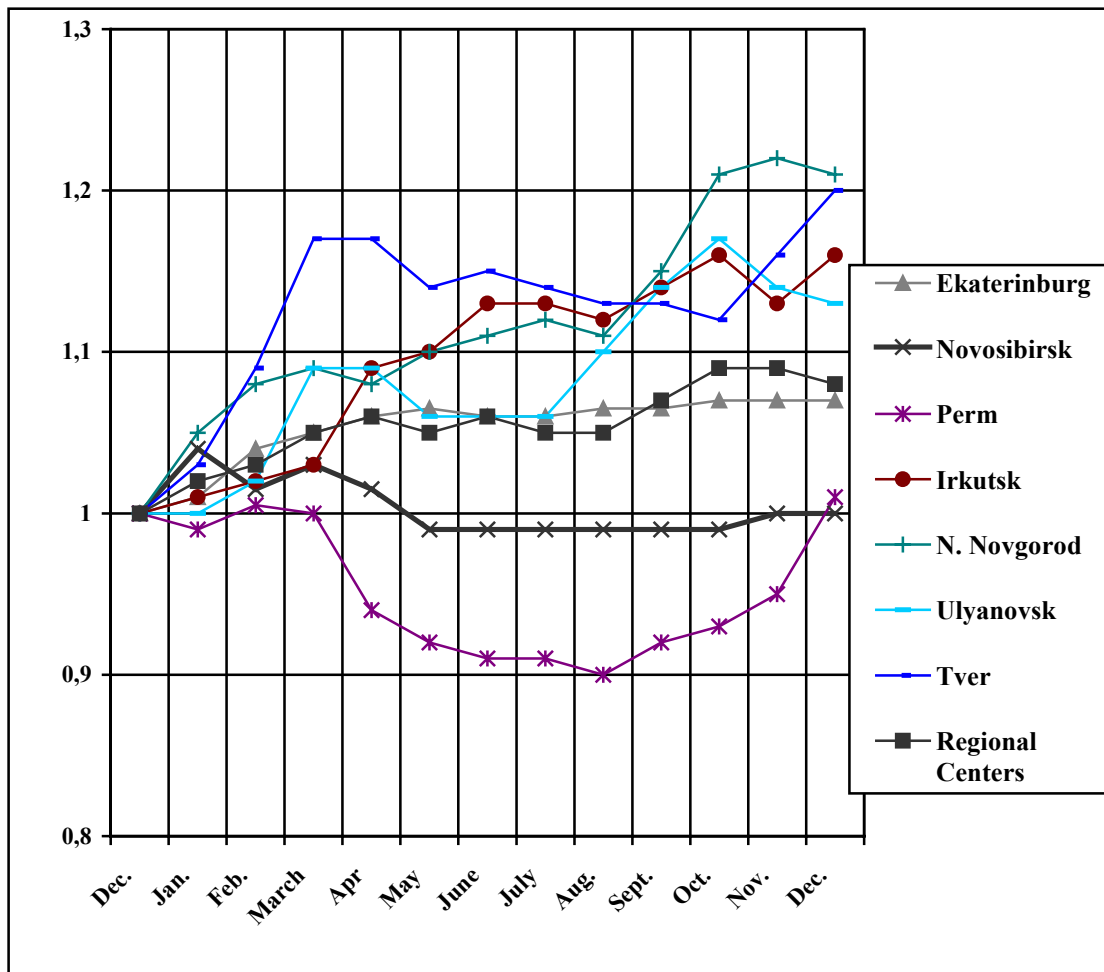


Fig. 13. Housing offer price indices in Russian cities – regional centers, 2002.

It was Perm, Novosibirsk and Ulyanovsk where the price rise was the greatest one in 2001; consequently, as expected, in 2002 stabilization ‘overshot’ an original scenario: given that in winter offers were growing for some time, they dropped between spring to summer, while autumn saw a slight seasonal price rise. It was just Ulyanovsk where prices grew over the year (at 20%). The activity on the market fell, too. For instance, in Novosibirsk the Department of Justice of the oblast reported a 17% decrease in the average monthly volume of real estate transactions vs. 2001 and a 22% one compared with its respective rate of 2000.

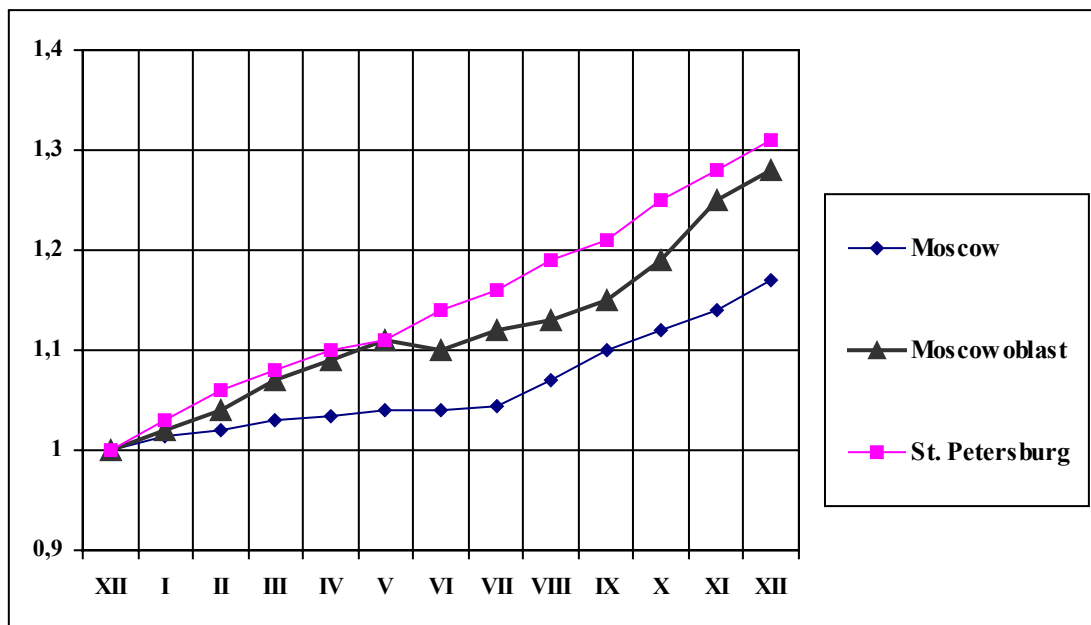
In 2002, for the first time ever there has been no autumn intensification of operations on the Ekaterinburg market. Traditionally, it led to a decrease in the volume of offer and acceleration of the price rise. Last autumn, the number of flats for sale was growing, which is not typical for this particular season. The cause for such a situation lies with the lowering demand, because a considerable part of potential buyers had to postpone the purchase of a new flat due to a rapid price rise for them. The time period between the moment the flat is put on the market for sale and until its actual purchase remains stable, which testifies to a low activity on the market, and so far there have been no prerequisites for the market resurgence in the short run.

As last year the N. Novgorod, Tver and Irkutsk markets were slow with the price rise and rebound to the pre-crisis level, the transition to stabilization has followed the ‘crawl-up’ scenario (asymptotically): offer prices continued to grow between winter to spring with a gradual slowdown and transition to a stable level followed by some rise in autumn (with the overall increment rate accounting for 16...21%).

In 2001 the average increment in nominal USD-denominated prices across regional centers accounted for 41%, while in 2002 – 9%.

The situation in St. Petersburg appeared radically contrast to the above (see Fig.2)

The price rise in Moscow and St. Petersburg was taking practically synchronous pace from the lowest point of the post-crisis period (May-June 2000) through the late 2001. Last year, the latter city experienced a non-stop offer price rise, with the respective increment accounting for 31% vs. December 2001. Thus St. Petersburg has become the only city (of all those included in the sample in question) where the offer price level has exceeded the pre-crisis one.



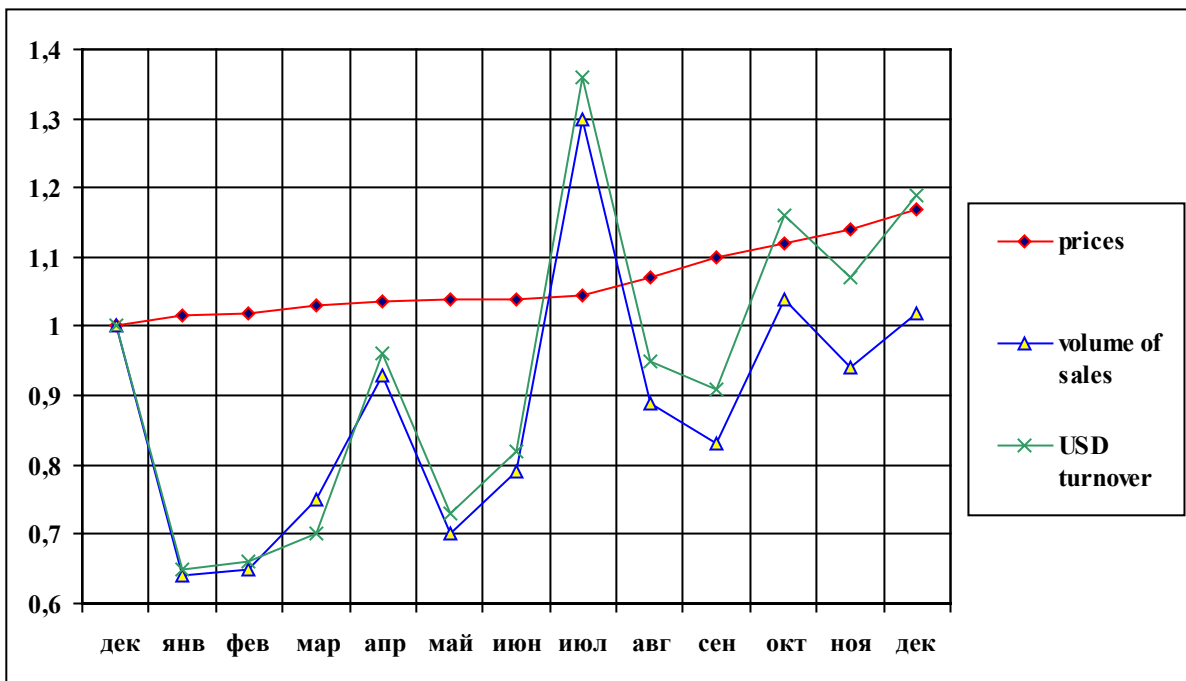
*Fig. 14.* Housing offer price indices in the city of Moscow, Moscow oblast and St. Petersburg, 2002

There is every reason to believe that such developments in the Northern Russian capital are related to the upcoming celebration of its 300<sup>th</sup> anniversary. The jubilee and the highest office’s focus on the city (more specifically, by increasingly making it the main arena for various summits and forums) have boosted tourism and ensured more frequent visits of representatives of political and business elites. The opportunity to capitalize on satisfying the increased rise in demand for goods and services generated a trade capital inflow, primarily on the part of foreign and Moscow-based net retail companies (supermarkets). As a result, there arose a very high market demand for trade facilities and offices for lease, which then outspreaded over investment projects on the market for commercial real estate and housing where the ongoing price rise has overrun any expectations.

Notably, the price rise took place chiefly downtown where vigorous efforts are undertaken to transform the so-called ‘communal’ apartments located in the pre-Revolution buildings into attractive objects for representatives of the noted corporations. By contrast, other city’s districts, with their mostly modern standard blocs of flats experienced just a minimal price rise.

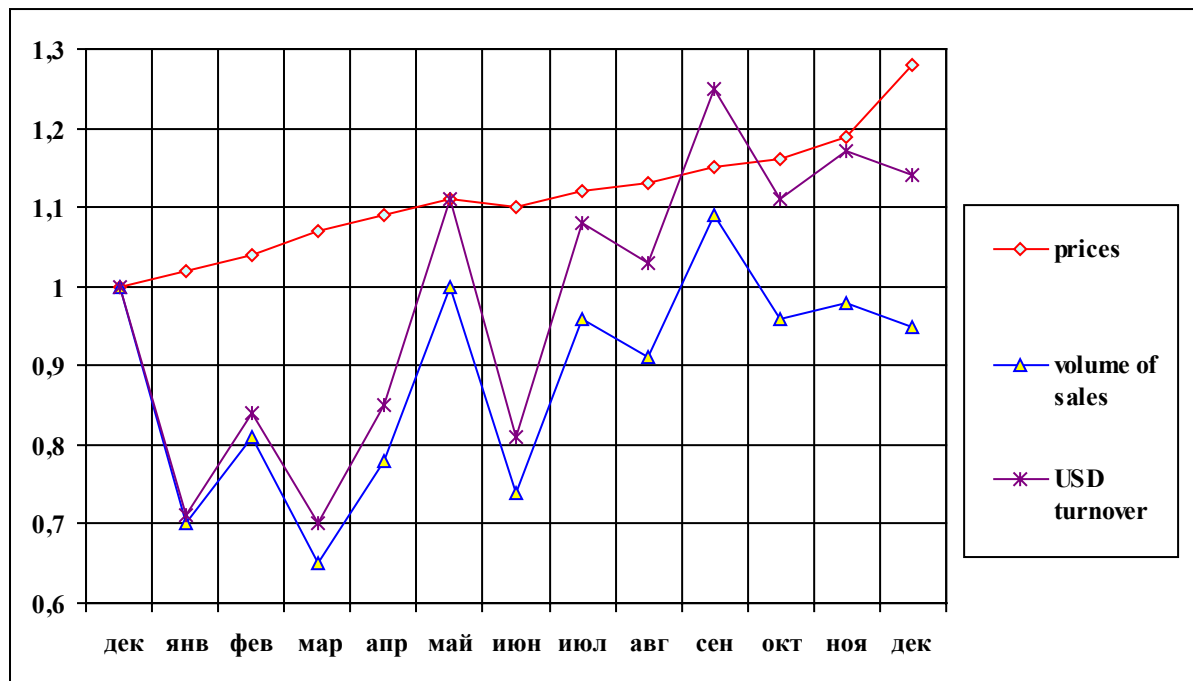
Once the celebration and the governor elections are over, one can expect the investment inflow in the city to contract, followed by stabilization and even downfall of housing prices.

As concerns Moscow, stabilization there was attained by summer under the ‘crawl-up’ scenario (a gradual discontinuation of the rise in offer prices). However, there has been no decline in prices and they have been climbing up since August, with the total annual increment accounting for 17% (see *Fig.3*)



*Fig.15* Nominal housing market indices in Moscow in 2002

The pattern of the Moscow oblast’s housing market’s development was analogous to that of the city of Moscow (with a regular half-year time lag vs. the latter’s schedule, though) – the annual increment rate in nominal prices in USD equivalent made up 28% (see *Fig.4*), with a notable rise in operations on the housing market for real estate in the towns around Moscow.



*Fig. 16* Nominal housing market indices in Moscow oblast in 2002

There are different views on the causes for a new price rise in both regions.

Some experts attribute the autumn growth to an insufficient volume of housing offer on the secondary market, which in turn is related to an accelerated disappearance of flats off the market in the wake of a price stabilization noted between spring to summer 2002. Indeed, according to Miel agency, in April 2002 the volume of offer across the city of Moscow as a whole dropped notably, and until the end of the year it did not exceed the respective level of May 2002. At the same time, since May 2002 the share of flats withdrawn from the market relative to the number of offers was growing practically non-stop.

It is clear that the volume of offer of housing on the market depends on two factors: first, the sellers' eagerness to put their objects on sale and, second, on the volume of sales, i.e. the pace of 'washing' the offer away. It can be assumed that rather a sharp transition from high growth rates on the market in 2001 towards their decline up to stabilization in the first half 2002 has lowered sellers' activity, and the inflow of objects to the market fell accordingly.

At the same time, as noted above, the monthly volumes of apartment sales in the city of Moscow and around it showed a fairly considerable growth.

According to the Moscow City Real Estate Transaction Registration Department, the dynamics of the volume of deals registered in the city appeared different from previous years. The seasonal, January decline in the volume of deals (this time – by nearly 40%) was followed by a regular increase, with the July index breaking the December record rate at a margin of 30%, while at the end of the year the rate was back to the level reported in December 2001.

Overall, during 2002 the volume of registered purchase/sale transactions covered 76,000 flats, thus beating the respective index of the prior year at 9% and the level of 2000 –



at 34%. At the same time, the share of real estate deals stricken in the second half of 2002 made up 57%.

However, these data needs some adjustment, because since 2000, in compliance with newly adopted “Law on registration of property rights for real estate and transactions involving it” of July 21, 1997 # 122-FZ (as amended on March 5, 2001<sup>35</sup>), the RF Ministry of Justice was keen to alter procedures of registration of deals involving purchase of flats in newly erected houses: more specifically, they insisted on the transition from the so-called ‘re-assignment of the claim right’ from the developer to the buyer<sup>36</sup> towards a normal registration of the developer’s property rights for the houses to be put into operation and registration of a purchase/sale deal between the developer and the buyer identical to the ones stricken on the secondary market for housing. At that point, some confusing of purchase/sale volumes in the secondary market with those in the primary markets occurs.

In practice, however, changes in the procedures were taking a slow pace, and sales of most of newly built flats were still being registered according to the said ‘re-assignment of the claim right’ procedure. In reality, in 2002, according to some experts dealing with sales of flats on the primary market, it was just some ¼ to 1/3 of them that was registered as purchase/sale deals. In other words, basing on their investment contract with the city, developers fixed the property rights with themselves and would consequently sell such flats to private buyers, and those were reported as ‘transactions’.

Notwithstanding, if we want to expose the dynamics of the volume of deals on the secondary market only and exclude the double count, this relatively small share of purchase/sale transactions (some 7,000 to 10,000 flats in 2002 and 3-5,000 in 2001 in absolute terms) should be ignored by the official statistics.

The table below highlights on the dynamics of the volume of purchase/sale deals on the secondary market in the city of Moscow between 1994 through 2002.

*Table 24*

**Annual volume of apartment sales on the secondary market of the city of Moscow**

year	As Thos. units	as % to the prior year	as % to 1997 (1997 = 100%)
1994	70,817		83,6
1995	79,664	112,5	94,0
1996	71,068	89,2	83,9
<b>1997</b>	<b>84,748</b>	<b>119,2</b>	<b>100,0</b>
1998	77,526	91,5	91,5
1999	76,093	98,2	89,8
2000	63,726	83,7	75,2
2001*	67,0	105,1	79,1
2002*	68,0	101,5	80,2

<sup>35</sup> In Moscow, the law was put in effect since early 2002

<sup>36</sup> This specific procedure implies the developer-investor signing an Agreement on re-assignment of the claim right for the given apartment with a buyer who appeals to the Moscow City Real Estate Transaction Registration Department and obtains the property right for the flat. Once registered the agreement is qualified for the ‘Registration of Newly Rights’ section, rather than ‘Purchase/Sale Transactions’ one.

\*the data for 2001-02 were computed with account of exclusion of the double count caused by mixing of deals on the secondary and primary markets because of the transition from the sales of newly built housing basing on 're-assignment of the claim right' from the developer to the buyer to the procedures of registration of the developer' right for houses put into operation and the consequent registration of a purchase/sale deal between the developer and the buyer.

The data of *Table 2* show that the intensity of operations on the secondary Moscow market began to rise between 2001-02, however, it has not yet hit the pre-crisis level of 1997 when it had reached its peak over the whole period between 1994 to 2002.

The intensity of operations on the Moscow market was as follows: given that in 2000 there were 44,414 registered deals involving purchases/sales of flats, in 2001 – 47,903 (up at 11.4%) and in 2002 – 49,471 (another 3.3% up), of which 56% was stricken over the second half year.

Thus, the rise in the monthly volume of sales over the year could form one of the reasons for contraction in the volume of offer on the market and the consequent price rise. At the same time, this process should have some grounds – more specifically, a rising demand for housing. According to some experts, such a rise, indeed, has taken place since last July and been underway until February 2003. That was noted both by the Moscow and St. Petersburg analysts, as well as those from Novosibirsk, Vladivostok, and Voronezh. This gives a rise to a natural question about the causes of such a change.

### **The interrelation between macroeconomic parameters and prices for housing in the nation's capital in 2002 and price forecast options for 2003.**

It is the contraction in the increment rate in retail goods turnover noted for the first time over recent years that should be considered a major reason for the rise in demand for housing in Moscow. According to Goskomstat of RF, after 3 quarters of 2002 the respective index for Moscow accounted just for 3.5% vs. 7.6% reported over the respective period of 2001. That took place against a continuous rise in the population's real incomes. All that in turn puts an additional pressure onto the market and generates the price rise.

Another reason of the buying rush on the real estate market in January may well be an attempt 'to escape from the USD' caused by the fear of its depreciation due to the potential military conflict with Iraq, the state of the US market, and the strengthening Euro. The lack of clarity may urge holders of USD-denominated assets to invest them in a more stable real estate.

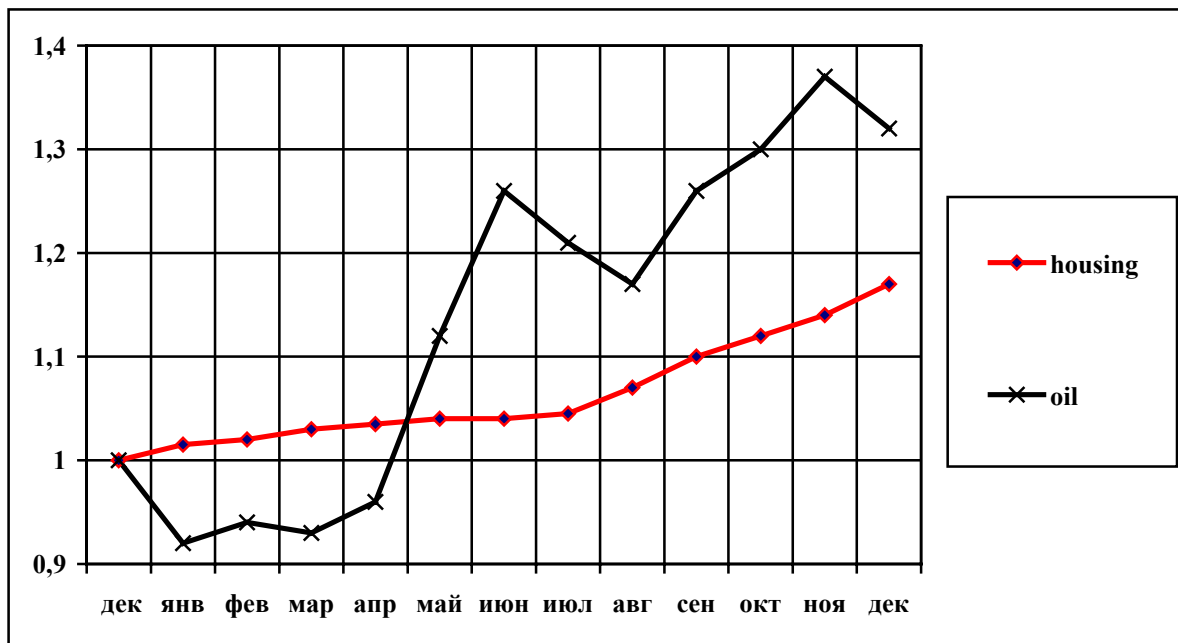
It is well known that Russia's macroeconomic situation is highly dependent on world oil prices. While the price for Russian oil slid to USD 18.8/barrel in the aftermath of 09/11, Russia's economic growth rate immediately dropped to 2.5%.

In the 4<sup>th</sup> quarter 2001 the output of goods and services of the five basic sectors (industrial, construction, agrarian, transport, and retail trade) fell by 5.5% in comparable prices vs. the 3<sup>rd</sup> quarter, while in the latter it was at 13.5% higher than in the 2<sup>nd</sup> one. The decline further intensified in the 1st quarter 2002 (by 11.5% vs. the 4<sup>th</sup> quarter 2001).

In March-April 2002, the price for Urals surged up to 22-24USD/ barrel, which allowed the economic bloc in the government and CBR to adjust towards increase their projections of the budget, forex reserves, and growth in GDP until the end of the year. The dynamics of the output of goods and services by the five basic sectors once again began to grow from quarter to quarter (7.9% up in the 2<sup>nd</sup>, 15.1% - in the 3<sup>rd</sup> quarter). Eventually, the reality exceeded all expectations: in the second half 2002 oil prices continued their growth, while the 2002 annual

results and all the macroeconomic indicators proved to be better than projected (though the 4<sup>th</sup> quarter once again saw the signs of a slump, which by intensity, could become comparable to that of late 2001).

Whereas under the housing market' transition towards stabilization the influence of external factors is becoming especially visible, there arises a natural question about its interrelation with the situation in the world oil market.



Source: oil price indices were computed basing on the data of the International Energy Agency, housing price indices –according to the data of RMLC, Miel-nedvizhimost and Kontakt- nedvizhimost real estate agencies.

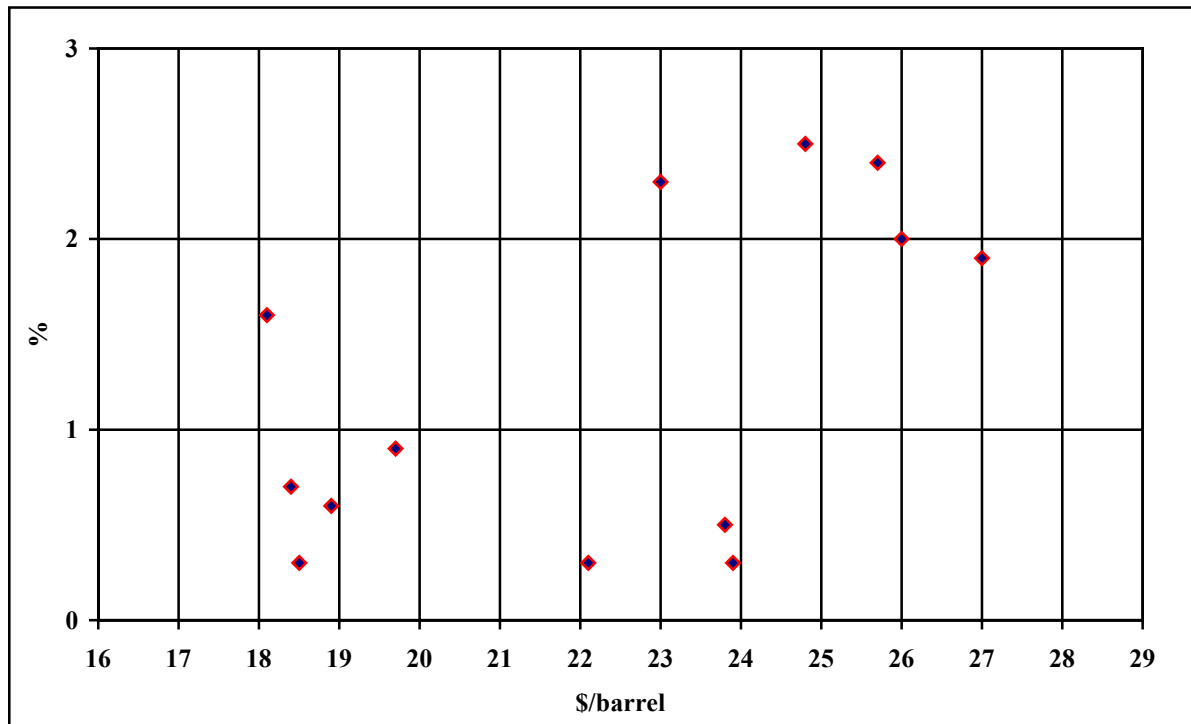
*Fig.17. Housing offer price indices in Moscow (in USD equivalent) and the prices of Urals in 2002*

Such an interpretation is correct, at least, as far as the Moscow housing market is concerned. In Moscow, it is the capital inflow from oil- and gas-producing regions that forms one of the factors forming the demand for housing (according to some sources, this particular factor contributes to up to 30% of the effective demand on the local real estate market).

The Chart above (see *Fig. 5*) helps compare the 2002 price rise rates for housing in Moscow with those for oil (with account of a 2-month lag related to the delay with repatriation of oil export receipts to Russia) by illustrating the relation between these two parameters. This allows hypothesis that the price rise in the 1<sup>st</sup> half of the year helped maintain housing prices in Moscow, while the record-breaking rise in the 2<sup>nd</sup> half of the year has led to a new price rise for housing<sup>37</sup>.

<sup>37</sup> To test this hypothesis one needs a considerable number of observations during a longer time period.





*Fig. 18.* The correlation between monthly housing price rise rates in Moscow and world prices for Brent basing on the data for 2002 (with a 2-month lag).

*Fig. 18.* clearly shows that with oil prices being under USD 22/barrel, the price rise for housing was minimal. By contrast, when the oil prices were surging up to USD 27-28/barrel, the housing price index was growing, too.

Such a reaction of the real estate market on changes in oil prices of course serves as yet another proof of the national economy's dependence on this particular factor. Naturally, the demand for housing in Moscow is formed by the capital inflow from the oil and gas sector or more specifically, by both oil and gas producers and banks, trading companies and other economic agents that are indirectly influenced by the oil dollar inflow in Russia. The building sector also benefits from that.

It is worth noting that such a situation results in appearance on the market of both corporate structures themselves, their highly paid managers and, to a certain extent, their ordinary staff, which extends the demand for housing from high-quality segments to mass ones.

Will it be possible to use the revealed regularity to forecast housing prices in 2003?

If one bases his assumption on the RF government's forecast of the average annual oil prices underlying the budget computations, then the optimistic scenario (21.5USD/ barrel) allows forecasting a 1.2% average monthly price increment for housing in Moscow and 14-15%- over 2003 as a whole, while the pessimistic scenario (18.5 USD/ barrel) provides 0.8% and 10-11%, respectively. Let's add to this possible capital inflow into the real estate market due to the start of the pre-election cycle, which should also contribute to the price rise in the market, and one can assume that given other conditions being stable, the annual price change in Moscow may account for 12-16%.

However, the political situation in the country and in the world is such that the margins of the oil price range can expand substantially. As well, there is a probability that other un-



foreseen circumstances may arise that can radically change the ongoing trends in the economy and affect the real estate market.

So, the trends noted in the national market for real estate in 2002 allow the division of Russian cities into three groups: St. Petersburg, where the price rise started in 2002 and is still in place; the city of Moscow and Moscow oblast, where the transition to stabilization noted in the first half year was replaced by the renewed price rise; and the third group formed by all other cities included in the sample that after the period of rapid growth witnessed stabilization of housing prices over last 2-3 years.

Such a division in the market once again stresses the role of main factors that affect price dynamics on the real estate market. Those are currently external (relative to the market) factors: the general economic situation in the country, its particularities in single regions, their investment attractiveness, as well as the real estate market's relative attractiveness vs. other markets from the perspective of investing the growing export receipts in it.

## Section 2. Monetary-credit and Budgetary Sphere

### 2.1. Monetary Policy

In analyzing the processes in the monetary sphere and the Central Banks policies in year 2002, the overall decrease in attention to the developments in that sector of the Russian economy should be regarded as the key factor of analysis. In particular, the issues of monetary and currency regulation (perhaps, with the exception of the debates around new draft Federal Law "On Currency Regulation and Currency Control") remained in the background throughout the year in comparison with changes in the tax field, reforms of the public sector and natural monopolies, Russia's joining the WTO, structural policy and slowdown of growth rates in the real sector of the economy.

Against the background of significant changes in the aforementioned fields, the situation in the monetary sphere (inflationary processes, changes in the exchange rate of the Russian national currency and dynamics of demand for money) seem quite stable and predictable. E.g., the consumer price growth rate was lower in 2002 as against 2001, nearing the values envisaged in the Federal Law "On the Federal Budget for Year 2002" and in "The Main Guidelines of the Monetary Policy for Year 2002". The dynamics of changes in the RUR / US\$ nominal exchange rate remained smooth throughout the year, and the real RUR exchange rate growth remained moderate. The dynamics of RUR/ Euro exchange rate are characterized by greater volatility resulting primarily from fluctuations in the exchange rate of the single European currency against the US Dollar. Despite the change in the management of the Bank of Russia in March 2002, the politics of monetary authorities did not suffer any abrupt modifications and currency control liberalization continued.

At the same time, the set of monetary policy instruments remained in 2002 as limited as in the preceding years, not going beyond interventions in the foreign exchange market and accumulation of funds in the Federal Government's accounts with the CB RF. On the other hand, due to the weak relation between the monetary and real sectors of the Russian economy and lack of clearly defined monetary policy transmission channels, the issue of how urgent it is to expand the Central Bank's ability to implement its policy remains more theoretical than practical<sup>1</sup>.

On the whole, one may mark out the following important issues in the area of monetary and exchange rate policy (below we will expand on them in greater detail).

- the growing role of non-monetary factors (increase in regulated prices of natural monopolies) in determining consumer price growth rates, accompanied by further slowdown of the rate of inflation;
- smooth dynamics of the nominal RUR exchange rate, remaining low appreciation rates of the Russian national currency and accumulation of gold and currency reserves of the Bank of Russia;
- change of the management of the CB RF;
- policies of the monetary authorities in relation to currency control liberalization;

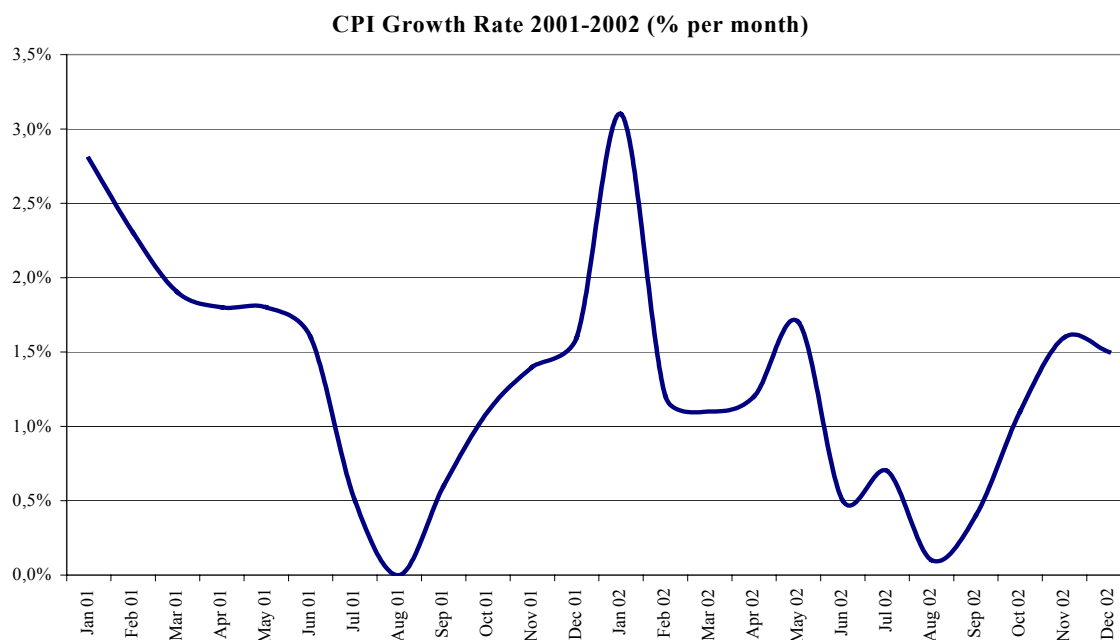
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<sup>1</sup> The possibility of existence of various monetary transmission channels in the Russian economy has been analysed in S. Drobyshevski and A. Kozlovskaya "Domestic Factors of the Russian Monetary Policy", *IET Working papers*, No. 45R, Moscow, IET, 2002.

- slowdown of capitalization of the banking system accompanied by relaxation of credit rationing and greater supply of money by the banking system by means of extending loans to the private sector;
- growth of population confidence in deposits with banks.

### **Inflationary Processes in Year 2002**

In 2002 the consumer price index growth was 15.1 percent, or 3.5 percentage points lower than in year 2001. Fig. 1 shows the month-on-month dynamics of CPI growth in 2001 - 2002. As one can see, in 2002 the intra-year inflation volatility increased. The commodity structure of consumer price growth looks as follows: consumer goods, 11.0 percent; non-foods, 10.9 percent; services, 36.2 percent; The highest price growth rates, 20.4 percent, have been observed for petroleum, (- 8.6 percent in 2001); housing and communal services: 48.8 percent against 56.8 percent in 2001; medical services: 30.7 percent against 22.5 percent in the preceding year; public transportation services: 26.0 percent against 25.3 percent in 2001, and telecommunication services: 37.6 percent against 23.3 percent.



Source: State Committee for Statistics of the RF

*Fig. 1*

In January 2002 inflation rate grew as usual. However, this year the January price fluctuation was greater than in year 2001 (see Fig. 1).

In the first month of 2002 inflation (measured by the CPI) amounted to 3.1 percent (ca. 44 percent p.a.). It should be noted that the January price growth occurred mainly in the two last weeks of the month, after the RF Government decided to increase prices and tariffs on the services of natural monopolies. The commodity structure of the CPI growth confirms the assumption that administrative and seasonal factors affecting the determination of the consumer price growth rate played the leading role while the contribution of monetary factors was insignificant. E.g., the index of prices for medicines grew 5.2 percent (which, to a great extent,



is explained by the repeal of the incentive rate of VAT for this class of goods; the index of service prices grew 7.5 percent. Such a high growth rate of service prices (the highest monthly growth rate of service prices since January 1996) has been caused primarily by a growth of prices for housing and communal services by 8.8 percent, prices for telecommunication services (18.0 percent) and railway transportation (18.9 percent).

However, in the beginning of 2002 the CPI growth rate began to decline sharply. At the end of the first two months CPI growth in 2002 lagged behind the respective figure for 2001 (4.6 percent as compared with 5.2 percent).

In May 2002 the CPI grew 1.7 percent, or 0.5 percentage points more than in the previous month. In the non-food group special attention should be drawn to a growth of prices for petrol that caused significant public response. In May the index of retail petrol prices amounted to 110.7 percent. Low octane brands of A-76 petrol (AI-80 etc.) grew in price by 12.5 percent, AI-92 (AI-93 etc.) grew by 10.5 percent and high octane brands (AI-95 and higher) by 6.3 percent. The growth of fuel prices was uneven from region to region. The greatest growth was observed in the Ulyanovsk oblast: 52.8 percent. Petrol prices continued to grow in June. The weekly growth from 3 till 10 June was 3.7 percent, from 10 till 17 June, 2.0 percent. Let us recall that a similar sharp increase in petrol prices in early summer was observed in 1999, which was related to the growth of petrol prices, in US Dollar terms, up to the level of 0.3 to 0.35 Dollars / liter after the Rouble devaluation. This level obviously reflects the equilibrium petrol price level in the internal market with the account for transportation costs and existing physical limitations on the volume of oil exports. Throughout the two last years petrol price growth rates lagged behind the US Dollar rate (although the difference in rates was significantly lower than in years 1998 - 1999), and, as we suppose, the present jump is of the same origin. Besides, in the spring of 2002 legal limitations on the volume of oil exports were removed, and, against a background of high oil prices on global markets, prices on the internal market also grew.

It is important to note that, besides the above-mentioned petrol prices, non-monetary factors affecting inflationary processes in the summer of 2002 include the decision of the RF Government of 20 June 2002 to increase tariffs on products of natural monopolies. In July 2002 tariffs on gas grew 15 percent.

Tariffs on electroenergy purchased on the Federal Wholesale Market of Electricity and Power grew 2.4 percent and tariffs on railway transportation grew 6.8 percent.

Thus, in the first six months of 2002 inflation in Russia (measured by CPI) was ca. 9 percent (against 12.8 percent in the first six months of 2001).

A seasonal decrease in consumer price growth rates was observed in the period from July to September 2002 (as low as 0.1 percent in August, see Fig. 1); at the same time, prices for housing and communal services continued to grow significantly: the increase was 2.4 percent in July and 4.1 percent in August. In September the CPI was 100.4 percent, with the main growth, 0.3 percent, falling on the last week of the month. Prices for fruits and vegetables continued to decrease: the index for this product group was 90.1 percent in September. The service price index grew 2.8 percent; the greatest growth, 10.9 percent, was observed for prices for education services, which occurred due to the beginning of the new academic year. Prices for housing and communal services grew as before: the increase was 2.6 percent.

In October the CPI started to grow faster. According to the State Committee for Statistics of the RF, in October the consumer price index was 101.1 and in November - 101.6 percent. The seasonal decrease in prices for fruits and vegetables in November was soon replaced

by quick growth: the index for this commodity group amounted to 106.2 at the end of the month. The service price index grew 4.4 percent in the two months of the autumn. In this group, the greatest rise in prices was observed for passenger transport: prices grew 6.6 percent (this occurred primarily owing to urban transport) and telecommunication: prices grew 5.9 percent.

In closing we would like to dwell on the issue of monetary and non-monetary factors contributing to the rates of consumer price growth in post-crisis years. In particular it is important to note that in 2002, for the first time after the 1998 crisis, producer prices grew quicker than consumer prices. According to preliminary estimates, in 2002 the increase in producer price index was 17.1 percent.

To assess the relative contribution of monetary and non-monetary factors to the inflation rate in 1999 - 2002 we have formulated cointegrating relationship between accumulated indices of consumer prices and nominal money supply M2 (the level at the end of August 1998 is taken for one). This formula implies that non-monetary factors would include all inflationary components (with the exception of the increase in money supply proper), namely the increase in regulated prices and tariffs, change in demand for real cash balances and inflationary expectations<sup>2</sup>.

The results of assessing cointegrating relationship (in the assumption about the presence of an intercept and a linear trend) on the basis of monthly data demonstrate that a one percent increase in M2 entails CPI growth of 0.419 percent (the standard error is 0.081 percent), the linear trend slope is -0.057 percent per month, the standard error is 0.008 percent). Consumer price index growth decomposition, adjusted for the calculated contribution of monetary and non-monetary factors in years 1999 - 2002, is shown in *Table 1* below.

*Table 1*

**Contribution of monetary and non-monetary factors to CPI growth in years 1999 - 2002**

	CPI growth	Monetary Factors	Other (non-monetary) factors	CPI growth (share)	CPI growth (share)
1999	36.6%	22.7%	62.1%	13.9%	37.9%
2000	20.1%	23.7%	117.9%	-3.6%	-17.9%
2001	18.8%	13.1%	69.8%	5.7%	30.2%
2002	15.1%	8.6%	57.2%	6.5%	42.8%

As is obvious from the results shown in the table, demand for money deterred inflation (i.e., demand for money grew due to increasing economic activity and lowering inflationary expectations) only in 2000, which resulted in CPI lowering by 3.6 percentage points against the value calculated on the basis of actual money supply growth in that year. Besides, in 2000 the greatest gap between the rates of growth of the consolidated consumer price index and

<sup>2</sup> M2 has been selected based on the results achieved in IET publications by S. Arkhipov and S. Drobyshevski "Simulation of Inflation Dynamics in Years 1992 to 1997"// Economy in Transition. Sketches of Economic Policy in the Postcommunist Russia in 1991 - 1997, Moscow, IET, 1998; and S. Drobyshevski, A. Kozlovskaya "Domestic Factors of the Russian Monetary Policy", *IET Working papers*, No. 45R, Moscow, IET, 2002.

Both series (price index and money supply) are first order integrated series. The Johanssen cointegration test does not reject the hypothesis of one cointegrating relation between the variables under review (with the account for the linear trend). The estimated relation is  $P_t = \alpha M2_t + \beta Trend_t$ .



prices and tariffs regulated by the government (electroenergy, railway transportation, telecommunication etc.) was observed<sup>3</sup>.

In 1999, on the contrary, the tight monetary policy was the key factor containing inflation against a background of lowering demand for Rouble money balances and remaining high inflationary expectations after the 1998 Rouble devaluation. According to our calculations, if inflationary expectations and the demand for real Rouble balances had been low, the CPI would have grown 22-25 percent in 1999 (actual growth: 36.6 percent).

Calculations for 2001 - 2002 predicted that the consumer price growth caused by the expansion of money supply proper would be lower than the figures observed in reality. In our opinion, this occurred due to manifold growth of tariffs and prices for the services of natural monopolies in the course of those years. This factor contributed ca. 30 percent (5.7 percentage points) to closing inflation values in 2001 and ca. 43 percent (6.5 percentage points) to the closing value in 2002.

The achieved results demonstrate that at the present time the mere implementation of a consistent monetary policy is not enough to control inflationary processes. The share of price growth falling on non-monetary factors (first of all, increase of regulated prices) becomes comparable with the share occupied by the monetary component. In this connection it becomes ever more important to regulate the policy of the Bank of Russia with the policy of the RF Government in the field of regulation of tariffs on and prices for the services of natural monopolies (electroenergy, railways, gas), reforms of price subsidies for social services (housing and communal services, public transportation, education, medical services), tax policy (first of all, in respect of modification and indexing of indirect taxes, e.g. excise taxes) and customs policy in relation to imports (import duties).

### **Currency Market and the Dynamics of the Rouble Exchange Rate**

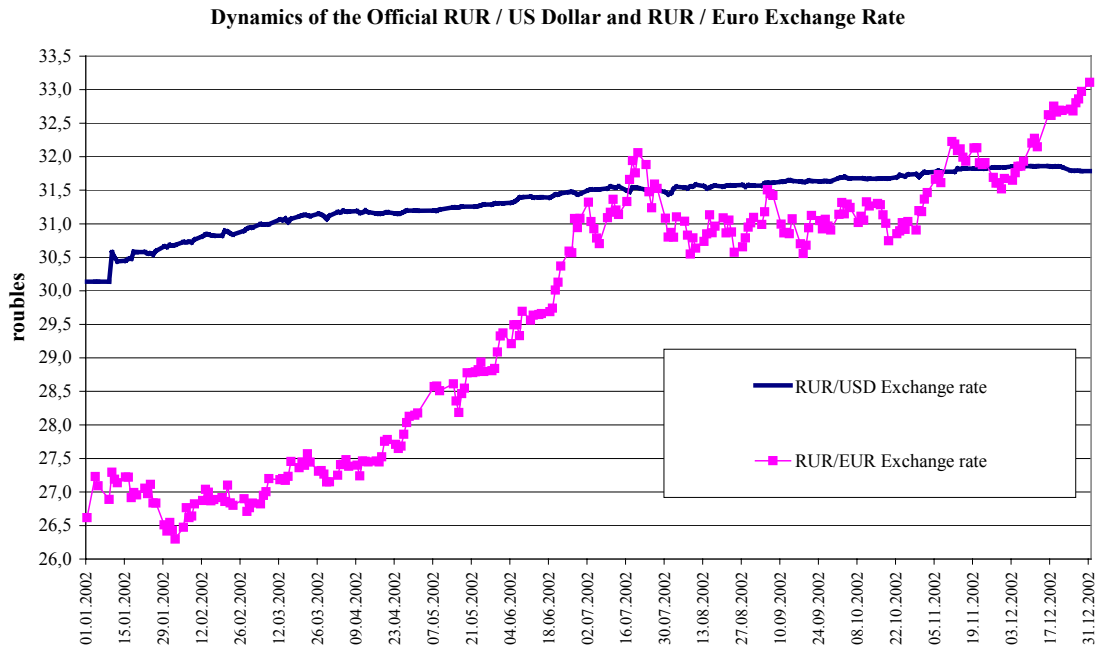
In 2002 the official Rouble exchange rate fell 5.46 percent, from 30.14 to 31.7844 Roubles for US Dollar. The official Rouble-Euro exchange rate fell 25.0 percent, from 26.62 to 33.1098 Roubles for Euro. The dynamics of the RUR / US Dollar exchange rate were rather smooth throughout the year while the Rouble - Euro exchange rate suffered significant fluctuations (see Fig. 2) in the wake of Euro rate changes in the global currency markets (see Fig. 3). Players in currency markets were active only for short periods of time.

Rapid growth of the US Dollar exchange rate was observed practically only in January 2002. After auctions on the forex market commenced, already on the first day the Dollar price grew 1.45 percent, or from 30.14 to 30.575 Roubles. Later on attacks on the Rouble exchange rate continued despite contracting excessive reserves of commercial banks. In January the Bank of Russia on many occasions made large-scale currency interventions in order to smoothen the dynamics of the Rouble exchange rate, and, according to indirect estimates, spent ca. 1.3 billion US Dollars from its reserves. However, the resulting decrease in foreign reserves turned out to be by far less significant, ca. 500 million US Dollars; obviously, the CB RF engaged in arbitrage transactions between the morning and the day-time sessions, buying the currency in case of Rouble exchange rate growth. Moreover, growth of the non-monetary component, gold in particular, was observed. The change of the Chairman of the Bank of Russia also affected the dynamics of Dollar quotations only to a small extent; besides, upon V. Gerashchenko's step-down the Rouble retained a certain trend towards nominal strengthen-

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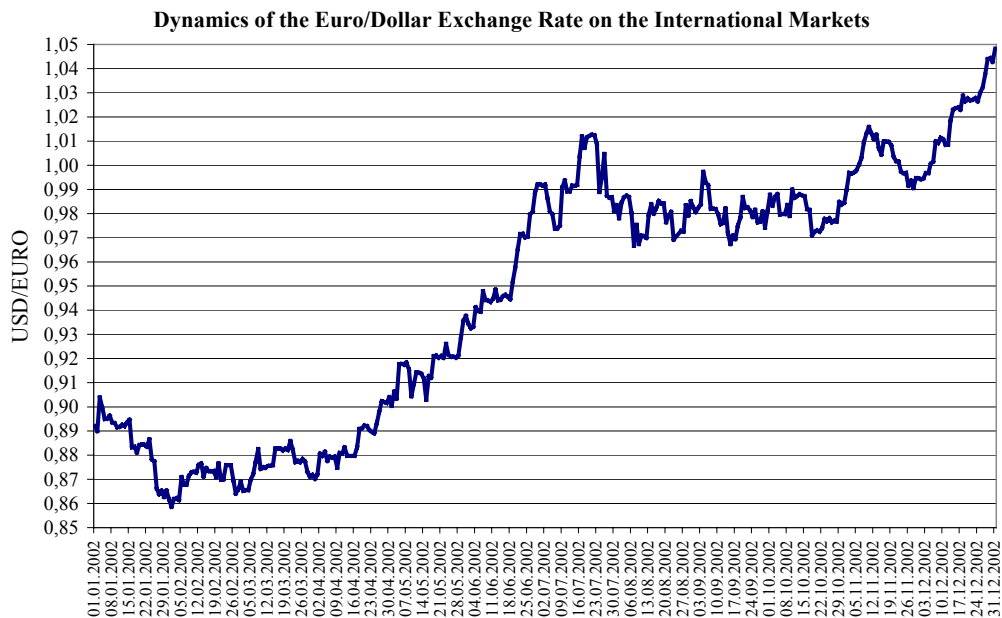
<sup>3</sup> See: Russian Economy in 2000: Trends and Prospects. (Issue # 22). - Moscow.: IET, 2001

ing. At the same time, in our opinion, the seasonal change of the situation around the balance of trade was the main factor contributing to stabilization of the foreign exchange market in the spring of 2002.



Source: CB RF

*Fig. 2*

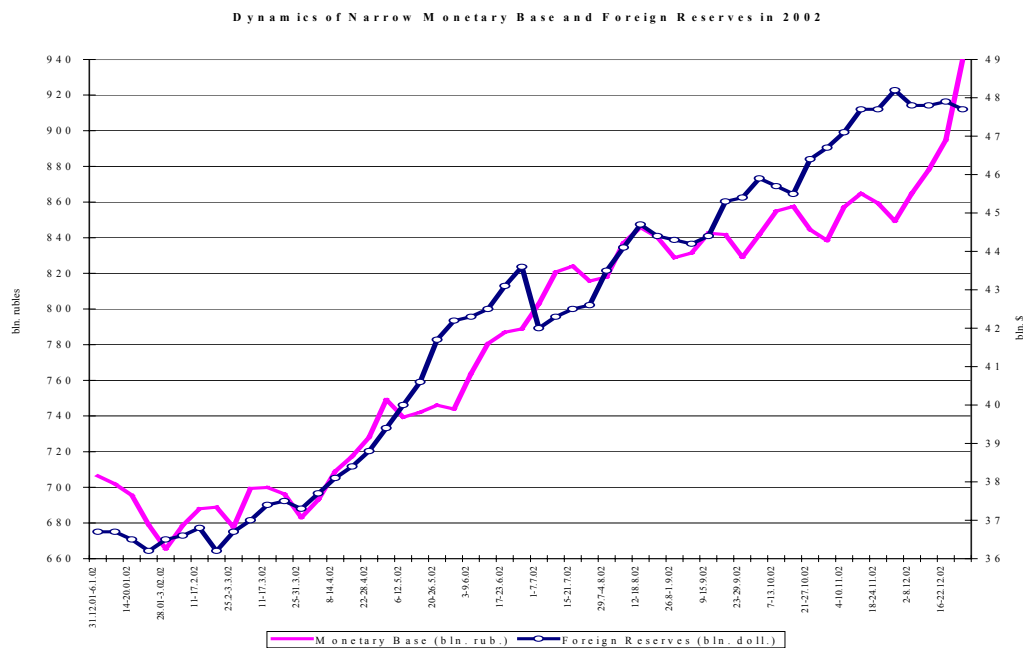


*Fig. 3*





From March to May, as usual (for the first time this trend became apparent in the spring of 1995), the supply of currency in the market exceeds the demand and the nominal Rouble exchange rate either stabilizes or grows (with the exception for the 1998 case which resulted from the overall financial crisis in Russia). On the whole, in March - May 2002 the reserves of the Bank of Russia increased US\$ 5.5 billion (15.2 percent), including the US\$ 2.5 billion increase in May. At the beginning of June the reserves reached US\$ 41.7 billion. In July 2002 the Bank of Russia changed the methodology of foreign reserves calculation by excluding short-term foreign liabilities from the reserves. In the Bank's view, this allowed "to increase the indicator's information capacity". Upon recalculation the reserves decreased ca. US\$ 1.5 billion, however the overall dynamics of the indicator remained the same (*see Fig. 4*)



Source: CB RF

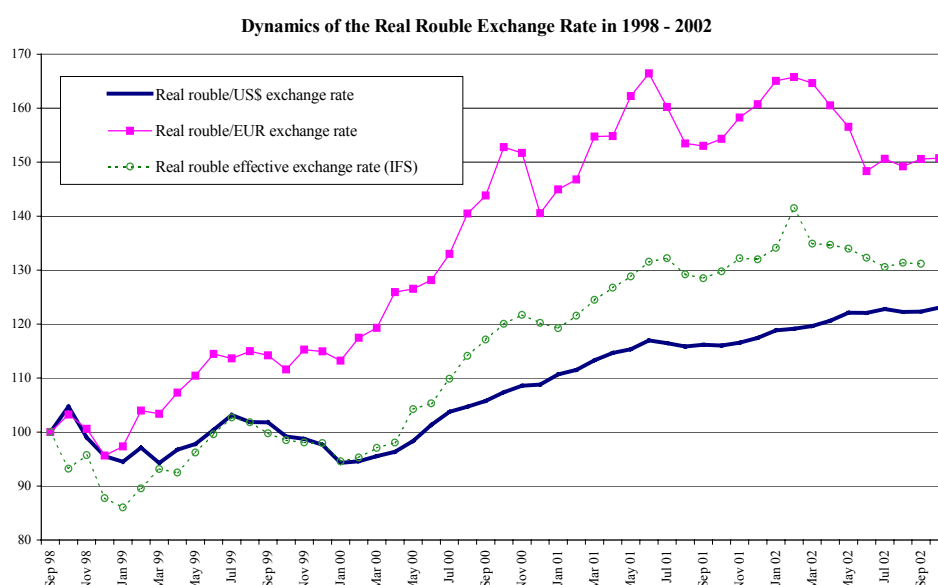
Fig. 4

In September 2002 the Bank of Russia published an Instruction establishing a new procedure for the mandatory sales of a share of exporters' foreign currency proceedings, starting from 1 December 2002. In particular, this document entitles banks to carry out mandatory currency sales over-the-counter. In other words, a considerable share of foreign exchange market turnover is taken out of the Central Bank's control and the Rouble exchange rate is more subject to manipulation by all the parties to a transaction. The issue of the methodology for establishing the official rate of exchange of the Rouble against foreign currencies has not been cleared, though.

Against the background of the forthcoming loss of monopoly, MICEX decided in November to cut the commission on transactions with foreign currency on the SELT dramatically. The fee charged for transactions with US Dollars was decreased 30 times, from 0.06 percent down to 0.002 percent of the transaction amount. In addition, the Exchange cancelled the necessity to deposit cash beforehand in order to participate in an auction. Now, to carry out a transaction on the SELT it is enough to establish a reserve amounting to 1.5 percent of the intended transaction. At the end of 2002 the amount of foreign reserves of the Bank of

Russia reached US\$ 47.79 billion. The share of gold in the reserves does not exceed 7.85 percent.

In 2002 the trends in dynamics of the real RUR exchange rate were different, subject to the selected foreign currency (see Fig. 5). E.g., during the first ten months the real RUR exchange rate against the US Dollar (calculated on the basis of data on dynamics of the nominal RUR / US\$ rate and the rates of CPI growth in Russia and the USA) increased 4.75 percent. The increase of the real RUR / US\$ exchange rate was 23.0 percent, as compared to September 1998. At the same time the real RUR / Euro exchange rate for the period from January - October 2002 decreased 6.21 percent, returning to the level of late 2000 - early 2001. In relation to the maximum 2002 value (February) the fall of the real RUR / Euro exchange rate reached 9.1 percent.



Source: International Financial Statistics, calculations of IET

Fig. 5

The real effective Rouble exchange rate (calculated with the account of the export structure) actually changed in co-ordination with the real Rouble / Euro exchange rate. According to this indicator, the real depreciation of the Rouble in the course of the first nine months of 2002 reached 0.63 percent (in 2001 the real effective Rouble exchange rate grew 11.1 percent). In the end of July 2002 the real effective exchange rate fell to the level of September 2001. The maximum value of the exchange rate was achieved also in February (+36.2 percent as compared with September 1998).

### The Policy of Monetary Authorities

As we have already noted above, the change in the management of the Central Bank of Russia was the key news in respect of the policy of the monetary authorities. It should be mentioned that, following the replacement of CB RF Head, the monetary policy did not undergo any abrupt changes. Already in his first statements the new Chairman of the Central Bank of Russia S. Ignatiev confirmed that the policy of accumulating foreign reserves and keeping low rates of appreciation of the Russian national currency were priority directions. At



the same time the Central Bank did not introduce changes to the claimed rates of increase in money aggregates in 2002 or speed up the process of currency regulation and capital control liberalization. In April 2002 a number of events directly related to the RF monetary policy occurred. On 1 April the Supreme Court of RF satisfied a claim by the Moscow Stock Exchange, which demanded to admit that the CB RF regulation on mandatory sales of currency proceedings by exporters exclusively through the authorized trade floor (in fact, on the SELT at MICEX) conflicted with the law. This ruling by the Court allowed exporters to sell currency within the limits of mandatory sales (50 percent) at any exchange authorized to carry out currency auctions and on the OTC market.

As it has been noted above, following a number of processes, the latest of which was won by the Central Bank (the ruling by the Presidium of the Supreme Court dated 01 August 2002), the Board of Directors of the Bank of Russia passed a decision on 23 August 2002 that the mandatory sales of a part of export proceedings may be carried out through authorized banks on interbank currency exchanges, directly to the Central Bank of the Russian Federation, on the OTC interbank currency market or to the authorized bank providing services to the resident. The monopoly of currency exchanges is thus liquidated.

In our view, economic consequences of such a course of affairs will be negative rather than positive. The only positive consequence would be the liquidation of MICEX's monopoly for this sort of operations and the resulting decrease in costs on currency conversion for all participants of the forex market (first of all due to a decrease in the exchange's commission fee)<sup>4</sup>. At the same time, liquidation of the single foreign exchange market reduces the ability of the Bank of Russia to carry out exchange rate policy and support the exchange rate of the Russian national currency, for one thing. Secondly, it becomes easier for speculation-minded players to attack the Rouble and destabilize the market. Thirdly, it creates conditions for plotting various schemes of fictitious sales of currency proceedings by exporters to affiliated banks on the interbank market and small trade floors. Fourthly, the methodology of determining the official exchange rate of the Rouble against foreign currencies still requires elaboration.

On 9 April the Bank of Russia, for the first time since November 2002, reduced its refinancing rate. The new rate is 23 percent p.a.; this is the lowest figure since November 1997. It should be noted that, just as before, this decision by the CB RF was predominantly symbolic, being aimed at creating expectations of a further reduction of inflation and interest rates in the economy since the mechanism of refinancing is up to the present time virtually non-existent and the current interest rates on loans and treasury bills are far below the level of the refinancing rate. The next reduction of refinancing rate, down to 21 percent p.a., occurred on 7 August 2002.

In our opinion, the other significant event in the field of monetary policy was the RF Pension Fund's entering the internal debt market. In particular, in April 2002 the RF Pension Fund acquired in primary auctions GKO and OFZs for ca. RUR 3 billion, thus creating a considerable portion of demand for the bonds. It is obvious that appearance of such a large institutional investor increases liquidity in the GKO - OFZ market and contributes to a further reduction of bond yields. In addition, investments by the RF Pension Fund of surplus funds in state bonds (on the stipulation that they are purchased from the CB RF on the secondary market) may be regarded as one of the measures aimed at sterilizing Rouble in-

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<sup>4</sup> As we have noted above, MICEX decreased its commission many times already in November 2002.

terventions by the CB RF accumulating foreign reserves (this is similar to the RF Minfin's depositing funds received in bond auctions in accounts of federal agencies with the CB RF).

The Central Bank of Russia introduced a new instrument as part of the policy aimed at increasing the importance of interest rates as a means of monetary regulation. On 26 September 2002 a new type of transactions – currency swaps – were added to the existing system of refinancing of credit institutions. In the course of a currency swap the Bank of Russia will buy US Dollars for Russian Roubles on conditions "today" at the official US\$ / RUR rate of exchange (base rate) with subsequent sale on conditions "tomorrow". In fact, this is lending to commercial banks overnight against a security in the form of foreign currency.

The directions, in which currency legislation would be liberalized, began to clear up in the autumn of 2002. The draft law adopted as a whole on 14 November provides for mandatory repatriation of currency proceedings within 180 days and for the Central Bank's right to impose limitations on capital operations: the so-called account regimen (list of allowed operations) and mandatory reservation of up to 20 percent of the transaction amount for a term of up to one year in case of importing the currency, and of up to 100 percent for two months in case of exporting the currency. The CB RF was also given a right to demand that residents undergo registration before opening currency accounts outside Russia. The upper limit of the mandatory sales of currency proceedings was fixed at the level of 30 percent. It is assumed that all limitations, with the exception of the 100 percent repatriation, will be canceled on 1 January 2007.

According to the "Main Guidelines of the Uniform State Monetary Policy for 2003" adopted by the Bank of Russia and the RF Government and approved by the RF State Duma, reducing inflation is the main aim of monetary authorities in 2003. The document states that the Central Bank of Russia will devote its main efforts to reducing inflation in 2003 down to a rate of 10 to 12 percent. According to the CB RF's calculations, the base rate of inflation, i.e. the indicator net of seasonal fluctuations and increases in administered prices, should be ca. 8.0 - 8.5 percent. The Bank of Russia will continue the floating rate policy. According to the CB RF's calculations, the increase in money supply (M2 aggregate) should reach from 20 to 26 percent in year 2003.

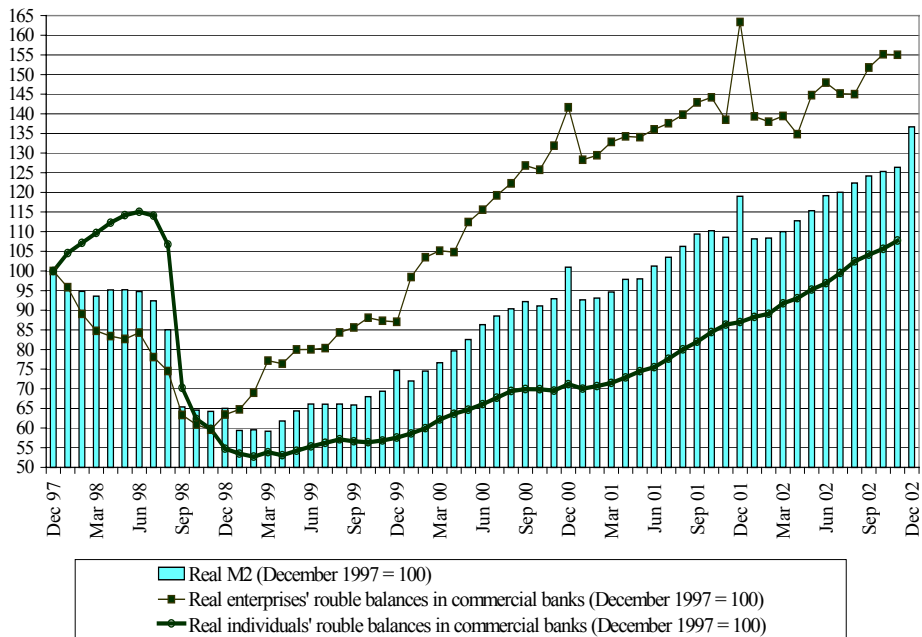
### **Dynamics of Money Supply and Demand and Credit Expansion of the Banking System**

In 2002 the growth of money supply M2 was 32.26 percent, from 1602.6 up to 2119.6 billion Roubles. At the same time, the narrow money base grew only 32.72 percent in 2002, and the broad money base (reserve money) by 32.73 percent. In 2002 the amount of cash (M0) increased 30.82 percent. Thus, in 2002 the real money supply (M2 aggregate) grew 14.9 percent. The monetization ratio (M2 / GDP) increased also up to 19.36 percent, as opposed to 17.72 percent at the end of 2001. The share of cash (M0) in M2 is ca. 36 percent.

As is obvious from Fig. 6, real money balances in year 2002 grew mainly due to the increase in cash in accounts and term deposits of individuals with banks. During 12 months, from November 2001 to November 2002, real balances in individual Rouble deposits increased 24.8 percent while real balances in corporate accounts grew only 11.9 percent<sup>5</sup>.

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<sup>5</sup> In our view, a comparison with December 2001 would be incorrect due to high volatility of real account balances in the December - January period related to seasonal factors.

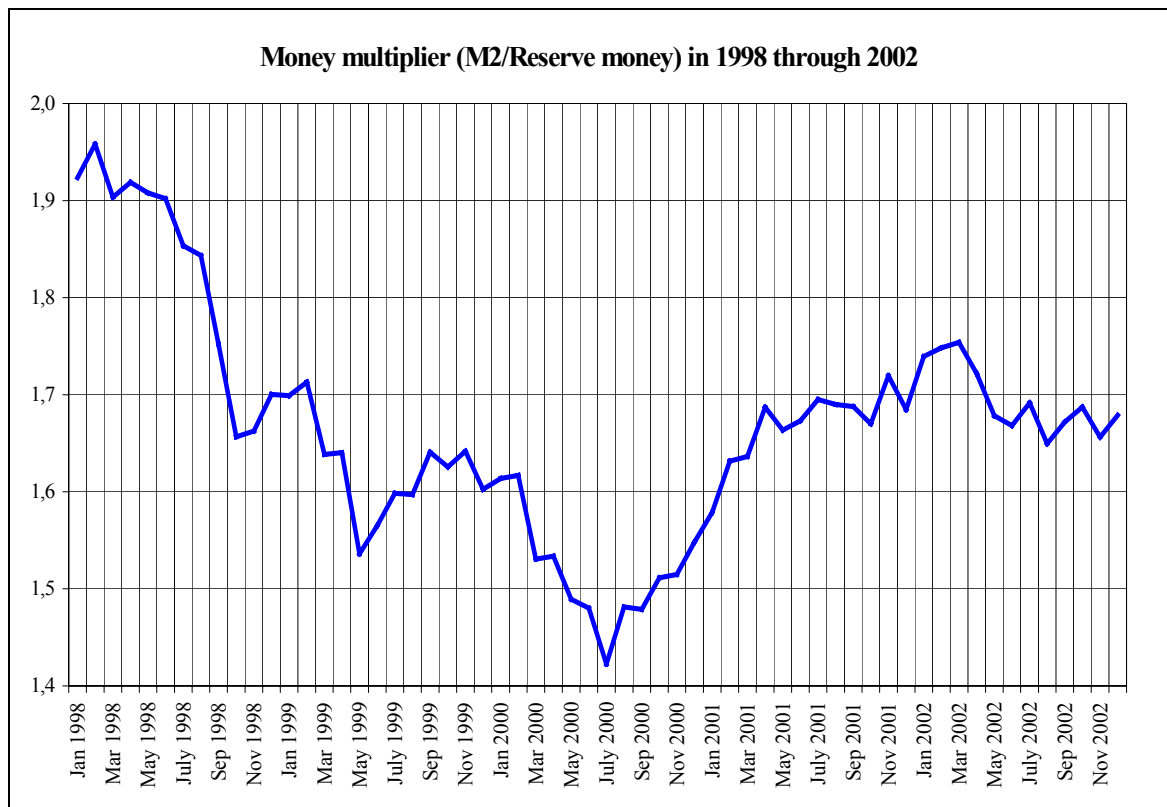


Source: Central Bank of RF, State Committee for Statistics of RF, IET calculations.

*Fig. 6. Real Rouble Cash Balances in Years 1998 - 2002.*

The structure of reserve money remained stable in 2002. The cash share fluctuated around the 60-65 percent level, while the amount of nonborrowed reserves (balances in commercial banks' correspondent accounts and deposits with the Bank of Russia) did not exceed 23 - 25 percent of the total amount of reserve money. Thus, the structure of the monetary base in 2002 was similar to the one observed in 1997, at the time when the financial market was at its best and commercial banks used available funds to the maximum.

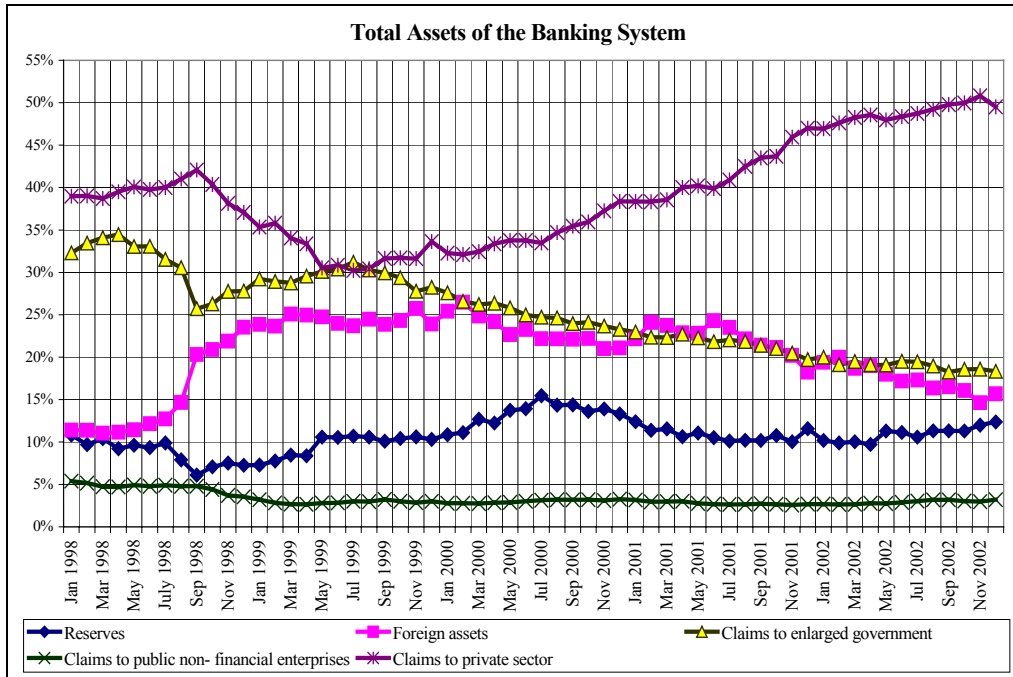
The dynamics of M2 and reserve money demonstrate that, after reaching the post-crisis maximum in March 2002, the money multiplier decreased sharply in the spring and early summer (see Fig. 7). By the end of the 2002 summer multiplier values reduced to 1.65 - 1.67, which corresponds to the level of the middle of 2001 when this indicator remained stable throughout eight months. In our opinion, this is explained by the fact that the maximum level of economy monetization possible under the existing conditions of financial markets and banking system had been reached. In spite of growing amounts of bank lending to the economy, money multiplication chains remain rather short.



Source: Central Bank of RF

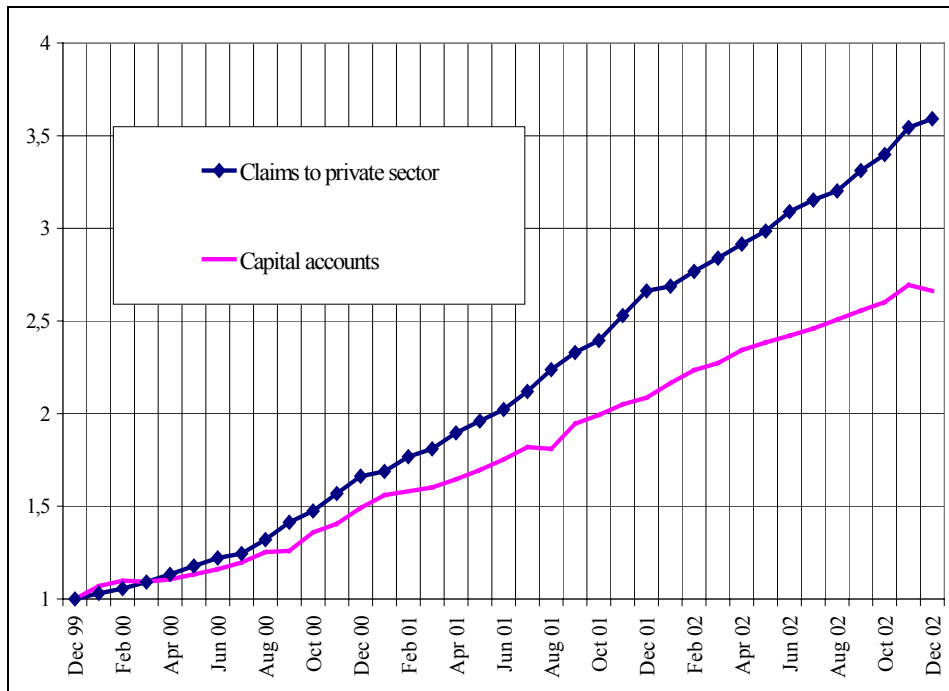
*Fig. 7*

At the same time it should be noted that, from the point of view of money supply, it may be said that the situation in 2002 has the features of a "lending boom". An analysis of the structure of the asset structure of the banking system (see Fig. 8) shows that liabilities of the private sector enterprises were the only growing component, and in 2002 their share grew from 45 percent to 50 percent of total assets. The nominal growth was ca. 34.9 percent, from RUR 1389 up to 1873 billion. The increase in the share of lending occurred due to a decrease in the liabilities of the extended government (from 20 percent down to 18.5 percent) and foreign assets (from 20 percent down to 15.5 percent). The amount of own reserves remained stable throughout the period, 10 - 12 percent of total assets.



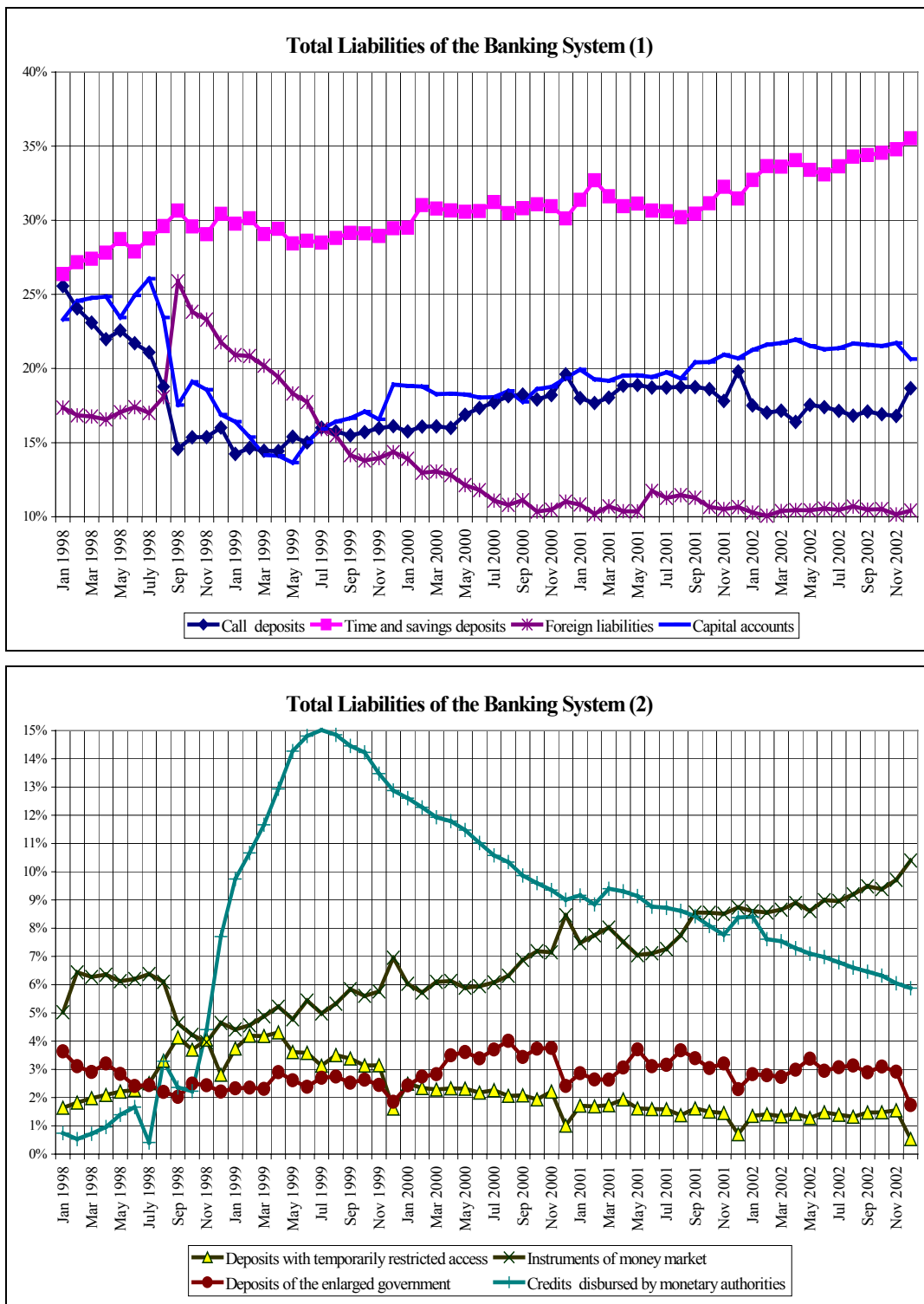
Source: Central Bank of RF

*Fig. 8. Structure of the Total Assets of the Banking System*



Source: Central Bank of RF

*Fig. 9. Dynamics of Liabilities of Non-financial Sector Entities and Capital Accounts of the RF Banking System in 2000 - 2002.*



Source: Central Bank of RF

Fig. 10. Structure of Total Liabilities of the Banking System





However, in our opinion, if the current trends remain, the observed positive dynamics of lending to the non-financial sector constitutes a threat to the stability of the banking system in the medium term (up to two years). As one may see in Fig. 9, in the course of the past two and a half years liabilities of the non-financial sector (in nominal terms) grew 1.35 times quicker than capital accounts, i.e. the own reserves of the banking sector. Thus, if the said disproportion remains, the achieved rates of lending may be preserved only by increasing balances in customers' accounts and attracting funds of individuals to the banking sector.

Changes occurring in the liability structure of the banking system during the past two years (see Fig. 10) confirm the proposed thesis of disproportion in the dynamics of bank lending and bank equity. The greatest growth rates were observed in 2002 for the share of term and savings deposits (from 32 percent to 36 percent of total liabilities) and money market instruments (from 8 percent to 10.5 percent). At the same time, the share of foreign liabilities fell down to an unexampled low: 10 percent of the total liabilities.

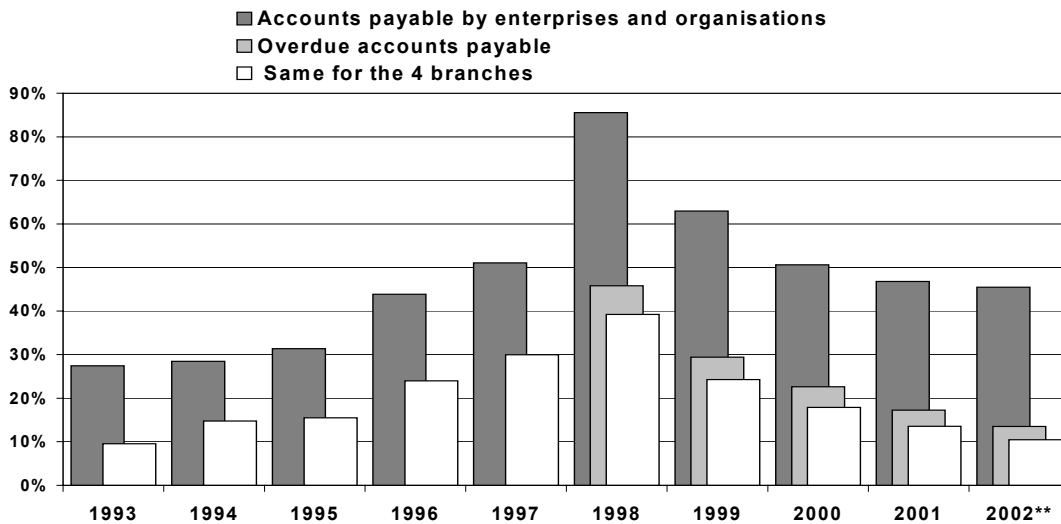
### **The situation with non-payments and settlement of accounts**

In 2002 (January to October) the trend of non-payments diminishing in the economy persisted. The aggregated volume of accounts payable by enterprises and organisations continued growing in their nominal value, in GNP shares it got stabilized at the level of 45% (see *fig. 11*). Overdue payments of enterprises and organisations in GDP shares continued to decrease and by the end of October 2002 they were about 11%. The share of debts to suppliers was less than 5%. It should be noted that this commodity credit to GNP ratio corresponds to analogous ratios in developed countries. In France the volume of commercial credit (debts to suppliers or debts of buyers) in 1989 accounted for 38% of GDP, overdue debts – 17%, In Finland the ratio was 20% and 9%, in Great Britain – 20% and 12%, In Sweden – 21% and 8% correspondingly<sup>6</sup>.

In nine months of 2002 the overdue accounts payable went down by 6% (93.5 bln roubles) compared to the total accumulated amount, and the accounts receivable by 3.4% (33.7 bln roubles). In the corresponding periods of 2001 there was registered an increase of overdue accounts payable and receivable (by 4.3% and 13.3% correspondingly). The major decrease of overdue accounts payable happened in January 2002, which accounted for 113 bln roubles. The major part of the decrease - 94% (106 bln roubles) – was caused by settlement of long-standing debts – payments overdue for more than 3 months. Taking into consideration that writing down of debts as financial results was not high (see *table 2*) one can say that the non-payments decrease was connected with restructuring and direct settlement of debts. The largest overdue debts were settled with the budget, off-budget funds and suppliers (35, 32 and 71 bln roubles or 11.1%, 4.3% and 22.7 of the accumulated amount correspondingly). Other types of debts increased by 44.6 bln roubles (24.6% to the level of accumulated debts).

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<sup>6</sup> *Schaffer M.E.* Do firms in transition have soft budget constraints? A reconsideration of concepts and evidence // *Journal of Comparative Economics*, 1998, 26(1). P. 80–103.



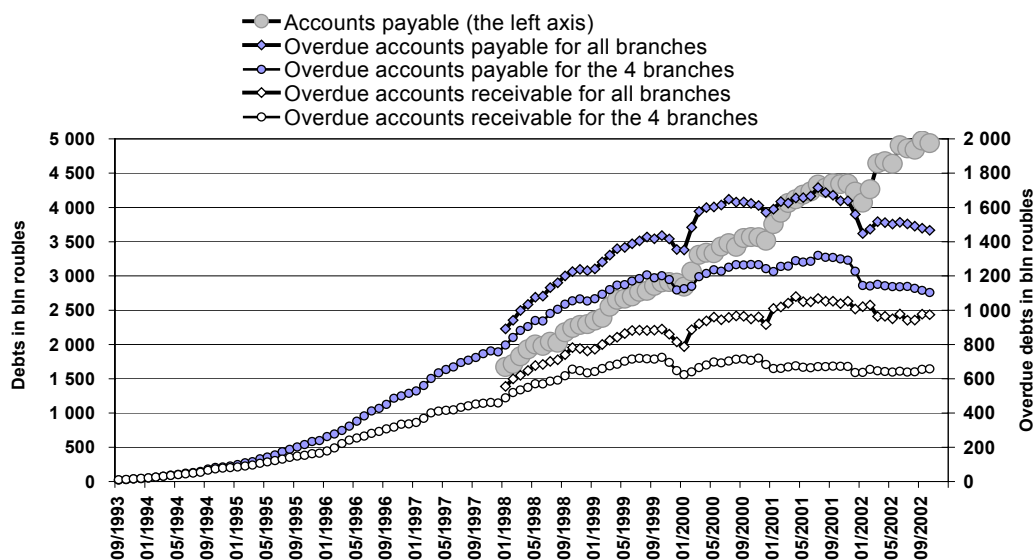
\*Until 1997 the 4 branches including

\*\*Assessment (January – October 2002)

Source: The State Statistics Committee of the Russian Federation, calculations by the authors.

Note: The total of overdue account payable by enterprises and organisation include overdue accounts payable and overdue debts to the bank system. The accounts payable in their turn consist of accounts payable to suppliers, debts to budgets of all levels and off-budget funds, arrears of wages and debts to other creditors. Until 1998 the State Statistics Committee of the Russian Federation published the statistics of non-payments only for four branches (industry, agriculture, transport and civil construction). Starting from 1998 the total of debts in the economy is calculated for all branches.

Fig. 11. Accumulation of non-payments in shares of GDP from 1993 until 2002.



Source: The State Statistics Committee, calculations by the authors.

Fig. 12. Accumulation of overdue accounts payable and receivable for all branches of the economy and for the 4 branches (industry, agriculture, civil construction and transport) in current prices

The share of overdue payments in the total amount continued to decrease and by October 2002 accounted for less than 30% (it peaked in 1998 and accounted for 55% then, see *fig. 13*).

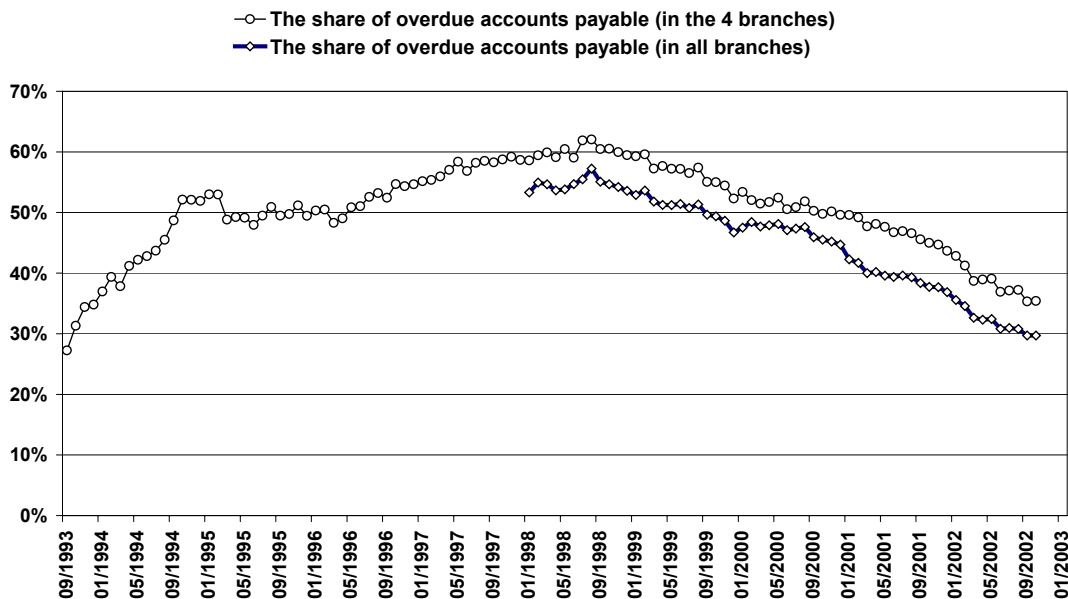
*Table 2*

**Volumes of writing down of debts of subjects of the economy  
with expired deadline terms as financial results**

Period	Accounts payable written off at the expense of profit			Accounts receivable written off as losses		
	Total, mln roubles	In % to overdue accounts payable	In % to annual increment of accounts payable (including the ones written off)	Total, mln roubles	In % to overdue accounts receivable	In % to annual increment of accounts receivable (including the ones written off)
1997	874	0.1%	0.4%	1 921	0.4%	1.5%
1998	2 777	0.2%	0.7%	7 990	1.0%	3.2%
1999	5 597	0.4%	4.3%	12 420	1.5%	19.1%
2000	6 598	0.4%	3.0%	21 955	2.4%	17.8%
2001	10 185	0.7%	-774.5%	25 783	2.6%	22.1%
2002*	6 999	0.5%	-8.1%	15 201	1.6%	-82.2%

\*January – October 2002

Source: The State Statistics Committee, calculations by the authors.

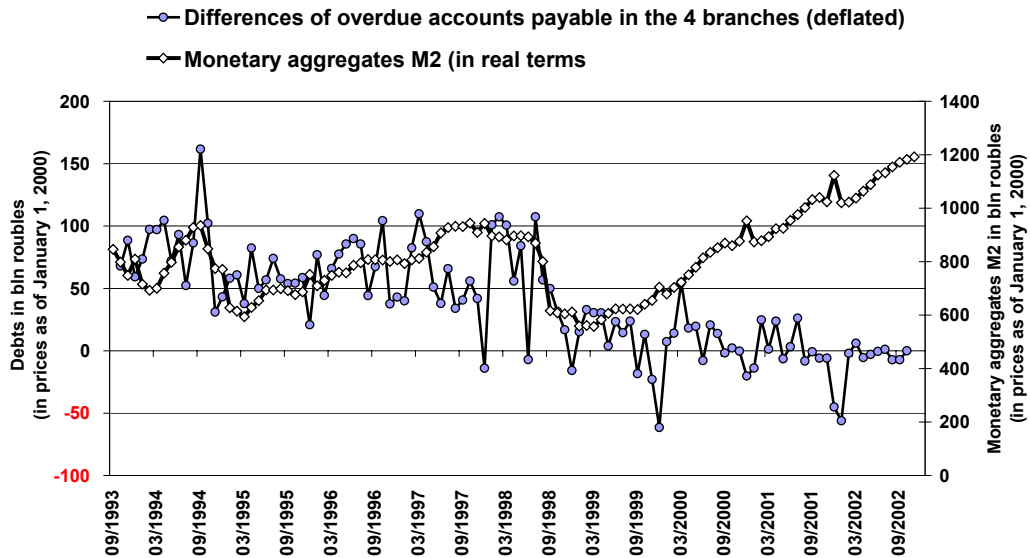


Source: The State Statistics Committee, calculations by the authors.

*Fig. 13.* Changes in the share of overdue accounts payable in the total of accounts payable

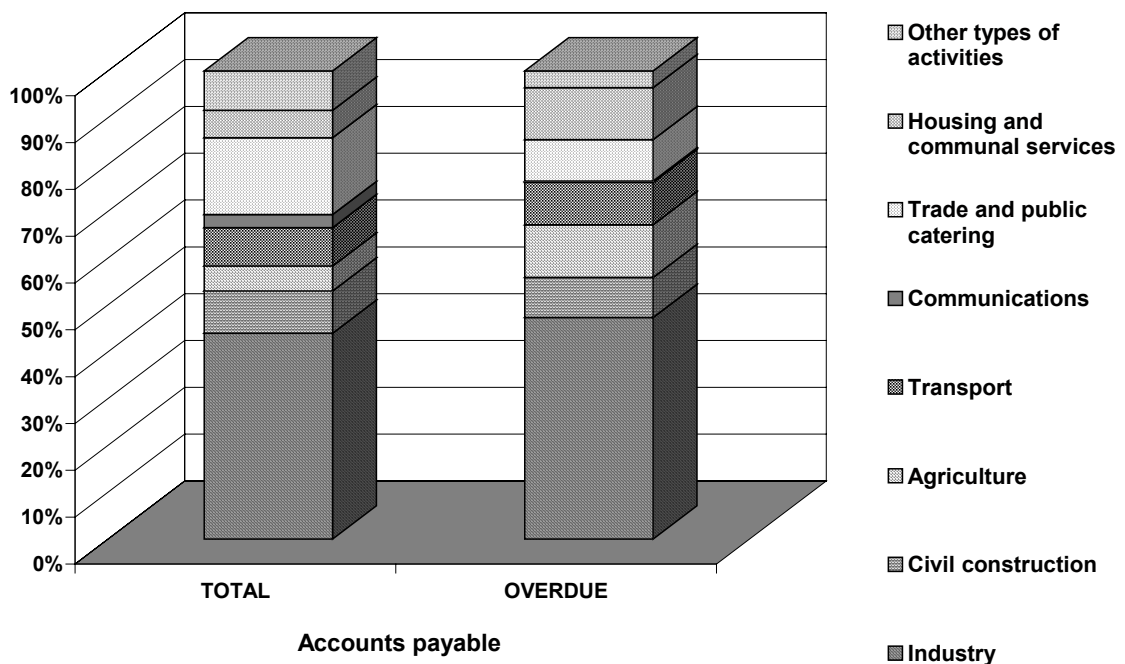
Transition to settlements in money presupposes a higher demand for transactional balances. In all probability this is one of the factors of a stable growth of monetary aggregates in recent years. Starting in 2001 the volume of monetary aggregates has been at its maximum for the period since 1993 (see *fig. 14*). Another reason for this is the increase of banking credits

to the real sector, which promotes replacement of commercial credits and a decrease of non-payments.



Source: The State Statistics Committee, The Central Bank, calculations by the authors.

Fig. 14. Changes in increment of overdue payments and monetary aggregates M2



Source: The State Statistics Committee, calculations by the authors.

Fig. 15. Breakdown of accounts payable by branches of the economy by the results of the first half of 2002

Among branches the biggest share of the total and overdue debts has permanently belonged to the industry. While in the total of accounts payable the share of the industrial sector



accounts for approximately 42%, its share in overdue debts is 47% (as of October 2002). Similarly, the housing and communal services sector and agriculture have a bigger share in overdue accounts payable, than in the total. Overdue debts are 66% of accounts payable in agriculture and 59% in the housing and communal services sector. On the whole in Russia this figure is 30%.

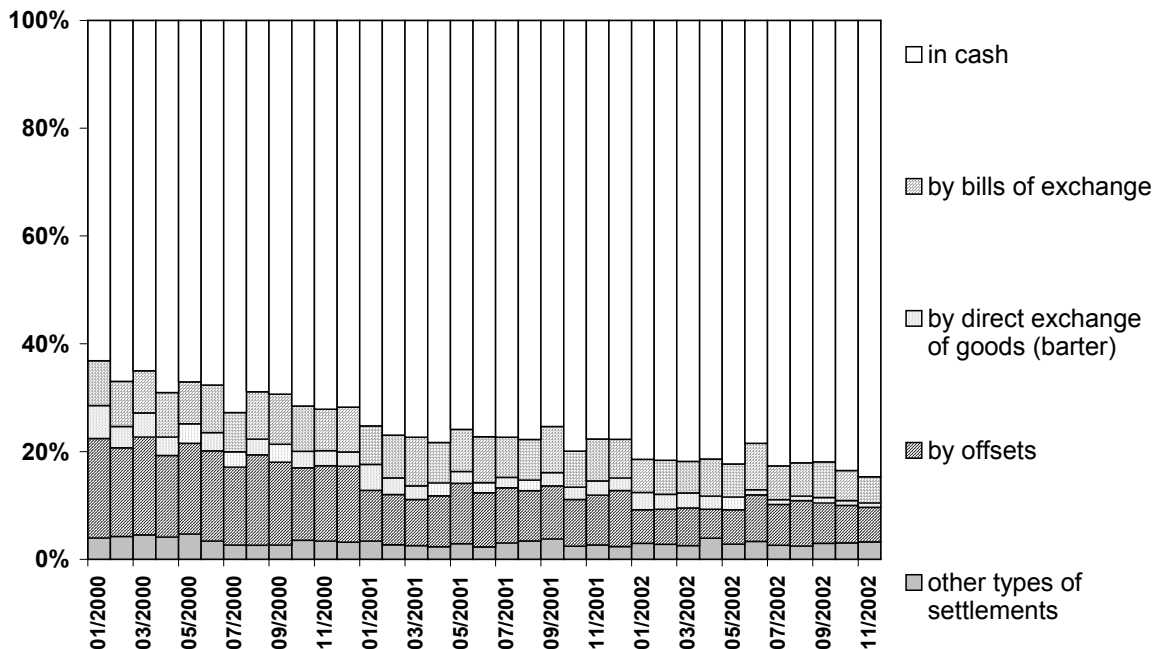
*Table 3***The structure of accounts payable by industrial branches as of the end of October 2002**

Branches of industry	Accounts payable		The share of overdue debts in the total, %	The share of accounts payable of the branch in the total debt of the industry, %	The share of overdue accounts payable in the branch in the total overdue debt of the industry, %
	Total, bln roubles	Overdue, bln roubles			
<b>The Industry, total</b>	<b>2040.1</b>	<b>728.9</b>	<b>35.7%</b>	<b>100.0%</b>	<b>100.0%</b>
Including: power industry	234.1	122.9	<b>52.5%</b>	11.5%	16.9%
Fuel industry	500.3	143.1	28.6%	<b>24.5%</b>	<b>19.6%</b>
Including:					
Oil industry	160.4	34.1	21.3%	7.9%	4.7%
Oil refining industry	66.4	5.5	8.3%	3.3%	0.8%
Gas industry (production and processing of natural accompanying gas)	178.2	33.2	18.6%	8.7%	4.6%
Coal industry	93.8	69.1	<b>73.7%</b>	4.6%	9.5%
Ferrous metallurgy	114.7	39.9	34.8%	5.6%	5.5%
Nonferrous metallurgy	141.3	50.6	35.8%	6.9%	6.9%
Chemical and petrochemical industry (without pharmaceutical industry)	109.4	46.9	42.9%	5.4%	6.4%
Machine- building and metal processing	567.1	201	35.4%	<b>27.8%</b>	<b>27.6%</b>
Timber industry, wood-working, pulp and paper industry	58.7	25.6	43.6%	2.9%	3.5%
Construction materials industry	56.9	25.9	45.5%	2.8%	3.6%
Glass, china and faience industry	5.8	2.3	39.7%	0.3%	0.3%
Light industry	34.4	17.3	<b>50.3%</b>	1.7%	2.4%
Food industry	158.7	31.7	20.0%	7.8%	4.3%
Including: fish industry	25	6.2	24.8%	1.2%	0.9%
Microbiology	3.4	2.2	<b>64.7%</b>	0.2%	0.3%
Flour-milling and feed mill industry	13.9	4.2	30.2%	0.7%	0.6%
Medical industry	9.6	2.5	26.0%	0.5%	0.3%
Printing industry	4.3	0.2	4.7%	0.2%	0.0%

Source: The State Statistics Committee, calculations by the authors.

Among branches of the industry the leaders with respect to the share of overdue payments in the total debts are the coal industry (74%), power industry (53%), light industry (50%) and microbiology (65%) (table 3). While the amounts of debts of the last two branches are comparatively small, the power industry and fuel industries taken together represent about one third of total debts in the economy. The largest consumer of commercial credits in absolute expression is the engineering and metal-working industries. Their share of debts is about 30% of the total accounts payable in the economy.

An important part in reducing non-payments (starting since 1998) is played by energy monopolies that have cut all types of non-money payments for delivered and purchased goods and services. Among the basic changes in the pattern of settlements for goods and services delivered by the monopolistic enterprises<sup>7</sup> one shall single out a further ousting of barter transactions by mutual settlement of outstanding accounts. The share of settlements in money in 2002 has increased and was kept at the level of approximately 80% (see fig. 16).



Source: The State Statistics Committee, calculations by the authors.

*Fig. 16.* The pattern of settlements for goods and services delivered by monopolistic enterprises

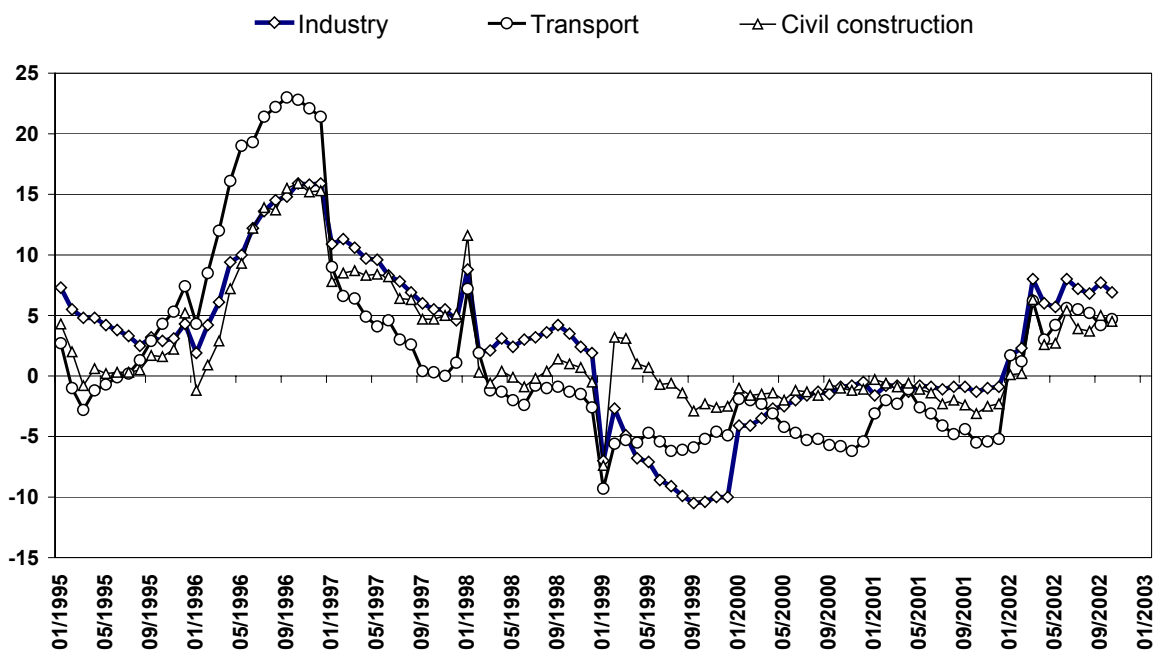
At the same time some of the recent tendencies are alarming. This is connected first of all with the factors of overdue payments growth<sup>8</sup>. For example in 2002 there was registered a

<sup>7</sup> Pursuant to the Decree of the Government of the Russian Federation #10 of January 6, 1998 The State Statistics Committee of the Russian Federation shall perform a permanent statistical monitoring of settlement of accounts of the largest taxpayers in Russia: RFO "EES Rossii", OAO "Gazprom", OAO "Aeroflot – Russian International Airlines", organisations in the federal railway transport, as well as industrial monopolistic organisations.

<sup>8</sup> By the results of econometric research the growth of non-payments is connected in particular with the lack of efficiency of domestic producers, decrease in crediting by banks, etc. For more detail see in "Razvitiye rossiyskogo finansovogo rynke i novye instruments privilecheniya investitsiy" by R. Entov, A. Radygin, V. Mau, S. Sinelnikov-Murylev and others, Moscow, IET, 1998, p. 96-149; in "Neplatazhy v Rossiyskoy Federatsii" by O.

stable growth of the share of losing enterprises in the economy (see *Fig. 17*), which compared to the previous year increased by 7-10% in different branches of the economy. As of October 2002 the share of losing enterprises in industry was 45.3% (38.4 in October 2001), 40.5% in civil construction (36% in October 2001), 46.1 in transport (41.4% in July 2001).

Calculations show<sup>9</sup>, that ineffectiveness and financial insolvency of enterprises was one of the decisive reasons of non-payments in the economy, which reveals the presence of a “channel of financing bad companies”. This connection was most typical for the period before 1998. After the crisis the share of ineffective enterprises was constantly decreasing, which also was the case of the statistical significance of this factor. Though no growth of non-payments is being registered, the risk of it is still present.

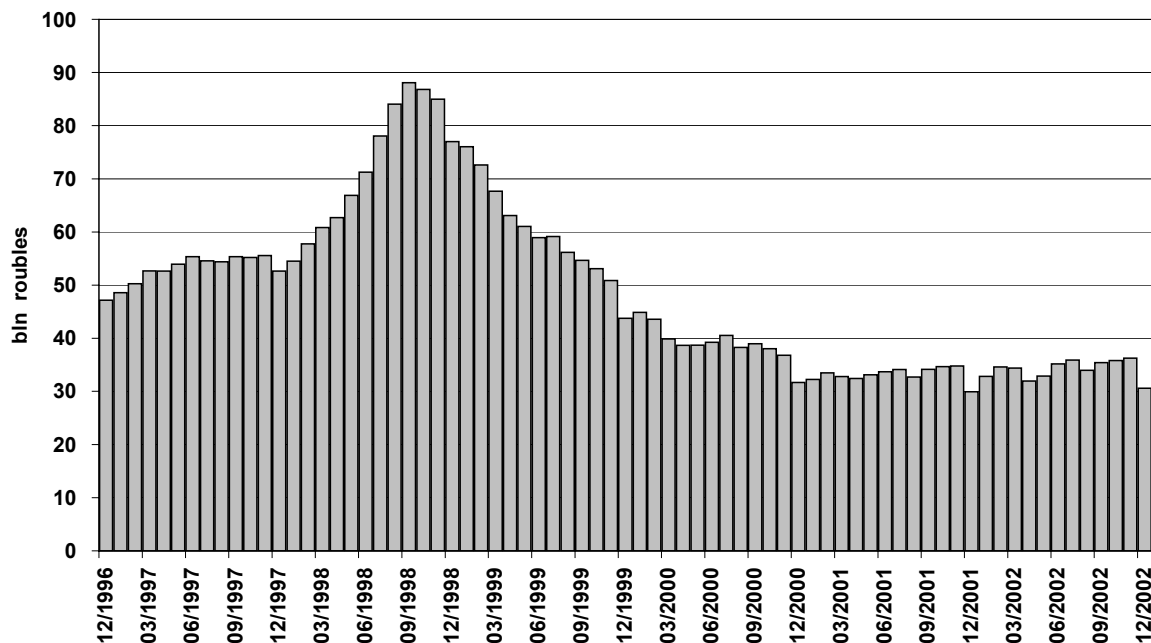


*Fig. 17.* Changes in the share of losing enterprises in industrial branches (seasonal differences to the corresponding period of the previous year)

Overdue arrears of wages starting from 2000 have been stable at the level of 30-40 bln roubles (in current prices, see *fig. 18*). Their growth since the beginning of 2002 was equal to 2%, which is much lower than the inflation and the real growth of average wages.

*Lugovoy, L. Semyonov*, IET (with support of USAID), 2000; in “Neplatezhi v rossiyskoy ekonomike i regionakh” by *A. Zolotaryova, L. Liderman, O. Lugovoy, R. Entov*, IET\_CEPRA, 2001.

<sup>9</sup> Ibid.



Source: The State Statistics Committee, calculations by the authors.

Fig. 18. Changes in overdue payment of wages by enterprises<sup>10</sup>

In all probability the reasons for the lack of an upsurge of non-payments in spite of the larger number of losing enterprises and the real exchange rate of the rouble<sup>11</sup> lie first of all in normalised government finances, increased financing by the banks, positive changes in the sphere of contract legislation (including the law on bankruptcy) and the reverse effect of the multiplier<sup>12</sup> used in settling accumulated non-payments.

In future the situation in the sphere of payments will depend upon the progress in the real sector of the economy, as well as upon the views of the authorities, which to a high degree depend upon budget revenues.

Though, as we see it, the major reason for the non-payments crisis in an economy in transition lies in non-market measures, which result in covert financing of ineffective companies. The non-payments economy as opposed to the market one can respond to exogenous shocks not only by making smaller debts, but to a much greater degree by an increment of overdue payments. This form of managing the situation is far from being a market one, as far as competition mechanisms, which are essential for the process of ousting ineffective companies by more successful ones, are being switched off. In contrast to a normal market situation,

<sup>10</sup> Given here are overdue payment of wages by enterprises and organisations in industry, civil construction, agriculture, transport, education, health service, culture and arts, science and scientific service, housing and communal services, as well as (starting in August 1998) by organisations in the social security sphere, public authorities in the subjects of Russian Federation and local governments, public order institutions. The given figures are for the end of month.

<sup>11</sup> Statistical assessments of relation between the real exchange rate of the rouble and non-payments are given in IET papers (see notes above). According to the basis hypothesis growth of the real exchange rate of the rouble decreases profitability of domestic production, which promotes bigger arrears caused by ineffective production.

<sup>12</sup> For detail about multiplicative effects of non-payments spreading see in: *Lugovoy O.* Arrears in a Transition Economy: the Mechanism of Contagion. RECEP, Russian Economic Trends 2002-Q2. P. 19–30.





losing enterprises in the economy of non-payments can survive as long as there is the possibility not to pay persists (enforcement mechanisms don't function).

If the growth of losing enterprises persists also in the future, which is partially promoted by a higher real exchange rate of the rouble, there will be a rather high probability of a stronger upsurge of overdue payments. Taking the positive experience of recent years into consideration, renewal of non-payments crisis in the same scope become less and less probable with each year, but in case of unfavourable tendencies in the economy on the whole one cannot view such a crisis as improbable. Most alarming at that would be non-performance of budget expenses, which can be caused by a bigger number of losing enterprises and a generation of non-payments by the government itself. The last one can provoke non-payments spreading and crisis renewal in the economy.

## 2.2. Balance of Payments

Last year, a certain change was registered as concerns the downward trend demonstrated by the current account balance since the year before last. Thus, since the 1<sup>st</sup> quarter there has been observed a growth in the balance of payment on current account. While in 2001 this balance declined almost twofold (from US \$ 11.5 billion in the 1<sup>st</sup> quarter to US \$ 5.7 billion in the 4<sup>th</sup> quarter), in 2002 the current account balance increased from US \$ 6.9 billion in the 1<sup>st</sup> quarter to US \$ 9 billion in the 3<sup>rd</sup> quarter; however in the 4<sup>th</sup> quarter it decreased to US \$ 7.7 billion (according to the preliminary CB RF estimates). As before, the major factor determining the amount of current account balance was the balance of trade, which, in turn, fully depended on the changes in prices of energy resources and other staple Russian exports on world markets. The data presented in *Table 1* demonstrate that the relationship between world oil prices and Russian balance of trade, which was noticeable in 1995 through 2001, also manifested itself over 2002<sup>13</sup>.

It shall be pointed out that in 1<sup>st</sup> through 3<sup>rd</sup> quarters of 2002 the increasing volumes of Russian exports accounted for the growth in the balance of trade. The amounts of import also grew, but at a slower rate. However, in the 4<sup>th</sup> quarter of 2002 the rates of increase in imports outpaced rates of growth in Russian exports. For instance, the amount of Russian balance of trade in the 4<sup>th</sup> quarter of 2002, according to the preliminary estimates of the CB RF, made US \$ 11.5 billion, at the same time, export of goods increased from US \$ 28.8 billion in the 3<sup>rd</sup> quarter to US \$ 29.6 billion, while imports grew from US \$ 15.6 billion to US \$ 18.1 billion (i.e. by almost 20 per cent).

Alongside with the declining balance of trade, in 2002 the current account balance was significantly affected by the negative values of the balance of nonfactor services - the surplus of imports over exports increased from US \$ 460 million in the 1<sup>st</sup> quarter to US \$ 1.6 billion in the 3<sup>rd</sup> and 4<sup>th</sup> quarters, what was determined by the growing import of services.

Reviewing the trends of changes in the balance of payments across its components, it may come to notice that in spite of the declining values of the active balance of trade, in 2002

<sup>13</sup> Evaluations carried out for 1993 through 2002 detected a statistically significant relationship between the RF trade balance (*TB*) and the index of world oil prices (*P*), dummy variable equals 1 in III and IV of 1998 when other factors determined the RF trade balance.

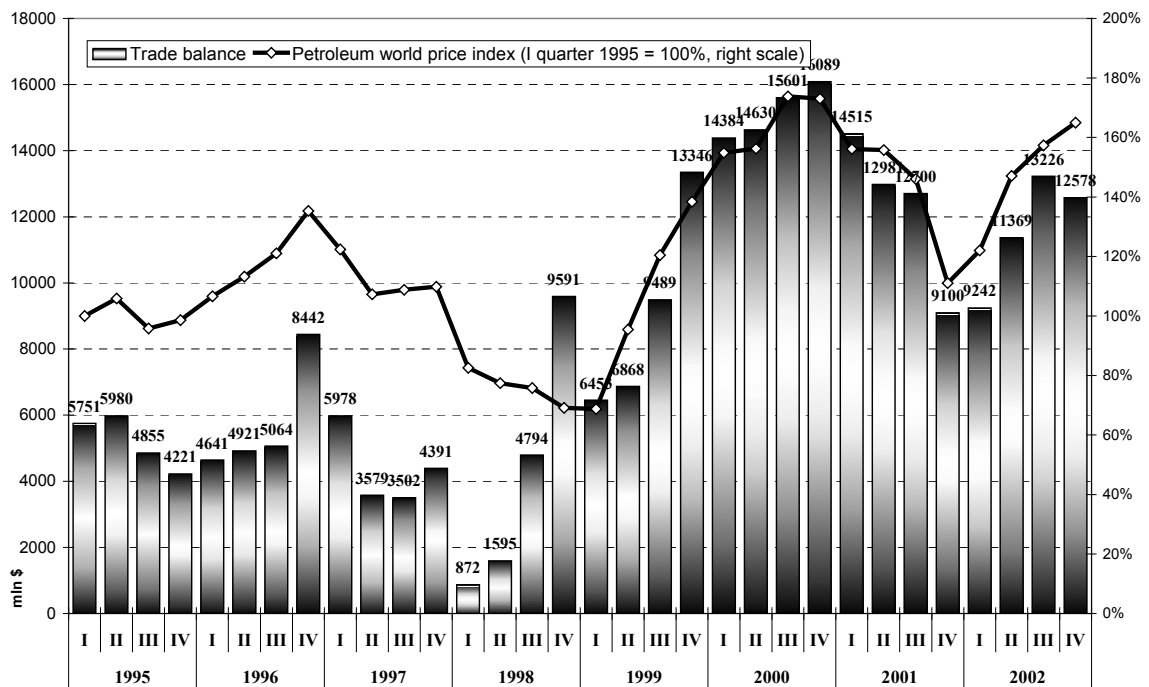
$$TB = -9,2 + 14,3 \cdot P + 5,9 \cdot Dummy$$

$$(-5,1) \quad (10,0) \quad (3,5)$$

$$R^2=0,78$$

the surplus of exports over imports primarily accounted for the growth in forex denominated holdings of residents. In other words, all payments to non-residents, as concerns transactions not related to export and import of goods, as well as changes in foreign assets and liabilities of residents, were financed at the expense of the active balance of trade. It primarily concerns the financing of the negative balance of labor and capital services (payment of non-resident's wages and debt servicing), portfolio investment abroad, increase in foreign holdings of Russia's residents, as well as payments aimed to diminish Russian residents' liabilities to non-residents.

An analysis of the aggregate indicators of the Russia's balance of payments in 2002 reveals that as concerns the balance of assets and liabilities Russian forex denominated holdings increased by US \$ 45.3 billion (the balance of trade in January through December of 2002) at the expense of trade transactions between residents and non-residents. Besides, Russian foreign holdings were replenished from such sources as foreign direct investments (US \$ 2.6 billion), portfolio investment in non-financial enterprises (US \$ 2.2 billion), official guaranteed borrowings (US \$ 1.4 billion), as well as loans, deposits, and borrowings on the part of Russian banks and non-financial enterprises (US \$ 8 billion).



Source: CBR, IMF International Financial Statistics, authors' calculations.

Fig. 19. RF trade balance and oil price index in 1995 through III quarter of 2002

The increase in foreign holdings was offset by the changes in balances on the following accounts: net import of nonfactor services (US \$ 8.7 billion), investment income paid on direct and portfolio investment in Russia (US \$ 4.7 billion), repayment of debt securities and repurchase thereof on the secondary market by federal authorities (US \$ 16.7 billion), direct and portfolio investment abroad, other investment in foreign holdings (about US \$ 16.5 billion representing the increase in balances on foreign accounts and deposits, extended trade credits and advances, the increase in non-residents' overdue indebtedness and non-residents'



indebtedness relating to non-repatriated export proceeds and non-repatriated import advances), as well as accumulated reserve assets (US \$ 14.4 billion). Besides, the negative balance on “net errors and omissions” made US \$ 8.7 billion.

Therefore, in 2002 there was observed the same ratio between assets and liabilities as in preceding years: a growth in foreign holdings determined by the large amounts of the trade balance not offset by considerable borrowings was the source of repayment of accumulated over preceding years indebtedness to non-residents, replenishment of Russian foreign holdings, and other forms of capital outflow.

Among the operations primarily financed at the expense of the surplus of the balance of trade there shall be pointed out not only changes in liabilities to non-residents, but also an increase in foreign holdings of Russia’s residents, what has for a number of years remained an important way to utilize residents’ holdings obtained as a result of the active balance of current account. While net liabilities to non-residents by end-year remained at the practically same level, net foreign holdings of Russian residents had increased by US \$ 5.5 billion over the year (at the same time official assets declined by US \$ 14.4 billion, while foreign holdings of banks and non-financial enterprises increased by US 16.8 billion). The major types of Russian foreign holdings, which grew most significantly in 2002, were balances on current accounts and deposits, increase in non-residents’ indebtedness relating to non-repatriated export proceeds and non-repatriated import advances (totaling US \$ 10.6 billion), as well as direct and portfolio investment (US \$ 2.8 billion).

As concerns the increase in the Russian foreign holdings, it is necessary to note the problem of capital flight. It is well known that some foreign holdings of residents in the form of overdue indebtedness and indebtedness relating to non-repatriated export proceeds and non-repatriated import advances, as well as a portion of resources on the “Net errors and omissions” account of the balance of payments may characterize unregistered outflow of capital from the country. It may be assumed that in the case the balances of these accounts have been negative over a long period of time, the dynamics of this indicator may characterize the dynamics of unregistered outflow of capital from Russia. In 2002, basing on the aforesaid indicators, the unregistered outflow of capital remained practically at the same level. While in 2001 the balance of the “Net errors and omissions” account made US \$ -8.5 billion, in 2002 this indicator was at US \$ -8.7 billion. A slightly different pattern may be observed in the course of analysis of the sum of net errors and omissions, overdue indebtedness, and indebtedness relating to non-repatriated export proceeds and non-repatriated import advances: this indicator was at US \$ -19.1 billion in 2002, while in the preceding year this amount made US \$ -9.9 billion. In other words, basing on the latter indicator it may be suggested that unregistered outflow of capital from the country somewhat increased. However, concerning these estimates it shall be stressed that, first, the analyzed indicators may be regarded only as indirect indicators of the dynamics and not of absolute amounts of illegal outflow of capitals, and, second, the increase in both overdue indebtedness, and net errors and omissions might result from the growing value of exports, what in turn might bring about a proportional increase in indebtedness relating to non-repatriated export proceeds and non-repatriated import advances, and account for statistical discrepancies encountered in the process of estimation of the base indicators of the balance of payments.

In the course of the analysis of the Russia’s balance of payments it is necessary to point out that, similarly to the preceding year, the amount of the favorable balance of trade proved so significant that in spite of considerable amounts of payments aimed to diminish

Russian liabilities to non-residents and the growth in Russian foreign holdings the reserve assets also grew: in 12 months of 2002 this indicator increased by US \$ 11.4 billion (the most considerable increase - US \$ 6 billion – was registered in the 2<sup>nd</sup> quarter). However, the actual increase in reserve assets was below the respective indicator registered in 2000, when gold and forex reserves grew by US \$ 16 billion – the maximal increase observed over the years of monitoring.

As concerns possible future changes in the indicators of the Russian balance of payments, the prospects for 2003 remain rather vague, first, due to the mentioned above dependence of the balance of trade on world oil prices, it may be presumed that changes in foreign holdings of residents resulting from this type of exports depend on the business situation on world markets of raw materials, for instance, on the developments in Iraq.

Second, it is necessary to take into account the foreign creditors' demands to repay the Russian debt. According to the law on the federal budget for year 2002, the expenditures of the Russian Federation for repayment and servicing of the external debt shall make US \$ 17.3 billion. This amount exceeds the actual payments made in 2002, when the federal government assigned about US \$ 15.2 billion for repayment and servicing of the public debt (not including US \$ 1.5 billion for repurchase of Russian debt securities on the secondary market). In this situation it may be presumed that in the case high oil prices persist in 2003, the Russian authorities will be able, similarly to the preceding years, repay and service the debt at the expense of high values of the favorable balance of trade. In conclusion, it shall be pointed out that the trend towards an increase in the rates of real Ruble appreciation, noticeable over the last few months, may negatively affect the Russian balance of payments. In the case the developments on the world oil markets are unfavorable, Russia, in contradistinction to the last year situation, would not be able to anticipate the payments related to the repayment and servicing of the public external debt.



## **2.3. Public Finances**

### **2.3.1. State Budget**

#### General Description of the Budgetary Situation in 2002

According to the Finance Ministry, the revenues of the federal budget in 2002 made Rub. 2202.1 billion, or 20.1 per cent of GDP, what by 2.5 p.p. exceeds the figures registered in 2001. The revenues primarily grew due to increasing tax revenues, which made 18.6 per cent of GDP in 2002 and grew by 2.3 p.p. as compared with the preceding period. However, it shall be taken into account that in 2002 the single social tax (SST) was included in the composition of federal budget revenues. Therefore, the level of tax revenues of the federal budget minus SST not only failed to grow in 2002 in comparison with the figures registered in 2001, but significantly declined (by 0.7 p.p. of GDP in comparison with the level registered in the last year). Accordingly, budgetary revenues (without SST) also fell and made Rub. 1862.7 billion (17.0 per cent of GDP), what is by 0.6 p.p. of GDP below the level of 2001.

The share of tax revenues in the structure of revenues of the federal budget for 2002 remained at the level registered in the preceding year – 77 per cent (without SST, or 92 per cent with SST), while non-tax revenues (taking into account revenues of budget targeted funds, primarily the Targeted Fund of the RF Ministry of Atomic Energy) made 7.6 per cent of the total revenues, declining somewhat in comparison with the figures observed in the preceding year (8.1 per cent of the total revenues).

It shall be pointed out that in 2002 there was observed a certain increase in tax revenues of territorial budgets (by 0.6 per cent of GDP). As concerns the total revenues of territorial budgets, they also grew by 0.6 per cent of GDP. On the whole, it may be noted that in 2002 the level of revenues of territorial budgets was at its record high over the last five years.

At the same time, budgetary expenditures increased to 18.7 per cent of GDP in 2002, what is by 4 p.p. above the indicator registered in the preceding year. Even without transfers to the Pension Fund for financing of the base component of the labor pension at the expense of SST, the level of expenditures was by 1 p.p. above the level of 2001. Accordingly, in 2002 the level of budgetary surplus declined to 1.4 per cent of GDP (as compared with 2.9 per cent registered in 2001). In this situation, the financing of the financial reserve of the federal budget was possible at the expense of privatization of state owned blocs of shares in Lukoil and Slavneft (about 0.7 per cent of GDP) and at the expense of unutilized balances on accounts of recipients of budgetary funds (about 0.5 per cent of GDP).

Expenditures of territorial budgets also grew in 2002 – by 1 p.p. of GDP in comparison with the figures registered in 2001 (from 14.3 to 15.3 per cent of GDP). For the first time since 1998 the aggregate budget of RF subjects has been balanced with a deficit, which made of 0.4 per cent of GDP.

In 2002, the consolidated budget was administered with a profit (1 per cent of GDP). The level of budgetary revenues was somewhat below the level registered in the preceding year (29.0 % in 2002 (without SST) as compared with 29.3 per cent in 2001), however, it exceeded the figures observed in 2000 and earlier. At the same time, the expenditures of the consolidated budget were noticeably higher than over last four years, even without SST transferred to the Pension Fund from the federal budget (28 per cent of GDP).

A few major factors, which are discussed below, has been behind a decline in tax revenues. On the whole, such dynamics of revenues of the budgetary system, primarily as concerns the federal budget, may be explained by the following developments. First, world oil prices were volatile over the year and significantly below the level estimated for the budget. Second, changes in taxation of profits of organizations and VAT negatively affected the amount of tax revenues.

*Table 4*

**Administration of revenues and expenditures  
of the federal and territorial budgets (in % of GDP)**

	1998	1999	2000	2001	2002
<b>Federal Budget</b>					
Tax revenues*	9,3	11,6	14,3	16,2	18,6
Including SST	–	–	–	–	3,1
Revenues	11,0	12,8	15,5	17,6	20,1
Expenditures	13,8	13,9	14,1	14,7	18,7
Including transfers to Pension Fund at expense of SST	–	–	–	–	3,1
Deficit	-3,2	-1,1	1,4	2,9	1,4
<b>Territorial Budgets</b>					
Tax revenues*	11,9	11,2	11,8	10,8	11,4
Revenues	14,5	13,6	14,1	14,3	14,9
Expenditures	14,7	13,6	13,7	14,3	15,3
Deficit	-0,3	0,0	0,5	0,0	-0,4
<b>Consolidated Budget**</b>					
Tax revenues*	21,2	22,8	26,0	27,0	29,7
Revenues	24,0	26,8	28,3	29,3	32,1
Expenditures	27,5	28,0	26,4	26,4	31,1
Deficit	-3,5	-1,1	1,9	2,9	1,0

\* Before 2001 there were included revenues of Federal Road Fund, Fund of Reproduction of the Mineral and Raw Materials Base, Fund of Management, Study, and Reproduction of Water Biological Resources, Federal Fund of Rehabilitation and Protection of Water Resources, Federal Ecological Fund.

\*\* Excluding interbudgetary transfers.

Source: RF Finance Ministry, authors' calculations.

At the same time, the budgetary situation was positively affected by non-tax revenues. For instance, share dividends, proceeds from state owned property and privatization, and proceeds of external economic activities exceeded targets. However, it shall be taken into account that these revenues make only a small share in the total amount of revenues (below 7 per cent of the total amount of federal budget revenues).

In 2002, the amount of indebtedness to the budgetary system increased in comparison with the figures registered in 2001, what may be explained by the inclusion of the SST related indebtedness relating to the share of SST, which prior to 2002 had been due to the budget of the Pension Fund and since 2002 – to the federal budget. Without taking into account this share of indebtedness, the deflated increase would have made 8 per cent over the first 9 months of 2002 (0.3 per cent of GDP).

It shall be pointed out that the dynamics of arrears in the indebtedness composition were positive. In real terms, tax arrears related to the consolidated budget have diminished more than 1.5 times since 2000. These developments may be explained, on the one hand, by the implementation of measures aimed to restructure the arrears, and, on the other hand, coercive



measures undertaken to exact the indebtedness due to the budgets of all levels, the latter resulting in Rub. 174.8 billion (2.2 per cent of GDP) of repaid indebtedness in 2002.

*Table 5*

**Tax indebtedness to the consolidated and federal budgets**

	1999	2000	2001	2002
<i>Indebtedness to consolidated budget (Rub. billion)</i>	378	464	475	522
Including arrears	343	365	245	209
Share of arrears in indebtedness	91%	79%	52%	40%
Annual increase in indebtedness (in real prices) in % of the amount of indebtedness by the beginning of the year		25%	3%	9%
Annual increase in indebtedness in % of GDP		1,2%	0,1%	0,4%

Source: RF Tax Ministry, authors' calculations.

In spite of the fact that in 2002 oil prices were below the estimates used to calculate budget targets, they were above the average price of long standing – US \$ 19 per barrel<sup>14</sup>, what affected execution of budgets of all levels. According to our estimates, in tax revenues of the enlarged government budget (including revenues of targeted budgetary funds formed at the expense of taxes), the share of tax revenues presented in *Table 6* may be explained by the oil prices being out of line with the average price of long standing (US \$ 19 per barrel):

*Table 6*

**An Analysis of Major Tax Revenues in 2002**

1994	1995	1996	1997	1998	1999	2000	2001	2002
2,9%	1,9%	-1,5%	-0,1%	-6,8%	-1,3%	8,6%	5,1%	4,4%

*Table 7*

**Major tax revenues of the RF budgetary system**

	In % of GDP			
	1999	2000	2001	2002
Profit tax	4,6	5,4	5,7	4,2
Personal income tax	2,5	2,4	2,8	3,3
Value Added Tax	8,8	6,2	7,1	6,9
Excises	2,2	2,3	2,7	2,4
Taxes on foreign trade	1,8	3,1	3,6	3,0
Payments to social extra-budgetary funds (single social tax)	7,2	7,3	7,1	7,7*
Including SST due to the federal budget				3,1
Total tax revenues (including revenues of targeted budgetary funds formed at the expense of taxes and mandatory payments)	32,1	35,6	35,2	35,4

\* Estimate adjusted for actual SST revenues of the federal budget.

In 2002, the profit tax revenues declined by more than 25 per cent in comparison with the figures registered in 2001 (by 1.5 p.p. in terms of GDP), what may be explained by several factors. First, the approval of the new chapter of the Tax Code concerning the tax on profits of organizations resulted both in significant shifts in the structure and considerable in-

<sup>14</sup> According to IET estimates.

crease in amount of costs deductible from the tax base. Second, the application of so called “transitional” procedure for determination of the tax base (transition to the accrual basis accounting method) allowed the number of enterprises significantly reduce the tax base. Third, in 2002, there was registered a general decline in the balance of financial results of enterprises and organizations.

Profit tax revenues grew by almost 20 per cent in real terms in 2002. The positive dynamics of profit tax revenues related both to the gradual legalization of incomes of individuals (the main goal of the reform), and the general growth of the economy resulting in an increase in aggregate incomes.

VAT revenues somewhat declined in 2002 as compared with the figures registered in 2001 (by 0.2 p.p. in terms of GDP). At the same time, the collection of VAT made 95 per cent of the target. The major factors behind the failure to meet the budgetary target were considerable amount of VAT compensation to exporters (2 per cent of GDP); persisting tax privileges relating to medicines, medicinal products, and books; the amount of GDP was below the target; and there were enacted provisions of the Tax Code permitting to deduct VAT imposed on capital construction and commissioning of objects. Excise revenues have also declined in GDP terms – by 0.3 p.p.

In 2002, the revenues generated by taxes on foreign trade significantly decreased in comparison with the figures observed in 2001 (from 3.6 per cent to 3.0 per cent of GDP). At the same time, in real terms the decline made more than 15 per cent in comparison with the levels registered in the respective period of the preceding year. This development is primarily related to the introduction (since February 1, 2002) of the new procedure governing the calculation of oil duties based on the monitoring of world oil prices in November through December of 2001. Although the targets of the federal budget based on estimated amount of duty at US \$ 21.7 per metric ton, the actual duties were at or below US \$ 10 over the first six months of 2002. As a result, the export tax revenues were by 5 per cent below the target set by the budget. At the same time, due to a growth in imports the revenues generated by import duties increased by about 1.2 per cent of GDP in 2002.

Since January 1, 2002, a certain part of the single social tax has been entered in the federal budget to be further transferred to the budget of the Pension Fund for financing of the base component of the labor pension. Revenues of the federal budget generated by this tax exceeded targets by more than one fourth, what was related to, first, inflow of tax charged in December of 2001, and, second, repayment of respective tax indebtedness due to the federal budget in accordance with the law on the federal budget for year 2002.

#### Consolidated Budget: Expenditures

The structure of expenditures of the consolidated budget did not change significantly in 2002. While the expenditures for law enforcement have somewhat increased (from 2.0 per cent of GDP in 2001 to 2.2 per cent of GDP in 2002), the expenditures for HPU and subsidizing of agriculture declined (from 2.5 per cent of GDP in 2001 to 2.3 per cent of GDP in 2002 and from 0.8 per cent of GDP in 2001 to 0.5 per cent of GDP in 2002 respectively). There may be also mentioned a slight decrease in expenditures for servicing of the public debt (from 2.7 per cent of GDP in 2001 to 2.2 per cent of GDP in 2002, exceptionally at the expense of the federal budget).





At the same time, the expenditures for education and financial aid to other budgetary levels increased considerably (from 3.1 per cent of GDP in 2001 to 3.8 per cent of GDP in 2002 and from 2.5 per cent of GDP in 2001 to 2.9 per cent of GDP in 2002 respectively).

Table 8

**Expenditures of the federal budget, territorial budgets and the consolidated budget in 2001 and 2002 (in % of GDP)**

	2001			2002		
	Federal budget	Territorial budgets	Consolidated budget	Federal budget	Territorial budgets	Consolidated budget
State administration and local government	0,50	0,80	1,20	0,51	0,85	1,36
Judiciary	0,10	0,00	0,10	0,18	0,02	0,20
International activities	0,30		0,30	0,29		0,29
National defense	2,70		2,70	2,70		2,70
Law enforcement and state security	1,60	0,40	2,00	1,74	0,47	2,20
Basic research and promotion of scientific and technologic advance	0,30	0,00	0,30	0,28	0,02	0,30
Industry, power engineering and construction	0,50	1,20	1,70	0,96	1,35	2,31
Agriculture and fisheries	0,30	0,50	0,80	0,25	0,29	0,55
Transportation, road maintenance, communications and information technology *	0,40	0,60	1,10	0,09	0,40	0,49
Housing and public utilities		2,50	2,50		2,34	2,34
Education	0,60	2,50	3,10	0,75	3,04	3,78
Culture, arts and cinematography	0,10	0,30	0,40	0,09	0,39	0,48
Mass media	0,10	0,10	0,20	0,09	0,08	0,17
Health and physical fitness	0,30	1,80	2,10	0,29	2,09	2,38
Social policy	1,20	1,10	2,40	0,29	1,29	1,58
<i>Transfers to PF at the expense of SST for financing of the base component of pensions</i>				3,10		3,10
Government debt servicing	2,60	0,10	2,70	2,04	0,13	2,17
Financial aid to other levels of government	2,50	0,00	X	2,91	0,01	X
Military reform	0,10	0,00	0,10	0,13	0,00	0,13
Road network				0,35	0,39	0,74
Targeted budgetary funds	0,20	1,40	1,60	0,14	1,42	1,56
<b>TOTAL EXPENDITURE</b>	<b>14,70</b>	<b>14,30</b>	<b>26,30</b>	<b>18,69</b>	<b>15,32</b>	<b>31,09</b>

In 2001, including expenditures for the road network.

**Enlarged Government Budget**

Table 9 presents the budget of enlarged government. It shall be pointed out that in the process of formation of such aggregate data there inevitably arises the problem of consolidation, i.e. the necessity to avoid double accounting. Since certain data relating to the execution of extra-budgetary funds and budgets of RF subjects can not be interpreted unambiguously

(for instance, it is not clear if the summary statistics relating to territorial and road and ecological funds include information of the funds consolidated in the budgets of RF subjects) and final data on the execution of the budgets of extra-budgetary funds are unavailable, revenues and expenditures of the enlarged government budget may be somewhat distorted. However, it shall be pointed out that these discrepancies can not radically change the general picture.

*Table 9*

**Enlarged government budget in 2000 through 2002 (in % of GDP)**

<b>2000</b>				
	<b>Federal budget</b>	<b>Territorial budgets</b>	<b>Extra-budgetary funds</b>	<b>Enlarged government budget</b>
Total revenues	15,5	14,1	10,7	38,3
<i>Tax revenues</i>	14,3	11,8	9,5	35,6
Total expenditures	14,1	13,7	9,1	34,8
<i>Health and physical fitness</i>	0,2	1,8	0,9	2,7
<i>Social policy</i>	0,9	0,8	5,6	6,9
<i>Transport and roads</i>	0,8	1,6***	2,2	3,3
<b>2001</b>				
	<b>Federal budget</b>	<b>Territorial budgets</b>	<b>Extra-budgetary funds</b>	<b>Enlarged government budget</b>
Total revenues	17,6	14,3	9,2	38,0
<i>Tax revenues</i>	16,2	10,9	8,2	35,3
Total expenditures	14,7	14,3	9,1	34,8
<i>Health and physical fitness</i>	0,3	1,8	0,9	2,8
<i>Social policy</i>	1,2	1,2	6,4	8,4
<i>Transport and roads</i>	0,7	1,7***	1,2	2,2
<b>2002</b>				
	<b>Federal budget</b>	<b>Territorial budgets</b>	<b>Extra-budgetary funds</b>	<b>Enlarged government budget*</b>
Total revenues	20,1	14,9	8,4	36,4
<i>Tax revenues</i>	18,6**	11,4	7,3	34,2
Total expenditures	18,7	15,3	9,2	36,1
<i>Health and physical fitness</i>	0,3	2,1	1,0	3,0
<i>Social policy</i>	4,4	1,3	6,7	8,9
<i>Transport and roads</i>	0,6	1,5***	0,8	1,5

\* Estimate.

\*\* Including SST.

\*\*\* Including expenditures of territorial road funds consolidated in the budgets of RF subjects.

Source: RF Finance Ministry, Goskomstat, authors' calculations.

The following conclusions may be derived basing on the available data:



First, in 2002 tax revenues of the enlarged government budget, as well as total revenues declined in comparison with the figures registered over two preceding years (by about 2 p.p. in terms of GDP as compared with 2000).

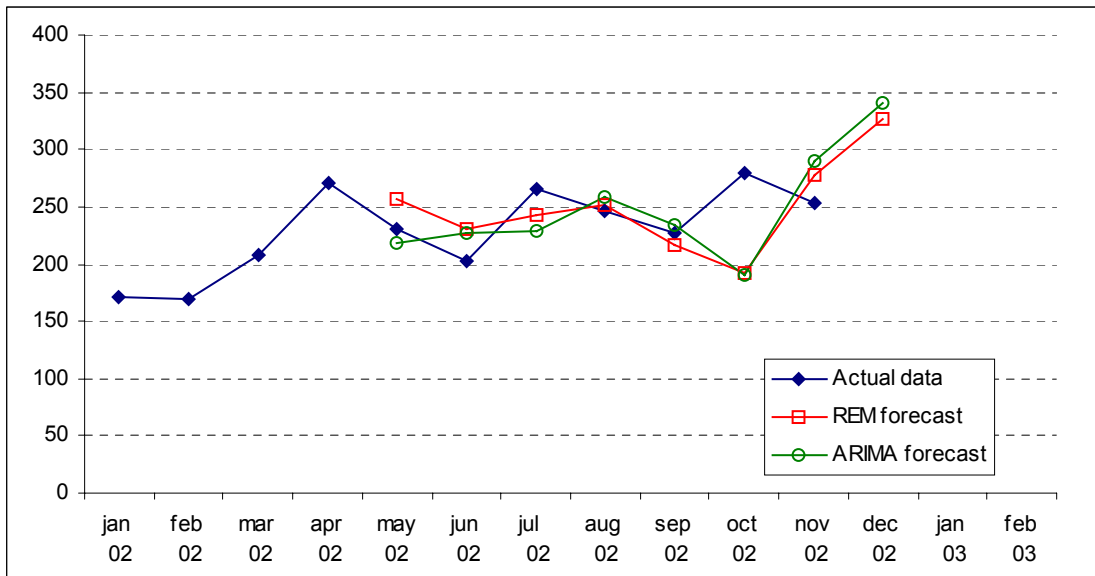
Second, the expenditures of the enlarged government budget increased somewhat (by 1.3 p.p. in terms of GDP as compared with the respective figures registered in 2000 and 2001). It shall be noted that in 2002 expenditures for social policy and healthcare grew by almost 2 p.p. and 0.3 p.p. in terms of GDP in comparison with respective indicators of 2001.

On the whole, it shall be pointed out that the tax burden on the economy has been significantly lightened over the last three years. At the same time, the level of expenditures of the budgetary system increased, what resulted in an approximate balance between revenues and expenditures of the enlarged government budget. It is yet another argument that any further reduction of taxes shall be conditioned on the simultaneous curtailment of expenditure obligations.

## **Appendix 1. Forecasting Tax Revenues in 2002**

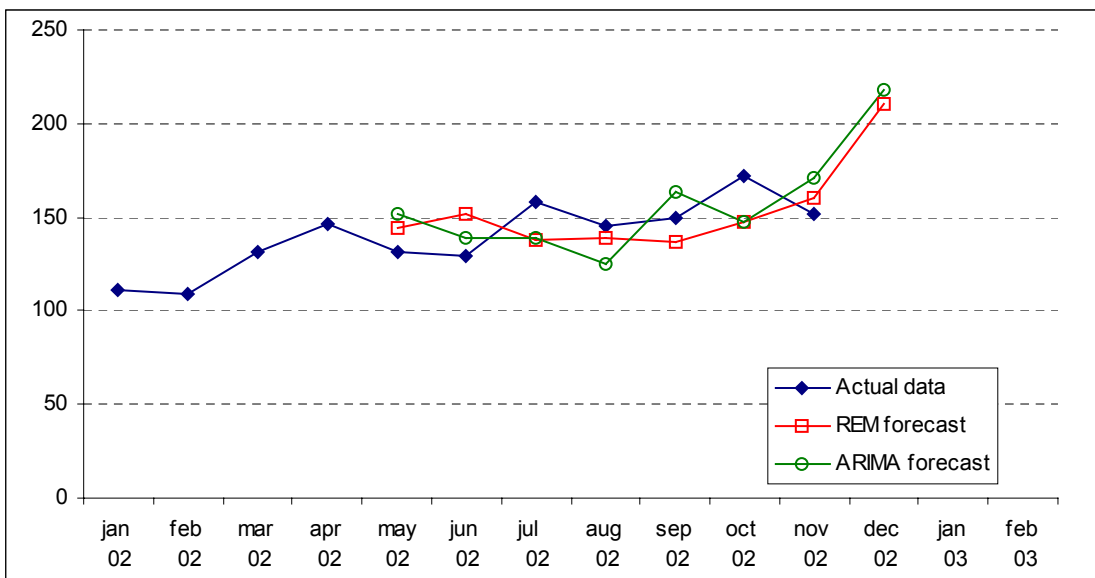
Over 2002, there were carried out estimates of tax revenues using two types of models: revenue estimation model (REM) and econometric univariate autogressive integrated moving average (ARIMA) models. The method of obtaining predicted values basing on the REM model is to transform the data about revenues for the respective period of the preceding year taking into account the growth in GDP, inflation, changes in tax rates, and the general shifts in the amount of revenues occurred from the beginning of the year until the predicted period in comparison with the preceding year. Therefore, the predictive accuracy of both models significantly depends on the stability of time series dynamics, primarily, their seasonal and trend components. In this respect, ARIMA models turn out to be more sensitive to changes in dynamics, what by no means implies better predictive accuracy, since the input of new data governed by a changed process in the evaluated interval results in deterioration of characteristic of regression and therefore the quality of forecasts. Thus, the changes in the tax legislation enacted since 2002 resulted in a change of dynamics not only with regard to the profit tax, but also with regard to the aggregate tax revenues of both the consolidated and federal budget of the Russian Federation.

The accuracy of the forecasts of tax revenues for year 2002 was tested basing on the comparison between the predicted and actual values from May to November of 2002 inclusively. The use of the progressive total values of tax revenues since the beginning of the year for the comparative analysis makes it difficult to evaluate the quality of forecasts, since by the end-year the rate of the forecast error diminishes significantly. Proceeding from this consideration, the data on the tax revenues and respective forecasts are presented in nominal monthly terms. The key criterion of the accuracy of forecasts is the relative deviation of predicted values from the actual data.



*Fig. 20.* Actual and predicted amounts of aggregate tax revenues of the RF consolidated budget (Rub. billion)

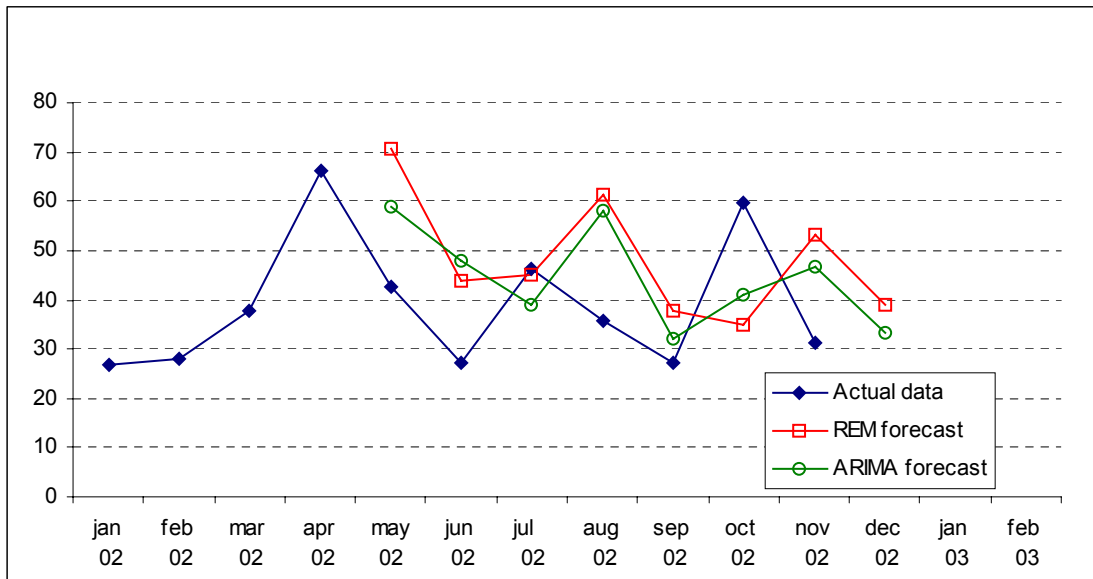
The mean relative error of the forecast of aggregate tax revenues of the RF consolidated budget for seven months (May – November) made 11.6 per cent for REM model and 12.3 per cent for ARIMA model. The least accurate forecast was obtained in October of 2002, when the relative error for both types of models was above 30 per cent.



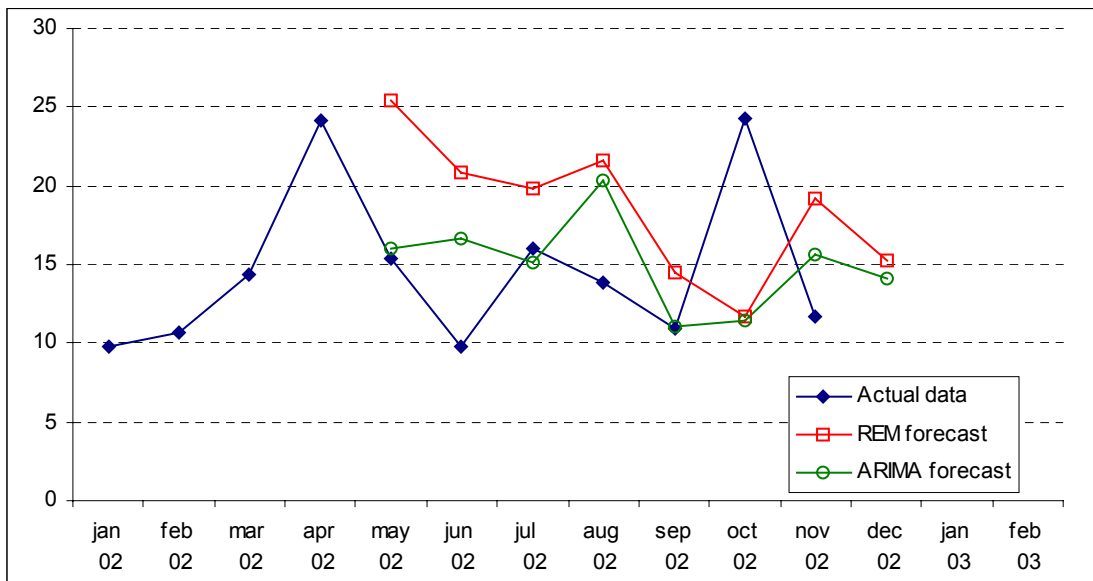
*Fig. 21.* Actual and predicted amounts of aggregate tax revenues of the RF federal budget (Rub. billion)

The mean relative error of the forecast of aggregate tax revenues of the RF federal budget for the period under observation made 10.3 per cent for REM model, while the relative accuracy of ARIMA model was at 12.2 per cent. On the whole, proceeding from the available

characteristics of forecasts in the interval from May to November of 2002, more accurate forecasts were obtained using REM model.



*Fig. 22. Actual and predicted amounts of aggregate profit tax revenues of the RF consolidated budget (Rub. billion)*

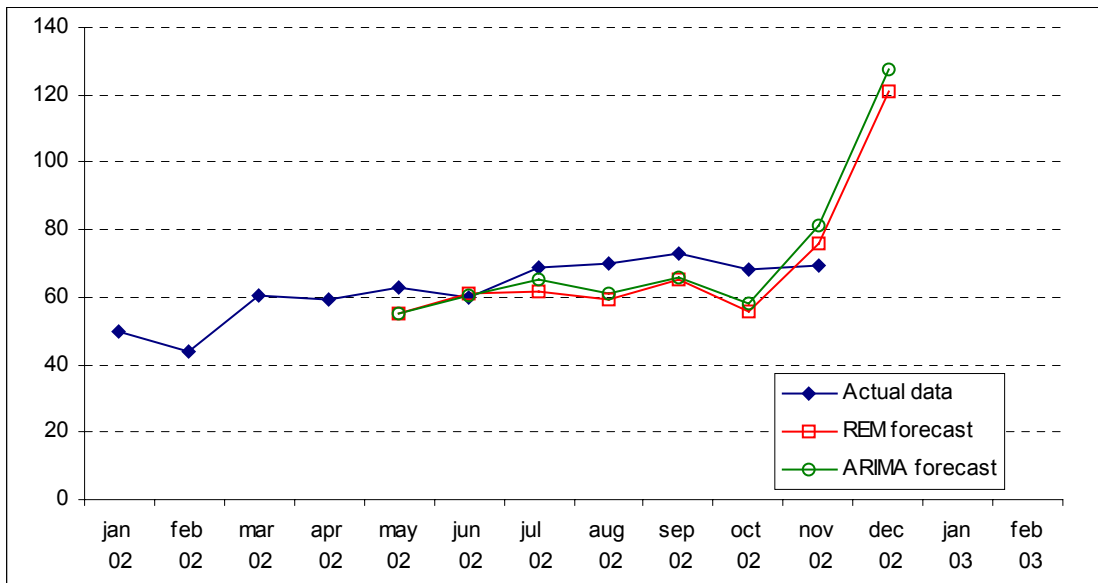


*Fig. 23. Actual and predicted amounts of aggregate profit tax revenues of the RF federal budget (Rub. billion)*

The mean relative error of the forecast of aggregate profit tax revenues of the RF consolidated budget made 50.5 per cent for REM model and 41.8 per cent for ARIMA model. This significant error of the forecast resulted from the changes in dynamics of the seasonal component in 2002 as compared with the respective indicator observed over preceding years. For instance, the peaks of inflow of profit tax revenues in May, August, and November, characteristic of 2001, shifted in 2002 and occurred in the first month of each quarter with the ex-

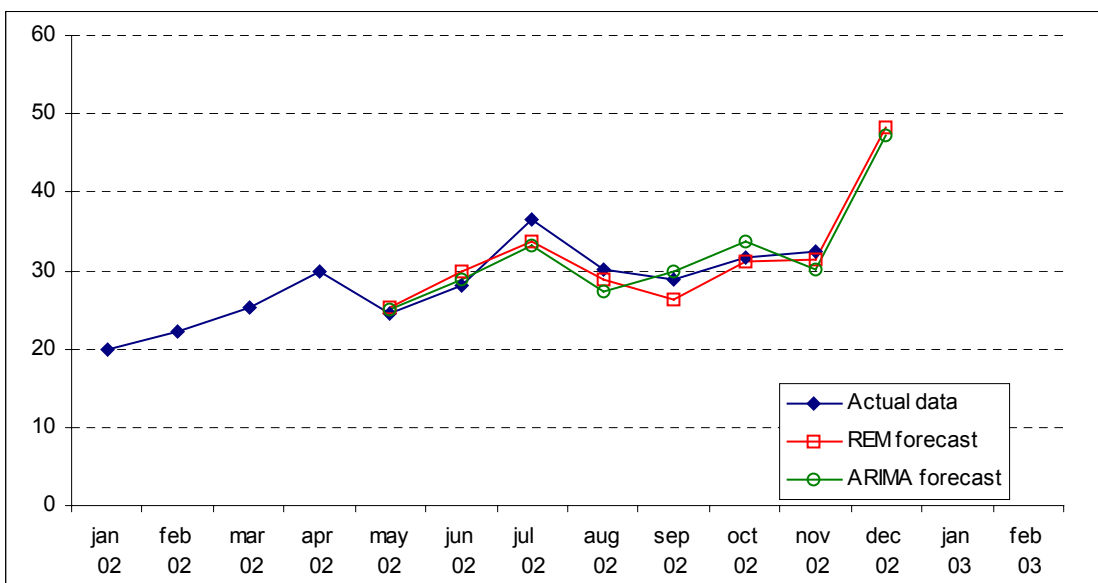
ception of January. Similarly important factor behind the error of the forecast is the general decline in the amounts of profit tax revenues registered in 2002, which reversed previous positive dynamics.

The mean relative error of the forecast of aggregate profit tax revenues of the RF federal budget made 58 per cent for REM model and 30.5 per cent for ARIMA model.



*Fig. 24. Actual and predicted VAT revenues (Rub. billion)*

The mean relative error of the forecast of VAT revenues made 11.1 per cent for REM model and 10.4 per cent for ARIMA model. The low accuracy of forecasts about inflow of the respective revenues may be explained by the volatility of the series dynamics over the whole estimated interval (since January of 1999) with the exception of regular peaks of inflows occurring each December, what negatively affects the reliability of autoregressive evaluations.



*Fig. 25. Actual and predicted income tax revenues (Rub. billion)*



The most accurate forecasts of inflows were obtained for the income tax. The mean relative error of the forecast of income tax revenues made 4.9 per cent for REM model and 5.8 per cent for ARIMA model.

On the whole, the low accuracy of the forecasts of tax revenues results from the intensive transformational processes underway in the Russian economy. Besides, changes in the tax legislation result in shifts in dynamics not only of the taxes directly affected by the respective legislative changes, but also impact the dynamics of revenues generated by other types of taxes.

### **2.3.2. Federal Budget for 2003 and Macroeconomic Forecast of Social and Economic Development of Russia**

#### Federal Budget for 2003

The key parameters of the federal budget for 2003 base on two versions of the forecast of social and economic development of Russia in 2003 and until 2005 - conservative (1) and optimistic (2). The parameters of the conservative (1) and optimistic (2) versions depend on the combination of external and internal factors.

An analysis of internal factors of economic development in the first six months of 2002 and shifts in the external business situation reveals that there is certain potential for more rapid restoration of favorable conditions and trends of growth in the Russian economy. According to the preliminary estimates of the RF Ministry of Trade and Economic Development, in 2002 GDP grew by 4.3 per cent in comparison with the figures registered in the preceding year.

The conservative forecast bases on the assumption of inertial development of the economy and persistence of factors and trends formed in 2001 and in January through June of 2002.

The optimistic forecast relied on more rapid rates of growth in the world economy and increasing influence of expanding external demand on the dynamics of growth in the Russia's economy.

The key differences of forecasts are conditioned by the external environment of development. The decisive factor is the level and dynamics of world oil and natural gas prices: the conservative forecast envisages the average world oil price at US \$ 18.5 per barrel and contract natural gas price at US \$ 78.5 per 1000 cubic meters, while the optimistic forecast sets these indicators at US \$ 21.5 and US \$ 85.4 respectively. At the same time, both scenarios assume that rise in prices will positively affect the dynamics of oil and natural gas exports. Both scenarios also relay on prompt repayment of the principal debt and unfaltering debt servicing.

The ratio between external and internal factors changes over time. While economic growth in 2002 based on the dynamic expansion of external demand for fuel and raw materials resources, in 2001 and early 2002 there was registered an intensive growth in internal demand generated by increasing household incomes and persisting investment activity.

In 2003, the outpacing rates of growth in the internal demand in comparison with the external demand were the dominating trend of changes in the structure of utilized GDP. The conservative forecast envisages, basing on the hypothesis that prices of hydrocarbon raw materials would decline relatively the figures registered in 2002, while dynamics of growth in

the world economy would be even, that falling export revenues become a factor checking rates of growth in the real sector of the Russian economy.

An analysis of major trends of development of the Russian economy over the last three years demonstrates that cardinal changes in the structure of investment in the real sector oriented towards a large scale modernization of fixed assets, increase in productivity of labor and competitiveness of domestic products on the internal and external markets is a key factor behind further economic growth. The substantive component of the estimates underlying the forecast for 2003 through 2005 was the assumption that this factor would be affecting economic development. In 2003, the rates of growth in GDP, taking into account external and internal factors and conditions of economic development, are envisaged to be at 3.5 per cent to 4.4 per cent depending on the version.

Due to the increasing share of funds assigned for the repayment of the public external debt, the structure of gross national savings will change. According to the forecast, in 2003 the share of investment in GDP will make 17.5 to 18.0 per cent as compared with 15.2 per cent registered in 2002. At this scope of savings, the increase in investment in fixed assets in 2003 is estimated to be at 6.3 per cent to 7.5 per cent. The practical implementation of these parameters of investment activities presupposes active shifts in the investment environment and improvement of legal, financial, and economic mechanisms of transformation of savings in investment.

Evaluating attainability of forecasted rates of investment activities, it shall be taken into account that the estimated decline in the share of profits in GDP from 17.6 per cent in 2001 to 12.3 per cent in 2002 will seriously affect the situation. Taking into account the persistence of traditionally high concentration of profits in the export oriented industries of oil and raw materials sectors and the lack of mechanisms of inter-sectoral flow of capitals and accumulation of gross savings for the development of competitive components of the economy it may be hardly expected that radical changes would occur in the nature of the reproduction of fixed capital. The forecast for 2003 envisages that in the case rates of production and proceeds of enterprises decelerate, the current trends will persist. Due to limited own funds in the real sector of the economy and the lack of possibilities of long term borrowing, the situation provoking a shrinking of the domestic investment demand is reproduced in the Russia's economy.

It is forecasted that in the case the present level of household incomes and expenditures is maintained and accompanied by a rise in consumer prices the trends towards growth in savings of the household sector will persist. According to the estimates, in 2003 the growth in real cash incomes will make 5 per cent to 5.8 per cent depending on the forecast version, while the share of poor households will decline from 27 per cent to 25.5 per cent. However, in spite of the forecasted trend towards a growth in real wages and salaries and increase in the share of pay to employees in the structure of GDP, real household incomes remain at 93 to 94 per cent of the figures registered in the pre-crisis 1997.

The forecast relies on hypotheses about improving efficiency of the economy, for instance, it is assumed that power intensity of GDP would decline. At the given level of power intensity of production, the relatively slow development of the fuel and energy complex may become a considerable constraint on economic growth. At the forecasted rate of growth in output of industries manufacturing final products, the power intensity of GDP would decline 2 per cent to 3 per cent a year. It is urgent to pursue active energy conservation policies also because of the forecasted shift in the economic priorities in favor of modernization of production, development of manufacturing industries and sectors oriented towards services and in-





roduction of resource-saving technologies. However, a comparison of dynamics of investment in fixed assets and power availability per worker demonstrates that this factor will not have an impact on labor productivity dynamics in 2003.

*Table 10*

**Revenues as per budget laws and administration of the federal budget in 2002 and 2003**

	2002 budget law	2002 budget law, administered	2003 budget law	2002 budget law	2003 budget law, administered	2003 budget law	2003 budget law in % of 2002 budget law	2003 budget law in % of administered 2002 law
	Rub. mil.			% GDP			%	
<b>Tax revenues</b>	1726310,1	1696137,4	1892363,7	15,8	15,5	14,5	92,0	93,6
Taxes on profit (income), capital gain	208452,9	173463,5	179550,5	1,9	1,6	1,4	72,3	86,8
Taxes on goods and services. License and registration fees.	1000976,5	970976,9	1178971,2	9,1	8,9	9,0	98,8	101,9
VAT	773508	752654,6	946218,5	7,1	6,9	7,3	102,6	105,5
Excises	224815	214865,068	227708,8	2,1	2,0	1,7	85,0	88,9
Taxes on aggregate income	5677,6	6200,0	8478,4	0,1	0,1	0,1	125,3	114,7
Fees for use of natural resources	183715,7	214237,432	183129,5	1,7	2,0	1,4	83,6	71,7
Taxes on foreign trade and external economic operations	324108,9	323368,946	335975,5	3,0	3,0	2,6	87,0	87,2
Other taxes, duties, and charges	3378,5	6449,9	5418,6	0,0	0,1	0,0	134,6	70,5
<b>Non-tax revenues</b>	104284,2	150536,052	145721,8	1,0	1,4	1,1	117,2	81,2
Revenue from state and municipal property or activity	50472,5	76887,0	83158,8	0,5	0,7	0,6	138,2	90,7
Proceeds from the sale of land and intangible assets	290	1967,2	0,2	0,0	0,0	0,0	0,1	0,0
Administrative charges	804,1	670,0	1406,5	0,0	0,0	0,0	146,8	176,1
Penalties and indemnity	1691,4	1614,4	1353,6	0,0	0,0	0,0	67,1	70,3
Revenue from foreign economic operations	47911,9	65558,9	55932,7	0,4	0,6	0,4	97,9	71,6
Other non-tax revenue	3114,3	3838,5	3870	0,0	0,0	0,0	104,3	84,6
<b>Fund of the RF Ministry of Atomic Energy</b>	13893,9	15129,8	14066,3	0,1	0,1	0,1	84,9	78,0
<b>Single social tax</b>	281230	339461,0	365640	2,6	3,1	2,8	109,1	90,4
<b>TOTAL REVENUE</b>	2125718,2	2202139,4	2417791,8	19,4	20,1	18,5	95,4	92,1

According to the Finance Ministry estimates, the federal budget lost about Rub. 30 billion as a result of all changes introduced in the revenue section of the law on the federal budget for year 2003 as compared with targets of the budget law for 2002. It is planned to compensate for the budgetary losses by tightening tax administration, for instance, via reduction of the respective accumulated indebtedness and optimization of management of state owned property.

It is planned to generate about Rub. 23 billion at the expense of repaid tax indebtedness. Besides, over Rub. 83 billion (more than 1.5 times above the target set by the budget for 2002 and by 8 per cent higher than expected) should be generated due to the enhancement of efficiency of management of all types of state owned property. The bulk of the increase (two thirds of the expected growth) should be generated at the expense of “other operations relating to state reserves,” which was included in the revenues of the federal budget in 2002.

*Table 11*

**Expenditures as per budget laws and administration of the federal budget in 1999, 2000, 2001, 2002 and 2003 (in % of GDP)**

	1999		2000		2001		2002		2003	
	Budget law *	Administration	Budget law **	Administration	Budget law *	Administration	Budget law *	Administration	Budget law *	
State administration and local government	0,34	0,31	0,37	0,34	0,53	0,46	0,52	0,51	0,51	
Judiciary	0,12	0,10	0,12	0,11	0,15	0,13	0,17	0,18	0,20	
International activities	0,91	1,24	0,54	0,15	0,29	0,33	0,43	0,29	0,34	
National defense	2,34	2,42	2,87	2,63	2,77	2,73	2,58	2,70	2,64	
Law enforcement and state security	1,28	1,17	1,53	1,44	1,70	1,64	1,52	1,74	1,88	
Basic research and promotion of scientific and technologic advance	0,29	0,24	0,23	0,24	0,29	0,26	0,27	0,28	0,31	
Industry, power engineering and construction	0,36	0,36	0,52	0,48	0,58	0,49	0,49	0,96	0,49	
Agriculture and fisheries	0,23	0,19	0,21	0,18	0,27	0,26	0,20	0,25	0,24	
Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	0,07	0,06	0,06	0,06	0,06	0,05	0,09	0,09	0,08	
Transportation, road maintenance, communications and information technology	0,02	0,02	0,03	0,03	0,39	0,41	0,05	0,07	0,05	
Market infrastructure development	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	
Prevention and/or elimination of the effects of emergencies and natural disasters	0,18	0,16	0,13	0,13	0,08	0,08	0,08			
Education	0,52	0,44	0,52	0,52	0,63	0,60	0,71	0,08	0,16	
Culture, arts and cinematography	0,08	0,06	0,07	0,07	0,08	0,07	0,09	0,75	0,75	
Mass media	0,05	0,04	0,08	0,08	0,08	0,08	0,09	0,09	0,11	
Health and physical fitness	0,26	0,21	0,23	0,23	0,29	0,26	0,28	0,09	0,09	
Social policy	1,05	1,03	0,91	0,93	1,39	1,24	3,71	0,29	0,30	
Public debt servicing	4,17	3,42	2,58	3,53	3,09	2,56	2,65	4,43	1,15	
Replenishment of state stocks and reserves	0,00	0,00	0,00	0,00	0,01	0,00	0,00	2,04	2,13	
Financial aid to budgets of other levels	1,09	1,32	1,33	1,39	2,41	1,21	2,24	0,01	0,16	
Utilization and liquidation of armaments, including under international treaties	0,04	0,08	0,00	0,05	0,08	0,03	0,09	2,91	5,48	
Mobilization preparedness of economy	0,01	0,01	0,01	0,01	0,01	0,00	0,00			
Military reform	0,07	0,07	0,06	0,06	0,06	0,03	0,09			
Research and use of outer space	0,00	0,00	0,00	0,00	0,05	0,03	0,15			
Other expenditures	-0,24	-0,13	0,09	0,09	-0,05	0,07	-0,03			
Road network	0,00	0,00	0,00	0,00	0,00	0,00	0,50			
Targeted budgetary funds	1,10	1,18	1,33	1,34	0,18	0,16	0,13			
<b>TOTAL EXPENDITURE</b>	<b>14,38</b>	<b>13,99</b>	<b>13,89</b>	<b>14,09</b>	<b>15,40</b>	<b>13,21</b>	<b>17,09</b>			

\* In per cent of target GDP.

\*\* In per cent of actual GDP.



Table 12

**Budget laws and administration of the federal budget  
in 1999, 2000, 2001, and 2002 (in constant prices)**

	1999		2000		2001		2002		2003
	Budget law	Admini- stration	Budget law	Admini- stration	Budget law	Admini- stration	Budget law	Admini- stration	Budget law
State administration and local government	13747	14832	21541	20816	28550	29434	34538	34223	36506
Judiciary	4848	4987	6758	6887	7950	8280	11492	11858	13987
International activities	36594	58080	46688	19171	15561	20820	28433	19622	24363
National defense	93703	116127	117181	158737	150597	173015	171845	179897	189110
Law enforcement and state security	51325	55445	66391	87684	92329	104284	101168	116010	134367
Basic research and promotion of scientific and technologic advance	11635	11197	13250	14588	15498	16613	17916	18922	22069
Industry, power engineering and construction	14583	16921	16698	29139	31329	30964	32527	64260	34803
Agriculture and fisheries	9284	9068	9572	11109	14591	16629	13571	16942	17108
Protection of the environment and natural resources, hydrometeorology, mapping and geodetic surveying	2904	2895	3110	3421	3349	3465	5859	6027	5932
Transportation, road maintenance, communications and information technology	902	942	1364	1541	21466	26033	3233	4550	3341
Market infrastructure development	0		0	42	63	63	12	12	55
Prevention and/or elimination of the effects of emergencies and natural disasters	7345	7374	7510	7862	4443	4863	5120	5355	11641
Education	20866	20945	26705	31714	34234	38219	47612	49780	53612
Culture, arts and cinematography	3062	2877	3893	4321	4479	4722	6184	6217	7715
Mass media	2087	2000	4763	5072	4371	5278	6028	6049	6562
Health and physical fitness	10239	10141	13306	14044	15577	16189	18707	19259	21596
Social policy	41871	49096	52410	55187	75605	78740	247588	295429	82711
Public debt servicing	166844	162583	183086	143280	168209	162056	176578	136294	152325
Replenishment of state stocks and reserves	97	93	140	138	304	209	321	412	11503
Financial aid to budgets of other levels	43444	62145	57528	84214	130914	161287	149530	193905	392250
Utilization and liquidation of armaments, including under international treaties	1736	3566	1722	2883	4234	4596	6235	6298	5906
Mobilization preparedness of economy	450	555	416	536	351	660	305	387	274
Military reform	2976	0	2853	0	3220	0	5919	5934	4200
Research and use of outer space	0	0	0	0	2972	0	10083	8763	8673
Other expenditures	-9532	0	0	0	0	0	33227	23604	43424
Road network	0	-2472	3401	10500	-2748	13075	-1692	7377	-4232
Targeted budgetary funds	44038	55275	50404	80929	9746	10187	6203	9185	7721
<b>TOTAL EXPENDITURE</b>	<b>575047</b>	<b>664674</b>	<b>711375</b>	<b>793815</b>	<b>705898</b>	<b>929680</b>	<b>1140805</b>	<b>1246571</b>	<b>1287525</b>

Tax revenues of the federal budget make Rub. 1 trillion 892 billion, or 14.5 per cent of GDP, what is by 1 p.p. below the respective indicators of 2002. Tax revenues declined due to the redistribution of profit tax revenues (since 2003, the federal share of this tax makes 6 %), half of the revenues from excises on oil products (gasoline, diesel fuel, and motor oil), and the full amount of the land tax in favor of territorial budgets. At the same time, since 2003 the federal budget shall receive the full amount of excises on tobacco products.

The aforesaid changes resulted in a decline in profit tax revenues to 1.4 per cent of GDP (1.9 per cent in accordance with the law on the budget for 2002, 1.6 per cent of GDP in accordance with the results of 2002), while excise generated revenues decreased to 1.7 per cent of GDP (2.1 per cent and 2.0 per cent respectively). Besides, it is assumed that in 2003 revenues from taxes on foreign trade may decline to 2.6 per cent of GDP (from 3 per cent registered in 2001 and 2002) in relation to the expected decrease in world oil prices and planned reduction of export customs duties.

At the same time, it is expected that VAT revenues will increase somewhat (up to 7.3 per cent of GDP from 7.1 per cent of GDP targeted in the budget for 2002 and 6.9 per cent of GDP according to the results of 2002).

In the course of elaboration of the budget, the Government proceeded from tax collection being at the level of the current year (95 per cent). Besides, VAT repayment budgetary target was increased by one fourth as compared with the respective indicator registered in 2002 and made Rub. 240 billion.

The federal budget expenditures for year 2003 are planned at the level of 17.97 per cent of GDP, estimated GDP making Rub. 13050 billion. Certain changes were introduced in the structure of expenditure classification as concerns the sub-item "Social assistance" (resources due to extra-budgetary funds were transferred to the section "Financial aid to other budgetary levels") and the section "Law enforcement" (expenditures for fire protection were moved to the section "Prevention and elimination of the effects of emergencies," some expenditures for national defense, which were transferred to other sections, and other changes.

The most considerable increase in expenditures as compared with the law on the budget for 2002 was registered in expenditures for social policy (by 1/4 of GDP point in terms of comparable classification and by almost 40 per cent in comparable prices), law enforcement (by almost 0.4 GDP point, or 30 per cent in comparable prices). The expenditures for judiciary were also raised (by 0.06 p.p. in terms of GDP and more than 20 per cent in comparable prices). Expenditures for national defense increased by 0.15 p.p. in terms of GDP and by 14 per cent in real terms. As concerns the structure of social expenditures, there were raised expenditures for culture and arts (by 0.02 p.p. in terms of GDP, or by 25 per cent in comparable prices), education (by 0.03 p.p. or 13 per cent respectively), and health (0.02 p.p. or 15 per cent respectively).

*Table 13*

**Certain expenditure items in the draft federal budget for year 2003 and the law on the federal budget for 2002 in comparable classification**

	2002 budget law in % of GDP, comparable classification	2003 budget law in % of GDP	2002 budget law in % of 2003 budget law in comparable prices and classification
International activities	0,45	0,34	81,6
National defense	2,50	2,64	114,0
Law enforcement and state security	1,53	1,88	132,4
Basic research and promotion of scientific and technologic advance	0,30	0,31	110,1
Industry, power engineering and construction	0,57	0,49	91,1
Prevention and/or elimination of the effects of emergencies and natural disasters	0,14	0,16	126,0
Social policy	0,90	1,15	138,5
Financial aid to budgets of other levels	5,46	5,48	108,3

The major factors behind the growth in expenditures were the rise in cash allowances for military personnel, increase in wages of employees of the budgetary sphere, and higher scholarships raised in the beginning of 2003 / 2004 academic year. Increasing expenditures for road network is related to the growth in subsidies to territorial budgets in order to compensate for the loss of revenues generated by the tax on motor road users. In 2003, expendi-



tures for the judiciary system include additional financing of newly created jobs across the whole structure of the judiciary system.

A decline in expenditures of the federal budget was most pronounced in the section “International activities” (by 0.11 p.p. in terms of GDP and by 18 per cent in comparable prices). Besides, the 2003 budget envisages a decline in financing of expenditures for support of industry, power engineering, and construction by almost 0.1 p.p. of GDP, or by 10 per cent in real terms in comparison with the current budget in comparable classification, as well as a number of other items, including the military reform, research and use of outer space, mobilization preparedness of economy, and utilization and liquidation of armaments. The aggregate reduction of these expenditures made 0.07 p.p. in terms of GDP or 15 per cent in real terms.

Interest expenditures as set forth in the budget for 2003 were reduced by one fifth of percentage point in GDP terms, or by 14 per cent in comparable prices in comparison with the respective targets of the budget for 2002.

On the whole, it seems that the revenue section of the 2003 budget was worked out proceeding from the optimistic scenario. First, the results of the execution of the 2002 budget do not allow to draw definite conclusions as concerns the Tax Ministry ability to meet the tax revenue targets in 2003 taking into account the fact that it collected less taxes than set forth in the law by Rub. 30 billion in 2002. Second, revenues at Rub. 23 billion in repaid indebtedness look questionable taking into account lack of positive trends in the preceding year (tax arrears increased by about 2 per cent in real terms, while deferred payments decline by less than 1 per cent).

Expenditures set forth in the budget for year 2003 do not require any serious changes in the structure of the expenditures of the federal budget, with exception of change in the amount of financing of certain items because of the reclassification of certain types of expenditures. On the whole, it may be concluded that two major problems the Government tried to address in the budget for 2003 were raise in wages and salaries of employees of budgetary organizations and repayment of external debt due in 2003.

## Scenario Based Macroeconomic Forecast for 2003

Three scenarios of the development of the economic situation in Russia in 2003 determined by different dynamics of world oil prices over the year seem most probable. The estimates proceed from the assumption that world oil prices will remain the decisive factor for the development of Russia’s economy in the short term in spite of the fact that at some moments the role of other variables (for instance, domestic demand) may gather in importance.

Two scenarios envisage a growth in oil (Brent) prices up to US \$ 40 over the first six months of 2003 due to the escalation of tensions relating to Iraq and North Korea, higher risks to extract and export oil from the Persian Gulf countries, and falling oil production in Venezuela. Both scenarios presume the US attack against Iraq or replacement of the country’s leadership in the second quarter of 2003. Further these scenarios diverge.

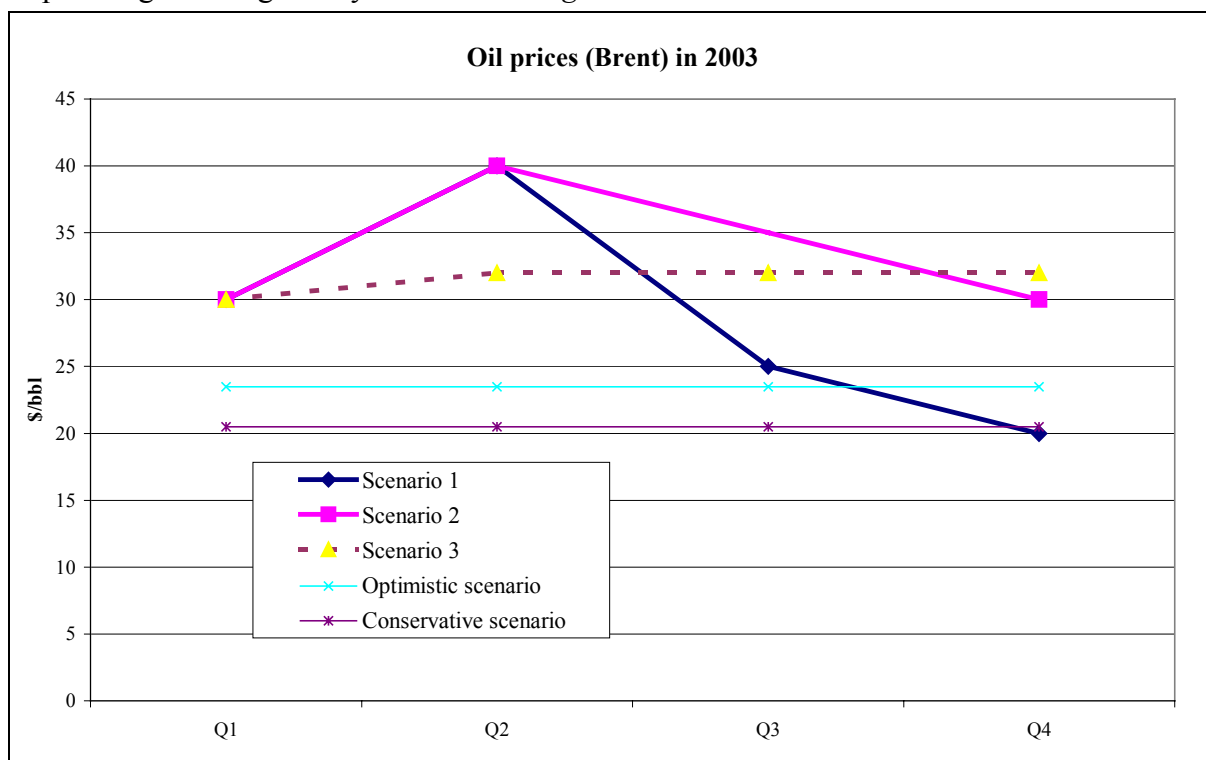
The first scenario envisages a fast and successful military campaign or a coup resulting in the replacement of the country’s leadership and resumption of Iraqi oil export in large volumes already in 2003. In this situation it is expected that oil prices will rapidly decline in the 3<sup>rd</sup> and 4<sup>th</sup> quarter of 2003 to US \$ 20 to 25 per barrel.

The second scenario is based on a prolonged war or instability in Iraq (over six months), what would prevent the resumption of Iraqi oil export and result in higher volatility on world raw materials markets. It is assumed that in this case oil prices will also go down by the end

of the year due to higher quotas of OPEC member countries, growing exports from other countries, and development of new deposits rendered profitable by high oil prices. However, the decline will be more smooth and Brent oil prices will be at or above US \$ 30 per barrel by the end of the year.

The third scenario envisages that the US either will not start the military campaign against Iraq, or delay it until 2004. However, persisting instability in the Persian Gulf region and the threat of military action will result in higher oil prices (at about US \$ 32 per barrel) over the year.

For the dynamics of oil prices in 2003 according to all scenarios described above and two scenarios elaborated by the Ministry for Trade and Economic Development in the course of planning the budget for year 2003 see *Fig. 26*<sup>15</sup>.



*Fig. 26*

The scenario based forecasts based on the model of medium term prognostication elaborated by the Russian European Center for Economic Policy at the request of the RF Ministry for Economic Development and Trade. The model consists of 8 equations and 3 identities.

Modeled variable	Explanatory factors
Real GDP	Real GDP with a lag, real investment in fixed assets with a lag, real household incomes with a lag, oil prices
Exports	Oil prices

<sup>15</sup> Scenarios of the RF Ministry of Trade and Economic Development (MTED) are based on the Urals oil prices, therefore for comparability purposes these prices were increased by US \$ 2 per barrel, what corresponds to the average difference in Urals and Brent prices over the last years.



Inflation (CPI)	Inflation with a lag, increase in money supply M <sub>2</sub> with a lag, real GDP with a lag
Tax revenues	Nominal GDP, exports
Imports	Real GDP, real Ruble rate
Gold and currency reserves	Exports, imports, nominal Ruble rate
Change in the Ruble nominal rate	Gold and currency reserves

It is assumed that changes of exogenous variables (the rate of increase in real investment and the rate of increase in real household incomes) will also depend on the level of oil prices due to the fact that a considerable share of domestic demand for investment goods is formed in the export sector, while growth in household incomes is secondary to the growth of incomes in the economy at large. Therefore, it is assumed that in 2003 there will take place the following changes of exogenous variables:

	Oil prices	Real investment in fixed assets	Real household incomes
<b>Scenario 1</b>	20-40	7-8%	7%
<b>Scenario 2</b>	30-40	7-9%	8%
<b>Scenario 3</b>	32	7-8%	8%
<b>Conservative scenario</b>	20,5	6,3%	5,0%
<b>Optimistic scenario</b>	23,5	7,5%	6,0%

The model has been built basing on the quarterly data for the period from the 1<sup>st</sup> quarter of 1995 to the 4<sup>th</sup> quarter of 2002. The data were obtained from official publications of Goskomstat, Bank of Russia, and International Monetary Fund (International Financial Statistics). Alongside with variables shown above, there was used a number of dummies, for instance, for seasonal effects (quarter, years), the crisis of 1998, etc.

The predicted values of variables were obtained in two stages. At the first stage, in order to better evaluate the predictive power of the model, equations were tested basing on the period from the 1<sup>st</sup> quarter of 1995 to the 4<sup>th</sup> quarter of 2001 and prognosis was made for 2002. The best specification of the model was chosen on the basis of the minimal discrepancy between predicted values of this model and actual values of variables.

*Table 14*

	Scenario 1	Scenario 2	Scenario 3	Governmental scenario
<b>Growth in real GDP, %</b>	4,6%	5,0%	4,9%	4,0%
<b>CPI, %</b>	11,7%	12,2%	11,9%	11,0%
<b>Nominal GDP, Rub. billion</b>	13440	13550	13480	13300
<b>Tax revenues of the RF federal budget, Rub. billion<sup>16</sup></b>	2322	2383	2353	2239
<b>Tax revenues of the RF federal budget, % of GDP</b>	17,28%	17,59%	17,46%	16,83%
<b>Export from RF, US \$ billion</b>	109,9	122,0	116,6	93,5
<b>Import from RF, US \$ billion</b>	64,9	65,6	65,2	63,7
<b>Gold and currency reserves of the RF CB, US \$ billion</b>	53,1	58,7	57,2	46,0
<b>Nominal Ruble rate, Rub. / US \$</b>	33,72	33,13	33,38	34,57
<b>Real effective Ruble rate (December of 1994 = 100)</b>	106,3	108,7	106,5	103,1

At the second stage the best specification was evaluated basing on the whole available data array, including 2002. Prognosis for 2003 based on coefficients obtained for the last model. For the results see the Table. Calculations for the governmental scenario were carried out basing on mean values of the conservative and optimistic scenarios of the RF MTED.

<sup>16</sup> Including SST revenues.

Therefore, the estimates indicate that according to the most probable scenarios the situation in the Russian economy in 2003 will be better than shown in the forecasts of the RF Ministry for Trade and Economic Development used for work on the draft federal budget. The rates of growth in real GDP are expected to somewhat exceed target indicators (up to 5 per cent), while inflation estimates demonstrate that the rise in prices most probably will be within the range of base values selected by the Finance Ministry and RF Central Bank. Predicted tax revenues of the federal budget exceed the amounts set forth in the law on the federal budget for 2003, what allows the Government to execute the budget taking into account the record high amount of payments related to repayment and servicing of the RF external debt. Moreover, it is expected that by end-year the financial reserve, which may become the basis for formation of the future stabilization fund, will be preserved, or even increased the more so that the RF Finance Ministry has in fact balanced the target expenditures of the budget for 2003 against revenues derived in the case oil prices would be close to the average long term level (US \$ 18 to 20 per barrel).

### **2.3.3. Interbudgetary Relations and Sub-National Finance**

The main specifics of the preceding year were attempts to take radical decisions in the sphere of economic policies directly relating to problems of interbudgetary relations, regional and municipal finance. First, possible policy shifts may be attributed to the effect of the preliminary results of the reform concerning the tax on profits of enterprises, especially such its aspect as changes in the sharing arrangements of this tax among the federal budget, budgets of RF subjects, and municipal budgets. Second, there started an active discussion about the possible ways to compensate federal and regional budgets for the revenues generated by the abolished since January 1, 2003, taxes on users of motor roads and vehicle owners. Third, the Presidential Commission working out recommendations as concerns delimitation of jurisdictions and powers among the federal authorities, subjects of the Russian Federation, and local governments completed its work, which resulted, among other documents, in the draft new version of the federal law "On general principles of organization of local government in the Russian Federation" and the draft law "On general principles of organization of legislative (representative) and executive authorities of RF subjects." It is expected that enactment of these documents will have a serious impact on the development of interbudgetary relations, regional and municipal finance.

#### **Budgets of Different Levels: Trends in Relationships**

In order to analyze main trends observed in 2002 as concerns the relations among budgets of different levels, it would be feasible to review the structure of the consolidated budget of the Russian Federation and its dynamics over the few past years. For data characterizing the share of tax revenues, revenues and expenditures of budgets of RF subjects in the consolidated budget of the Russian Federation see *Table 15*.



*Table 15***The share of certain budgetary indicators in the consolidated budget of the Russian Federation in 1992 through 2002 (in %)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Tax revenues	44,20	53,10	53,40	47,60	49,50	53,10	54,00	48,90	43,50	37,40	39,34
Revenues*	44,08	53,08	52,91	47,59	49,52	53,07	50,64	46,42	43,57	36,81	37,39
Expenditures	34,00	40,30	37,70	43,40	45,40	48,10	48,40	46,90	54,40	56,60	49,27

\* Financial aid from the federal budget is excluded.

Source: RF Finance Ministry, authors' calculations.

The data presented in *Table 15* demonstrate that the trend towards a decline in the share of tax revenues of the consolidated budget received by the budgets of RF subjects observed over the last four years has somewhat changed. For instance, according to the results of budget administration in 2002, consolidated budgets of RF subjects received over 39 per cent of the total tax revenues of the budgetary system. At the same time, the share of aggregate revenues of RF subjects in the "Total revenues" item was at the level slightly above the level registered in the preceding year making a little over 37 per cent. At the same time the share of expenditures of the budgetary system financed from consolidated budgets of RF subjects declined: according to the results of 2002 it made about 50 per cent.

It shall be pointed out that the growth in the share of tax revenues of regional budgets in the revenues of the consolidated budget of the Russian Federation took place even at the background of technical increase in tax revenues of the federal budget at the expense of single social tax transferred to the budget of the Pension Fund for financing of the base component of the labor pension. As compared with budget administration in 2001, tax revenues of regional consolidated budgets have increased from 9.64 per cent to 10 per cent of GDP in 2002, while tax revenues of the federal budget declined from 16.16 per cent in 2001 to 15.5 per cent of GDP in 2002. Tax revenues of the budgets of RF subjects grew in spite of a decline in revenues generated by the tax on profits of organizations by 0.66 per cent of GDP as compared with the figures registered in the preceding year, which was nevertheless compensated by an increase in revenues generated by the tax on incomes of individuals, property taxes (primarily the tax on property of enterprises), charges for use of natural resources, and other taxes and charges. At the same time, a factor behind the increase in revenues from the property tax on organizations was the revaluation of fixed assets taking place in the beginning of the year. In spite of the decline in non-tax and other revenues, the total amount of revenues of the consolidated budgets of RF subjects has exceeded the level registered in the preceding year by 0.5 p.p. of GDP.

In 2002, there was also observed a growth in revenues of the consolidated budgets of RF subjects from 14.35 per cent to 14.91 per cent of GDP, while expenditures increased more considerably – from 14.32 per cent to 15.31 per cent of GDP. Accordingly, a deficit of the consolidated budget of RF subjects has been registered for the first time over the few past years. The deficit made –0.4 per cent of GDP (as compared with the surplus at 0.04 per cent of GDP registered in 2001). The deficit was primarily financed at the expense of issuance of government and municipal bonds and federal budget loans, other credits, and revenues generated by privatization of state and municipally owned property.

The following conclusions may be derived basing on the analysis of quantitative characteristics of financial aid to the budgets of RF subjects from the federal budget (see *Table 16*).

First, the total amount of financial support (including the balance of funds borrowed from and repaid to the federal budget) of regions at the expense of the federal budget has somewhat increased in comparison with the figures registered in the preceding year and made over 3 per cent of GDP in 2002. Second, subsidies for equalization of minimal budgetary security still made the bulk of the financial aid (transfers from the Fund of Financial Support of Regions) – over 50 per cent of the total amount of financial aid, while subventions and subsidies from the Compensatory Fund (CF) made about 15 per cent of the total amount of financial aid.

*Table 16*

**Federal financial aid to budgets of other levels in 1992 through 2003 (in % of GDP)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001		2002		2003*	
										Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP
<b>Subsidies and subventions</b>	0,00	0,02	0,09	0,06	0,09	0,13	0,10	0,06	0,15	49060,0	0,54	31059,2	0,34	31905	0,24
<i>Including:</i>															
Subsidies and subventions to CATEs and the town of Baikonur									0,11	10590,0	0,12	11544,4	0,13	14538	
Subsidies to CATEs														7955	
Subsidies to the town of Baikonur														564	
Capital investment subventions to CATEs														4195	
Resettlement subventions to CATEs														824	
Subventions to CATEs for financing of CATE development programs														1000	
Other subsidies and subventions									0,04	38470,0	0,42	19514,8	0,21	17368	
Subsidy to the town of Sochi														1046	
Subsidies to budgets of RF subjects to compensate for losses relating to excises on tobacco and alcohol products														6000	

*Table 16 (cont'd)*

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003*
--	------	------	------	------	------	------	------	------	------	------	------	-------



											Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP
Subsidies compensating losses relating to maintenance of HPU objects transferred under jurisdiction of local governments															5000	
Other subsidies to budgets of RF subjects															4069	
Other subventions to budgets of RF subjects and local governments															1253	
<b>Subventions</b>	0,79	0,69	0,42	0,12	0,12	0,09	0,02	0,20								
<b>Transfers from FFSR</b>	0,00	0,00	0,36	1,17	1,04	1,22	1,12	0,99	0,96	103210,0	1,14	147490,9	1,62	173168	1,33	
<i>Including:</i>	0,00							0,00								
Transfers	0,00	0,00	0,36	0,86	0,68	0,86	1,00	0,99	0,96	103210,0	1,14	147490,9	1,35	173168		
Of which: state support of seasonal deliveries to the North									0,06	7000,0	0,08	8963,0	0,08	8809		
Transfers at the expense of VAT	0,00	0,00	0,00	0,31	0,36	0,36	0,12									
<b>Subsidies and subventions from the Compensatory Fund</b>										33380,0	0,37	40757,6	0,45	47011	0,36	
<i>Including:</i>																
Subsides for implementation of the law on social security of disabled persons										11480,0	0,13	11943,7	0,13	6630		
Subventions for implementation of the law on state family allowances										21900,0	0,24	23904,5	0,26	22213		

*Table 16 (cont'd)*

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003*
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**RUSSIAN ECONOMY in 2002**  
trends and outlooks

											Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP
Subventions for compensation of privileges related to payment for HPU services in accordance with the federal legislation															13820	
Other subventions and subsidies from Compensatory Fund															4349	
<b>Resources of the Fund of Co-Financing of Social Expenditures</b>													18732,1		5000	0,04
<b>Resources of the Fund of Regional Development</b>								0,03		4530,0	0,05	17491,7	0,19	25072	0,19	
<b>State support of road networks</b>							0,18	0,11		24880,0	0,27	29736,0	0,33	39000	0,30	
<b>Resources of the Fund of Reformation of regional finances</b>										0,0	0,00	1200,0	0,01	1300	0,01	
<b>Funds transferred as mutual payments</b>	0,61	1,95	2,54	0,42	0,81	0,43	0,36	0,14	0,28	4510,0	0,05		0,00			
<b>Loans minus repayment to other budgetary levels:</b>	0,09	0,03	0,02	0,04	0,23	0,64	-0,03	-0,10	-0,08	1625,2	0,02		0,00			
<b>Arrears of transfers from budgets of RF subjects to target budgetary funds</b>	0,00	0,00	0,00	0,02	0,05											
<b>Other types of financial aid</b>									0,00	11500,0	0,13	8675,0	0,10	14240		

*Table 16 (cont'd)*

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003*
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											Rub. mil.	% of GDP	Rub. mil.	% of GDP	Rub. mil.	% of GDP
<i>Including:</i>																
Funds transferred to budgets of other levels for implementation of state programs									0,00		10400,0	0,11		0,00		
Measures of regional development															14240	
Total: funds transferred to budgets of other levels	1,49	2,70	3,4	1,8	2,3	2,5	1,60	1,36	1,54	232695,2	2,56	275210,4	3,03	336697	2,58	
Expenditures of the federal budget	21,76	21,18	23,0	16,6	15,8	15,3	14,5	14,62	8,95	1325688,2	14,58	1947386	21,42	2345641	18	

\* As stipulated by the law on the federal budget for year 2003.

The factors behind the growing amount of funds transferred to subjects of the Russian Federation from the federal budget were increases in amounts of following budgetary items: subsidies for equalization of minimal budgetary security increased to 1.6 per cent of GDP, funds transferred in the course of mutual payments (including the funds assigned for compensation of additional expenditures of regional budgets because of decision taken by higher level authorities) and an increase in the balance of granted and repaid loans from the federal budget. At the same time, the growth in the amount of transfers from the Fund of Financial Support of Regions in comparison with the figures registered in the preceding year was planned, while the amount of funds transferred in the process of mutual payments increased due to such factors as assignment of resources from the governmental reserve fund for liquidation of extraordinary situations and compensation of additional expenditures borne by regional authorities in relation to decisions taken by higher level authorities (this item includes transfers to the budgets of RF subjects aimed to rise wages and salaries financed from the budget and financing of other decisions of federal authorities generating growth in expenditures of sub-national budgets).

An analysis of distribution of financial aid from the federal budget across regions reveals that dependence of consolidated budgets of RF subjects on federal financial support somewhat increased in comparison with the preceding year: while in 2001 about 15 per cent of regional and municipal budgetary expenditures were financed from the federal budgets, in 2002 this indicator exceeded 17 per cent. This trend may be explained by the growth in the total amount of assigned federal funds discussed above (an increase in the amount of FFSR, assignment of additional types of federal aid, and the expansion of the list of federal expenditure mandates financed at the expense of subsidies and subventions from the Compensatory Fund). As before, the list of RF subjects most heavily financed at the expense of federal financial aid include such regions as the Chechen Republic, Republic of Tyva, Ust'-Orda Buryat Autonomous Okrug, Komi-Permyak Autonomous Okrug, the Republic of Dagestan, the Ingush Republic, the Republic of Altai, Yevreyskaya Autonomous Oblast, the Karach-Cherkessian Republic, Aginsky-Buryatsky autonomous okrug, the Karachayevo-Cherkesskaya Republic, the Kabardian-Balkarian Republic, the Koryak autonomous okrug, the Kabardino-

Balkarian republic, Aginsky Buryat Autonomous Okrug, Koryakian Autonomous Okrug, the Republic of North Osetia.

On the whole, the analysis of trends in the development of interbudgetary relations in 2002 did not reveal any significant changes in comparison with 2001 with exception of fluctuations of some indicators, such as an increase in the total amount of federal interbudgetary transfers to the budgets of RF subjects and insignificant changes in the structure of tax revenues of regional budgets.

### **The Law on the Federal Budget for Year 2003**

The law on the federal budget for year 2003 contains a number of substantial novations concerning the relations between the federal budget and the budgets of RF subjects, as well as formation of regional budgets. The most significant provisions of this legislative act as concerns interbudgetary relations and sub-national finances will be discussed below.

#### **Distribution of Tax Revenues among Levels of Budgetary System**

The law on the federal budget stipulates some changes in proportions of the distribution of certain federal taxes among budgets of different levels necessary to compensate the losses borne by budgets due to the abolishment of taxes on motor road users and on vehicle owners since January 1, 2003.

The following most significant novations relating to changes in the structure of distribution of tax revenues among the levels of the budgetary system shall be pointed out:

First, the rate of excises on fuel and lubricants (gasoline, diesel fuel, and motor oil) due to the federal budget was lowered to 40 per cent. In the preceding years all revenues generated by this tax were due to the federal budget.

Second, the law on the federal budget stipulates that in 2003 the total amount of revenues from excises on tobacco products shall be transferred to the federal budget, while previously the revenues generated by this tax were equally apportioned between the federal budget and the consolidated budgets of RF subjects where respective taxpayers were situated.

Third, it was proposed to grant the 15 per cent share of revenues generated by land tax, which had been previously due to the federal budget, to regional and municipal budgets to be equally apportioned between these budgetary levels.

Fourth, the law on the federal budget for 2003 has corrected the faults characteristic of laws on the budget for 2001 and 2002, which just stipulated that revenues from excises on vodka and other alcohol products should be equally distributed between the federal budget and the consolidated budgets of RF subjects. As a result, in the course of administration of the revenues of the federal budget federal treasury offices distributed revenues from excises on vodka and other alcohol products in equal shares between the federal budget and the consolidated budgets of RF subjects at each stage of sales (both at the stage producers transferred goods to excise warehouses, and at the stage the goods were transferred from excise warehouses to the retail trade network. The law on the federal budget for 2003 stipulates that the total amount of excises on vodka and other alcohol products collected at the stage of transfer of goods to excise warehouses shall be due to the federal budget and the total amount of excises collected at the stage of transfer to the retail trade network shall be due to regional budgets. As a result, the revenues from excises on alcohol products are more evenly distrib-



uted across the country's territory and better correspond to the volumes of consumption of alcohol products across regions.

It is necessary to point out that on the whole the enacted novations concerning the distribution of tax revenues among the levels of authorities will result in an improvement of effectiveness of the system of interbudgetary relations. For instance, the transition to the new methods of apportionment of excises on alcohol products, centralization of excises on tobacco products and decentralization of a part of the land tax will result in more fair distribution of revenues among the levels of authorities, since these developments are aimed to centralize taxes imposed on the base unevenly distributed across the national territory, while tax revenues imposed on the immobile and evenly distributed base shall be centralized.

At the same time, it shall be pointed out that it is planned to decentralize and assign to the consolidated budgets of RF subjects a considerable portion of excise revenues from oil products (60 per cent). In the case it is taken into account that since January 1, 2003, the new procedure governing collection of excises on oil products, which transfers the obligation to pay excises to wholesale and retail trade, this centralization may be viewed as an attempt to redistribute excise revenues in favor of the budgets of RF subjects where oil is consumed. This approach (not taking into account a possible decline in revenues due to deteriorated collection of excises) will allow to distribute revenues from indirect taxes on use of motor roads among regional budgets in accordance with evaluations of traffic intensity expressed via volumes of wholesale and retail sales of oil products. However, it would seem more feasible to organize collection of excises on oil products similarly to excises on alcohol products, i.e. a portion of the excise exacted from producers is transferred to the federal budget, thus eliminating ineffectiveness related to uneven distribution of respective plants across the national territory.

## **Financial Aid to Budgets of Other Levels**

The law on the federal budget for 2003 also contains a number of novations concerning distribution of financial resources provided by the federal budget among subjects of the Russian Federation.

The methods of distribution of resources from the Fund of Financial Support of Regions applied in the course of drafting of the law on the federal budget for 2003 have not changed considerably in comparison with the preceding year. Subsidies for equalization of budgetary security are still distributed among RF subjects basing on the comparison of estimated budgetary security, i.e. indicators of the per capita tax potential adjusted for the interregional index of the volume and cost of provision of base budgetary services. At the same time, 80 per cent of FFSR funds are distributed among all RF subjects where estimated per capita budgetary security is below the national average (the funds are distributed in proportion to the value of the aforesaid deviation), while the balance (20 per cent) is apportioned aiming to equalize per capita budgetary security indicators (the number of regions receiving subsidies from the 20 per cent portion of the Fund and the target level of equalization is determined proceeding from the absolute amount of resources the Fund assigns for these purposes).

At the same time, some changes were introduced in the methods of distribution of subsidies aimed at the equalization of budgetary security and calculation of regional tax potentials and expenditure requirements. For instance, since 2003 the methods applied to distribute

transfers have envisaged allocation of so called compensatory payments to certain regions<sup>17</sup>. These payments are primarily aimed, as formulated in the methods of apportionment of FFSR resources, to “maintain rates of growth in subsidies for equalization of budgetary security at a level at or above that of 2002 as adjusted for inflation” (12 per cent). In other words, the amount of subsidies to each RF subject shall be set at a level at or below the target stipulated by the law for 2002 as adjusted for estimated inflation rates. The amount of payment is calculated as the difference between the estimated amount of transfer for 2003 and the amount of transfer received in 2002 as adjusted for the estimated changes in the price index (only for regions receiving FFSR financing in 2002). The total amount of these compensations made Rub. 14.7 billion, or 8.5 per cent of FFSR. On the one hand, introduction of such compensatory payments is conditioned by the necessity to obtain approval of changes in the methods of FFSR funds apportionment and initial data, on which the distribution should be based, from RF subjects whose share of transfers declines in relation to the changes. On the other hand, the use of the mechanism of compensatory payments can not be a permanent component of the methods of distribution of equalizing transfers, since the present methodology seems to be non-optimal proceeding from a number of considerations, while its improvement shall result in a decrease in the number of recipients of equalizing subsidies. In this situation maintenance of amounts of financial aid at the previous level would result both in the lack of incentives to enhance the effectiveness of the system of apportionment of transfers on the whole, and the lack of effort to enhance the effectiveness of fiscal policies in regions being major recipients of federal financial aid (excluding subventions for financing of federal expenditure mandates) exceptionally in the form of compensatory payments. Therefore, admitting on the whole the necessity to compensate for sharp fluctuations in financial aid to regions resulting from changes in apportionment methods, it seems that such a mechanism should be more flexible and its role should be reduced to a partial compensation of losses within a predetermined amount. At the same time, the use of such compensations should be justified by considerable changes in the methods and not be reduced to a mechanical repayment of the difference in received financial aid.

It shall be also pointed out that no changes were directly introduced in the methods of calculation of subsidies aimed to equalize budgetary security in 2003. Accordingly, the fluctuations in the amounts of financial support most probably resulted from changes in the initial data. For instance, in the course of calculation of the tax potential index for 2002 there were used initial data on the gross regional product for 1998 and 1999, while calculations for 2003 relied on average values registered in 1999 and 2000. Taking into account the fact that the maximal rates of economic growth were observed in 2000, new initial data even used in accordance with the old methods considerably affected the results.

According to the apportionment of resources of the Fund of Financial Support of Regions as stipulated in the law on the federal budget for 2003, the number of RF subjects not receiving FFSR financing remained at the level registered in the preceding year (18 regions).

The methods of distribution of subventions and subsidies from the Compensatory Fund also has not changed considerably in comparison with the preceding period. The only novation was the abolishment of financing of expenditures borne by the consolidated budgets of RF subjects in relation to privileges granted to the military, militia, employees of the Interior

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<sup>17</sup> It shall be pointed out that in spite of the similar term, such payments do not relate to subventions and subsidies from the Compensatory Fund.





Ministry and Tax Police, and customs officials as concerns the payments for housing and public utilities services and communication services at the expense of subsidies from this fund. Instead of this item, the methods of distribution of the CF resources for 2003 envisage assignment of subsidies aimed to compensate for privileges relating to the payments for housing and public utilities services in accordance with the federal law "On amendment of the law of the Russian Federation 'On principles of the federal housing policies' and other legislative acts of the Russian Federation as concerns the improvement of the system of payments for housing and public utilities services." At the same time, proceeding from the initial data underlying the calculation of subsidies' amounts, it may be concluding that these subsidies are assigned exceptionally to compensate for privileges granted to disabled persons in relation to the payments for housing and public utilities services.

The law on the federal budget envisages Rub. 6 billion worth of subsidies for compensation of losses relating to excises on tobacco products, vodka, and other alcohol products in the composition of federal aid to lower budget levels. It shall be pointed out that for the first time amounts of such compensations have been calculated for all regions in accordance to the single methodology. Regions where the share of excises on tobacco products in the tax revenues of consolidated budgets for 2001 made over 1 per cent were eligible to participate in the distribution of compensations for the losses related to excises on tobacco products. The compensations relating to tobacco excises were apportioned proceeding from the total amount of available funds (Rub. 6 billion) in proportion to the tobacco excise generated revenues of regional budgets in 2001 taking into account respective levels of estimated budgetary security (after the distribution of FFSR resources) minus the estimated amount compensation for losses at the expense of FFSR financing (estimated). In addition to the compensation for losses relating to excises on tobacco products, the law on the federal budget envisages compensation for losses relating to excises on vodka and other alcohol products. These compensatory subsidies were distributed among the subjects of the Russian Federation where the share of excises on alcohol products in the tax revenues of consolidated budgets for 8 months of 2002 made over 10 per cent, while the share of respective excise revenues in the total amount of such excises generated in the Russian Federation exceeded the share of population in the total population of the Russian federation more than twofold. In accordance with these limitations, the right for the compensation was granted only to two RF subjects – the Kabardian-Balkarian Republic and the Republic of North Osetia. The total amount of such compensations made Rub. 251.7 million.

The law on the federal budget for 2003 envisages that since January 1, 2003, the RF Government shall ensure the transfer of ownership of budgetary loans for support of the seasonal deliveries to the North granted in 1994 and 1995 and earlier transferred under management of RF subjects. It shall be pointed out that until recently the federal authorities, which could not enforce the payment of debt on the part of regions have transferred the debt under management of regions. It seems that the transfer of the aforesaid subsidies in ownership of regions will result in formalization of the current situation where RF subjects can not repay the debt due to the lack of funds, and the write off of regional debts to the federal budget.

The provisions of the law on the federal budget for year 2003 also envisage assignment of Rub. 5 billion for repayment of federal indebtedness to RF subjects in the form of subsidies compensating for the losses relating to maintenance of housing, public utilities, and objects of the social and culture sphere transferred under jurisdiction of local governments. In previous years these expenditures were classified in the item "Funds transferred in the course of

mutual payments”; the total amount of the respective financing was not approved by the law on the federal budget and the Finance Ministry determined the concrete amount of subsidies to individual regions in the course of budget administration. Therefore, the law for year 2003 considerably curbs subjectivism in the distribution of funds pertaining to this item. At the same time, taking into attention the specifics of subsidized expenditures of regional budgets, it would be feasible to envisage in the law on the federal budget certain deadlines for transfer of housing owned by state agencies in municipal ownership thus facilitating the completion of the program of transfer of housing owned by state agencies in municipal ownership financed from the federal budget.

Analyzing the novations contained in the law on the federal budget for year 2003, it shall be pointed out that this document attempts to regulate tax privileges granted to the town of Baikonur (in preceding years such privileges were used for massive tax evasion as concerns excises and VAT). Similarly to the preceding year, provisions of the law envisage that all taxes and charges exacted in the territory of the town of Baikonur shall be due to the town budget, however, they at the same time limit the right of town authorities to grant tax privileges setting several eligibility criteria, including the necessity to have premises or property complexes for production and sale of goods (works, services) in the Baikonur territory. At the same time, the law prohibits to grant privileges relating to VAT, excises, profit tax on organizations, single social tax, and other federal taxes and charges. The law also prohibits to register in the town legal entities – taxpayers not operating in the Baikonur territory. While admitting that these stipulations considerably limit the potential for unfair tax competition, it is necessary to point out that it would be more feasible to either to make respective amendments to the Tax and Budget Codes, or adopt a special legislative act regulating the tax and budgetary status of extraterritorial administrative entities which, in contradistinction to the law on the federal budget, would be valid for more than one budget year.

The law on the federal budget for year 2003 instructs the RF Government to prolong the term of repayment of budgetary loans amounting to Rub. 20 billion granted before January 1, 2003, until September 30, 2003. The prolongation of budgetary loans is a form of financial aid governed by rather non-formalized procedure and therefore very subjective. On the one hand, it is necessary to allow regional budgets defer their obligations relating to federal budgetary loans in the situation where wages and salaries of employees of the budgetary sphere are rising in the framework of the single tariff schedule, while revenues decline due to incomplete compensation for the abolition of the tax on motor road users. On the other hand, it would be feasible to impose a number of conditions on such deferments, for instance setting forth requirements to undertake measures aimed to rehabilitate regional finances.

It is necessary to point out that the law on the federal budget for 2003 widely employs such type of penalties for infringements on the budgetary legislation and misuse of funds as transfer to the federal budget of the share of federal tax revenues due to the budgets of RF subjects and closed administrative territorial entities (CATEs). For instance, Article 77 of the law stipulates that in the case of failure to comply with the terms of repayment and misuse of funds to be repaid to the federal budget (i.e. budgetary loans and credits), respective amounts will be exacted by the federal treasury at the expense of revenues generated by federal taxes and charges due to respective budgets. This type of exaction is a most effective economic lever of influence on budgetary policies of RF subjects not being recipients of unconditional financial aid, or receiving insignificant amounts of subsidies from the federal budget.



In the framework of financial resources assigned from the federal budget to the budgets of RF subjects for financing of road networks, there has been formed a reserve amounting to Rub. 35 million, which the RF Government uses to increase the amounts of subventions and subsidies to the budgets of RF subjects for financing works relating to commonly used motor roads destroyed in the result of natural calamities. RF subjects are eligible to receive funds from this reserve only in the case they have formed own reserves for same purposes and in the case these funds prove insufficient to finance respective works. The creation of this reserve is also conditioned by the necessity to provide federal financial aid to regions in the case they may have difficulties financing road networks due to the abolishment of the tax on users of motor roads and the tax on vehicle owners.

Similarly to the preceding law on the federal budget, the resources of the Fund of Regional Development (total amount is Rub. 25.0 billion) are primarily used to finance two federal targeted programs: the federal targeted program "Social and economic development of the Republic of Tatarstan until 2006" amounting to Rub. 11.3 billion and the federal targeted program "Social and economic development of the Republic of Bashkortostan until 2006" amounting to Rub. 7.4 billion. Similarly to 2002, these considerable amounts of financing of development programs in two regions are primarily conditioned by the arrangements between the authorities of the two Republics and the federal center concerning the compensation for abolishment of the special fiscal regime applied to these RF subjects prior to 2001. However, it is necessary to point out that in the situation where funds are lacking to compensate for the decline in revenues resulting from the abolishment of the tax on users of motor roads and the peak of repayment of the external debt, it seems very inefficient and unfeasible to assign these considerable financial resources to two RF subjects ranked among national leaders in terms of budgetary security.

This structure of federal budgetary expenditures as set forth in the sub-item "Fund of Regional Development" seems to be one of the most serious flaws of the law on the federal budget for year 2003 as concerns interbudgetary relations. On the one hand, previous arrangement should be complied with in order to maintain stability of relations between the Russian Federation and its subjects. However, on the other hand, such arrangements were not officially registered in respective regulatory or legislative acts. In this situation adherence to the arrangements with two subjects of the Russian Federation only increases the asymmetric character of fiscal federalism. It would seem feasible to considerably reduce, if not abolish, these federal targeted programs and use the funds made available for other purposes.

The law on the federal budget for year 2003 contains a provision according to which territorial offices of the Tax Ministry ensuring that regional and local budgets receive additional revenues may act on paid basis depending on their performance by concluding agreements with the executive authorities of RF subjects and municipal entities. The additional revenues should be accounted for as proceeds from entrepreneurial activities and fully utilized for maintenance of territorial tax offices, development of material and technical base of territorial tax offices, and security of premises. On the one hand, this provision might be feasible in the case the regional authorities and local governments bore full costs of administering of regional and local taxes respectively. In this case, introducing regional and local taxes regional and local administrations could conclude agreements with territorial tax offices according to which the latter were reimbursed for the costs of administering these taxes. On the other hand, according to the legislation currently in force, administering of all taxes and charges in the Russian Federation is vested with federal tax agencies and carried out at the expense of the federal budget. In this situation no criteria exist to evaluate the performance of tax agencies as concerns mobilization of additional reve-

nues and, respectively, determine the amount of remuneration of tax authorities, what, in turn, may result in abuse of taxpayers on the part of tax agencies.

Similarly to preceding years, the law on the federal budget for 2003 approved the list of heavily subsidized regions whose budgets, according to Article 49, should be administered by the federal treasury offices. The list contains 29 regions, in comparison with the list for 2002, the Republic of Sakha, Primorski krai, and Taimyr Autonomous Okrug were excluded, while the Republic of Mari El was included.

### The Law on Federal Budget: Quantitative Characteristics

As concerns financial aid to regions, for respective major characteristics of the federal budget for 2003 see *Table 17*.

*Table 17*

#### The law on the federal budget for year 2003: Financial aid to budgets of other levels

	Rub. mil.	% of GDP
Subsidies and subventions	31905	0,24
<i>Including:</i>		
Subsidies and subventions to CATEs and the town of Baikonur	14538	0,11
Subsidies to CATEs	7955	0,06
Subsidies to the town of Baikonur	564	0,00
Capital investment subventions to CATEs	4195	0,03
Resettlement subventions to CATEs	824	0,01
Subventions to CATEs for financing of CATE development programs	1000	0,01
Other subsidies and subventions	17368	0,13
Subsidy to the town of Sochi	1046	0,01
Subsidies to budgets of RF subjects to compensate for losses relating to excises on tobacco and alcohol products	6000	0,05
Subsidies compensating losses relating to maintenance of HPU objects transferred under jurisdiction of local governments	5000	0,04
Other subsidies to budgets of RF subjects	4069	0,03
Other subventions to budgets of RF subjects and local governments	1253	0,01
Transfers from FFSR	173168	1,33
<i>Including:</i>		
Transfers	173168	1,33
Of which: state support of seasonal deliveries to the North	8809	0,07
Subsidies and subventions from the Compensatory Fund	47011	0,36
<i>Including:</i>		
Subsides for implementation of the law on social security of disabled persons	6630	0,05
Subventions for implementation of the law on state family allowances	22213	0,17
Subventions for compensation of privileges related to payment for HPU services in accordance with the federal legislation	13820	0,11
Other subventions and subsidies from Compensatory Fund	4349	0,03
Resources of the Fund of Co-Financing of Social Expenditures	5000	0,04
Resources of the Fund of Regional Development	25072	0,19
State support of road networks	39000	0,30
Resources of the Fund of Reformation of regional finances	1300	0,01
Other types of financial aid	14240	0,11
<i>Including:</i>		
Measures of regional development	14240	0,11
<b>Total: funds transferred to budgets of other levels</b>	<b>336697</b>	<b>2,58</b>

*Source:* the law on the federal budget for year 2003.

The data presented in the Table demonstrate that the total amount of financial aid to be granted to regions in 2003 is planned at 2.58 per cent of GDP, what is somewhat below the amount targeted in the law on the federal budget for year 2002 (3 per cent). Transfers from the Fund of Financial Support of Regions made the bulk of the expenditures for financial aid to budgets of other levels (60 per cent). The aggregate share of resources distributed in accordance with formalized methods (transfers from the Fund of Financial Support of Regions and



subventions and subsidies from the Compensatory Fund) made about 75 per cent of the total amount of financial aid. As compared with the targets set forth in the law on the federal budget for 2002 across all types of financial aid to regions, the more pronounced decline was detected in relation to such items (in per cent of GDP) as subsidies from the Fund of Reform of Regional Finances (78 per cent of the figure registered in 2002), subventions and subsidies from the Compensatory Fund (80 per cent), transfers from FFSR (82 per cent). The financing of road networks remained at the level targeted in the law on the budget for 2002.

Basing on the results of the analysis of characteristics of the law on the federal budget for year 2003 concerning interbudgetary relations, the following conclusions may be derived:

1. Changes in proportions of apportionment of revenues generated by federal taxes planned for 2003 should, on the whole, result in more even distribution of tax revenues among budgets of different levels, what would allow regions to partially compensate for losses borne in relation to the abolishment of the tax on users of motor roads (by transferring certain excises in the budgets of regions where excisable products are consumed), and generate additional revenues of the federal budget due to centralization of excises on tobacco products, the base of which is unevenly distributed across the national territory.

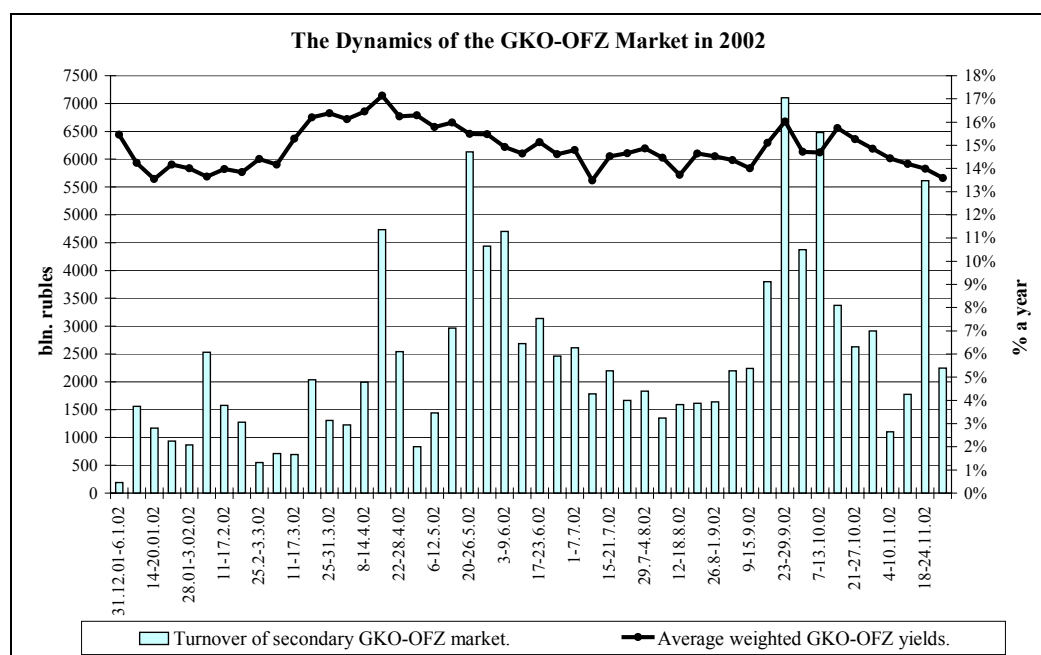
2. The system of federal financial aid to regions on the whole answers the principles set forth in the Program of reforming fiscal federalism until 2005 (the amounts of financial aid and methods of its apportionment will be presented at the second or third reading); however, certain types of financial aid to regions present in the budget rises questions. For instance, it does not seem feasible to assign about Rub. 20 billion (an amount equal to the planned amount of financial reserve for the next year) for implementation of federal targeted programs of development of Republics of Tatarstan and Bashkortostan in the situation where federal budget is stretched to meet external debt obligations and compensate for losses resulting from the lighter tax burden.

## **2.4. Russia's financial markets**

### **2.4.1. The public debt market**

**Internally held public debt.** As of the beginning of 2003 the internally held public debt in form of securities accounted for 654.5 bln roubles, that is about 6% of the GDP. Of this the basic sum of the debt (up to 90%) was held in federal bonds (OFZ) with a permanent or fixed yield, and amortization federal bonds, that is securities with a circulation period exceeding one year at the time of issue. The share of short-term government securities (GKO) did not exceed 3%.

The past year can be characterised first of all by an unprecedented decrease in dividend yields with low sales during the most part of the year (*see fig. 27*). The nominal average yield of the GKO-OFZ when redeemed decreased to 13.5-14% per annum, while the secondary market turnover in certain weeks went down under 1 bln roubles. Thus at the beginning of the year monthly sales became minimal since the spring of 1999, when the market was only starting to function after the 1998 crisis.



Source: Information agency “Finmarket”, calculations by the IET.

Fig. 27

The average yield level at the internally held public debt market in the Russian Federation grew in March and May of 2002. The average yield of the GKO-OFZ when redeemed reached 16.5-17.5% per annum, which was the highest peak since July – August of 2001. At the same time it should be noted that taking the downtrend in the inflation rates into consideration the real value of debts at the domestic market in that period became positive and accounted for 3-3.5% per year.

By the middle of 2002 a sales growth was registered. A greater interest to the GKO-OFZ can be explained as we see it first of all by currently lower inflation rates, which made investments into bonds at their present yields more attractive. Secondly, the Ministry of finance of the Russian Federation increased its additional distribution of bonds (in certain days these additionally floated securities accounted for as much as 50% of the total secondary market turnover). In the third place there appeared a new big player at the market in April – the Pension Fund of the Russian Federation.

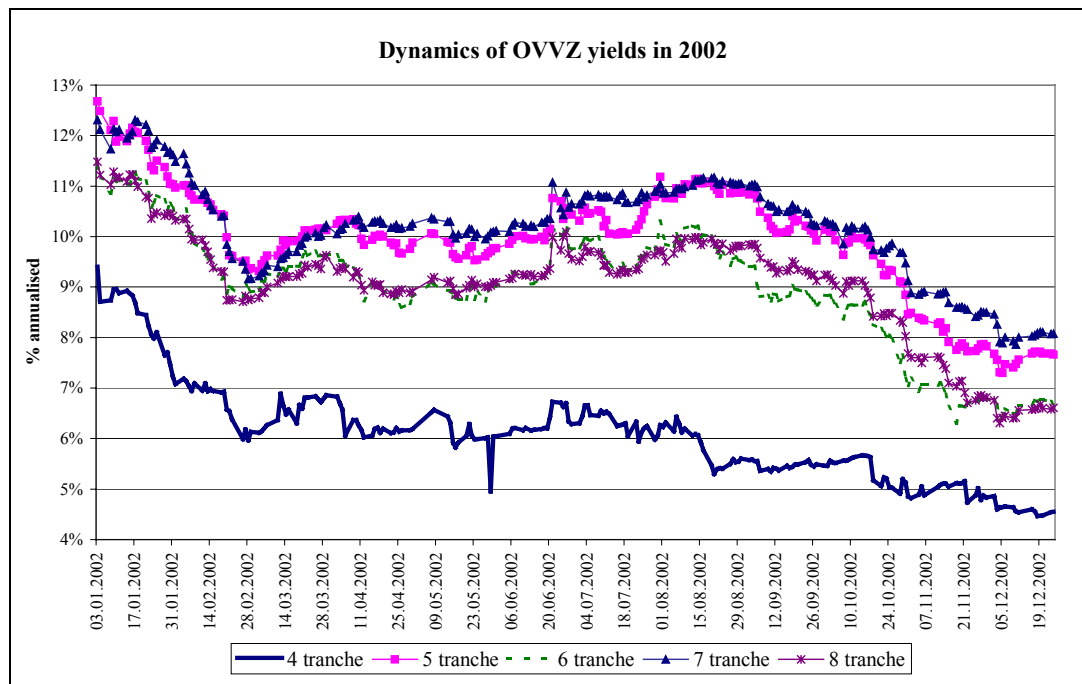
But already in June – July the securities’ yield dropped again to its historical minimum – 13.5-14.5% per annum. An essential point should be noted here, though, the one that adds to the negative assessment of the market situation – in the past months the Pension Fund has become one of the principal market participants that ensure a high demand for bonds, while private investors have practically lost their interest to this type of investments. According to its chairman M. Zurabov the Pension Fund’s monthly investments plans exceeded 3.5 bln rubles.

In 2002 on the whole the Ministry of finance held 29 auctions to float securities. The supply accounted for 180 bln rubles, including 29 bln rubles worth of securities to be paid off in 6 months, 19 bln rubles in one year, 26 bln rubles in two years, 23 bln rubles in 3 years and 95 bln rubles from 3 to 10 years. Total demand on the part of investors reached 134.9 bln rubles, there were floated bonds for a total sum of 86.2 bln rubles, that is less

than 48% of the total securities supply. The average yield at the auctions was 15.28%. The Ministry of finance of the Russian Federation sold securities for 80.9 roubles.

**External debt.** The total external public debt of the Russian Federation (according to the internationally accepted calculation methods and data provided by the Central Bank of Russia) in nine months of 2002 decreased by 7 bln US dollars from 113.5 to 106.5 bln dollars. The securities part of the debts in the first three quarters got reduced from 28.8 to 28.0 bln dollars, first of all due to the pay off of a part of European bonds floated within the framework of the second restructuring of debts of the former USSR to the London Club of creditors. During the whole of the year there were circulated at the market 6 tranches of the OVVZ and 10 tranches of the European bonds.

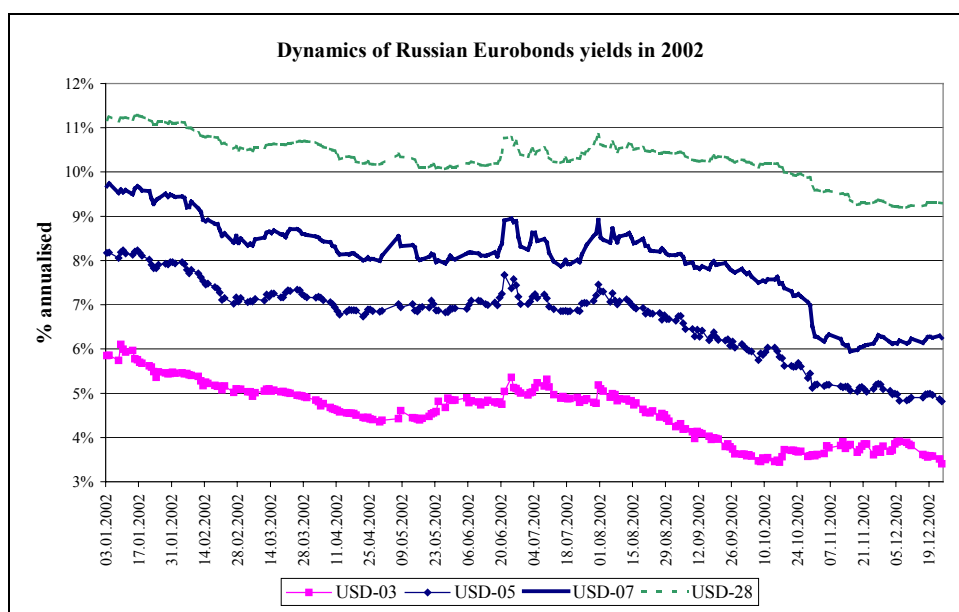
In 2002 a quick growth of quotations of all Russian securities continued (see *Fig. 28 and 29*). In particular, the yield of the OVVZ when redeemed decreased from 9-12.5% to 4.5-8.0 per annum, of the European bonds to 3.5-9.5% par annum. Thus the income derived from holding Russian securities (not counting bond coupons payments) reached 38.2% for the European bonds (the issue with pay-off in 2030) and 43.2% for the OVVZ (the 7<sup>th</sup> tranche, pay-off in 2011, they are referred to as debts of the Russian Federation).



Source: Information agency "Finmarket".

Fig. 28

Such a growth of prices on Russian securities as we see it is predominantly explained by a greater demand for them on the part of international investment funds. The stabilized economic situation in Russia, good showings in economic growth, a low probability of default on external debts made it possible for the investors to review their limits for Russian securities and to increase them. In one year the national ratings of the Russian Federation climbed several steps and by the end of the end reached the BB+ level (in national currency) and BB (in foreign currencies, Standard & Poor's) and Ba2 (Moody's), that is got really close to the investment ratings category.



Source: Information agency "Finmarket".

Fig. 29

It should be noted that in January – February 2002 the Ministry of finance of the Russian Federation was paying off the OVVZ of the 4<sup>th</sup> series at the secondary market, which (together with payments by the Bank of Russia to the International Monetary Fund performed before due time) allowed unburdening the federal budget for 2003. At present the default bonus for the 4<sup>th</sup> tranche of the OVVZ (obligations of the former USSR, which are traditionally viewed by the investors as the most risky ones; to be paid off in 2003) is assessed by the investors as 1 per cent point per annum, the yield of the European bonds to be paid off in the near future taken into consideration).

In addition to technical factors (a correction after the period of quick growth of quotations) the profitability of Russian securities in March was influenced by a number of other important factors. First of all, all the positive information about Russia's economic growth outlooks in 2002 had already been taken into account in the bonds' prices, as well as Russia's higher national credit ratings by international agencies. At the same time the real sector showings in the last months of 2001 and in the beginning of 2002 were clearly negative. Secondly, in March the Ministry of finance was probably not pursuing the policy of repurchasing its securities, which decreased the total demand for Russian securities. Hence, one can assume, that the yield reduction by 1-1.5 per cent points in January – February of 2002 was due to debts' pay-off operations, and in March bonds' ratings returned to the level corresponding to the risk assessments by the investors. Thirdly, in March there appeared expectations about a soon increase of rates by the US Federal Reserve System, which influenced rates of all assets in US dollars to grow.

In April 2002 the foreign debts market of the Russian Federation witnessed contradictory tendencies. When yields of the European obligations continued to decrease during the whole of the month and reached the lowest level in their history, the OVVZ ratings moved in the opposite direction. Yields of the 4<sup>th</sup> and the 6<sup>th</sup> issues of OVVZ, which dropped at the very beginning of the month got stabilized. At the same time prices on the 5<sup>th</sup> and the 7<sup>th</sup> issues remained at the same level as in March or even got slightly diminished. These changes in rat-





ings of Russian securities as we see it can predominantly be explained by lack of significant news from Russia and a relatively quiet situation at the developing markets on the whole (the persistent crisis in the Argentine has now practically no influence on other markets).

In June – July 2002 the Russian external debts market witnessed a new fall in securities ratings caused first of all by the developments in Brazil. The menace of a foreign debt default in this Latin American country, which is one of the largest loan securities issuers led to an overall revaluation of investment risks for bonds of developing markets. In this way the yield growth influenced also Russian bonds in spite of clearly expressed positive trends (gold and foreign currency reserves growth and the fact that the European Union acknowledged Russia as a country of market economy). In particular in the second part of July the yield of all of the OVVZ and the European bonds (independently of their pay-off terms) grew by approximately 1 per cent point.

In August 2002 the yield growth tendency at Russia's external debts market stopped and gave place to a downtrend for the most types of securities. These changes in Russian securities' ratings were basically caused by the fact that Standard & Poors increased the national rating of Russia from B+ to BB- (on July 26, 2002) and fluctuations at international markets were dampened among other things due to the agreement between Brazil and the IMF on a package of financial aid of 30 bln dollars. Besides, the negative expectations' potential connected with elections in Brazil in all probability got exhausted in October – November prior to the new president's appointments.

As the most important event at the Russian securities market in November one can regard the restructuring of commercial debts of the former USSR by the Ministry of finance for a total sum of 1.1 bln dollars into European bonds to be paid off in 2010 and 2030.

#### **2.4.2. The Market for Municipal and Subfederal Borrowings**

##### The State of the Market

The market for subfederal and municipal loans consists of two large sectors: bank lending and debt securities (bonds). Furthermore, there are loans of non-market character granted by higher-level government agencies. The market for subfederal and municipal loans was founded in 1992, reached its peak in 1997 and contracted significantly following the 1998 crisis when dozens of territorial government agencies defaulted on their obligations. (*See Table 1*).

As at 1 November, 2002, the estimated volume of the internal market for municipal and subfederal securities was RUR 32.1 billion, or 15 percent of the total volume of the internal market for government securities and one third of the corporate bond market.

Investments of commercial banks into city and regional securities amounted on that date to RUR 17.0 billion, or 53 percent of the market volume, and the volume of lending to subfederal and municipal government agencies was RUR 29.5 billion. Thus, the total funding granted by commercial banks to territorial government agencies was RUR 46.5 billion, or less than 1.2 percent in the structure of the banks' assets.

By November 2002 the exchange turnover in subfederal and municipal securities reached RUR 6.2 billion during the month; the St.-Petersburg Currency Exchange and MI-CEX were the main trade floors, and RTS is gradually entering this market. The yield spread between government securities and subfederal and municipal securities moved in the 1 - 4 percent range. The yield on most of securities was 13 to 18 percent, which, considering the inflation rate, meant an extremely low real interest rate.

Among constituent entities of the Federation borrowing in the internal market, Moscow and St. Petersburg became the largest borrowers (including the bond market). The main amount of accumulated debt nominated in foreign currency also fell to their share. Moscow's eurobonds, with the credit rating equal to the sovereign rating, sold with a spread of 1.0 to 1.2 percent to the yield of RF eurobonds, or within the range of 10 to 11 percent p.a. in Euros. Thus, even the regions formally entitled to borrow in foreign currency (in accordance with the Budget Code, this right has been granted to the regions repaying the accumulated currency debt) found this less attractive compared with internal loans. At the same time, external loans had the advantage of a comparatively longer term and the possibility to count on comparative lowering of the debt burden from currency-nominated liabilities in case the real exchange rate of the Rouble would grow.

The regions were quite successfully repaying or refinancing the accumulated debt against a background of economic growth and increasing budget revenues, and no new defaults occurred in the market. At the same time, a number of entities of the Russian Federation failed to meet their obligations on the so-called 'agricultural' bonds of 1997 - 1998, with maturity up to three years, that had been issued in the course of restructuring regional debts to the federal budget. However, some investors do not think that the default on the 'agricultural' obligations increases the risk on new loans significantly.

Growing investments by pension funds that are expected to take place in the course of the pension reform, create the necessary conditions for a considerable growth of demand for regional and municipal securities, both due to potential investments by the funds themselves and due to the possibility that they would 'squeeze' investor money out of other sectors of the financial market. The trend towards an increase of the international credit rating of the RF, which encourages the growth of regional credit ratings, has the same effect. In this connection, the ability of regional government agencies to use the attracted funds efficiently gains primary importance.

#### Dynamics of Market Growth

The resulting consolidated regional budget for 2002 had a deficit of RUR 44.1 billion, i.e. 2.7 percent of the expense side, or 0.40 percent of the GDP. The budgets of the entities of the RF had a deficit of almost RUR 37 billion (3.0 percent of the expense side), budgets of municipal entities - a deficit of RUR 20.5 billion (2.8 percent of the expense side).<sup>18</sup>

A deficit of the regional consolidated budget was previously observed in Russia in 1999. In 2000 the budget was implemented with a surplus amounting to 0.49 percent of the GDP, and in 2001 the surplus was 0.02 percent of the GDP. There were two reasons that contributed to the increase in budget deficit in 2002 in approximately equal proportions: growth of lending by higher-level budgets and growth in net borrowing on issues of securities and on lending by commercial banks (*Table 18*).

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<sup>18</sup> The amount of deficit of the consolidated regional budget is not equal to the sum total of the deficits of regional and municipal budgets since it does not include the amount of loans extended by regions to municipal entities that are carried as the deficits of municipal budgets but are not included in the deficit of the consolidated regional budget.



Table 18

**Net Borrowings by Regional and Local Budgets (percent of GDP)**

Year	1995	1996	1997	Jan. - Aug. 1998	Jan. - Decem. 1998	1999	2000	2001	2002
Borrowings from subfederal and local government agencies, including:	0.38	0.87	1.43	0.71	0.33	0.15	-0.29	-0.04	0.47
Repayable loans from budgets of other levels	0.07	0.23	0.66	0.05	-0.09	-0.11	-0.03	0.04	0.12
Subfederal (municipal) bonds	N.a.	0.16	0.22	0.08	-0.01	-0.05	-0.27	-0.07	0.16
Other borrowings	0.31	0.48	0.55	0.58	0.43	0.31	0.01	-0.02	0.19
Lowering of balances in budget accounts	...	0.03	-0.18	0.09	0.02	-0.19	-0.30	-0.05	-0.04
Funding deficit out of borrowings and lowering balances in budget accounts	0.38	0.9	1.25	0.8	0.35	-0.04	-0.59	-0.09	0.38

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

The relation of municipal budgets' deficit to their expense side increased only 0.18 percent compared to 2001. The deficit of the consolidated regional budget is explained exclusively by the budgetary policy of RF entities: the surplus of 0.98 percent of the budgets' expense side was replaced by a deficit of 3.02 percent of the expense side. (See Table 19).

Table 19

	<b>Consolidated Regional Budget</b>	<b>Regional Budgets</b>	<b>Municipal Budgets</b>
Year 2002	-2.67	-3.02	-2.81
Year 2001	0.12	0.98	-2.63
Year 2000	3.41	3.95	-1.41

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

In 2002, in 26 RF entities the consolidated regional budget was implemented with a surplus amounting to a total of RUR 10.98 billion, or 2.29 percent of the corresponding budgets' expenses. The median level of the budget surplus was 1.6 percent of the revenues of the corresponding budget. The greatest ratio of surplus to budget revenues was observed in the Lipetsk Oblast (11.9 percent), Jewish Autonomous Okrug (9.5 percent), Chechen Republic (6.6 percent), Yamal-Nentsi Autonomous Okrug (4.8 percent) and the Leningrad Oblast (4.5 percent).

Eight RF entities provided over 81.5 percent of the total surplus: the Yamal-Nentsi Autonomous Okrug (21.2 percent of the total surplus, or RUR 2.3 billion), Krasnodar Krai (11.8 percent, or RUR 1.3 billion), Lipetsk Oblast (11.6 percent, or RUR 1.27 billion), St.-Petersburg (9.7 percent, or RUR 1.1 billion), Leningrad Oblast (7.5 percent, or RUR 0.8 billion), Chukotka Autonomous Okrug (7.5 percent or RUR 0.8 billion), Chelyabinsk Oblast (6.3 percent or RUR 0.7 billion) and Tyumen Oblast (6.1 percent, or RUR 0.7 billion).

The consolidated regional budget of 63 RF entities was implemented with a deficit in 2002. The budget deficit in these regions totalled RUR 55.1 billion, or 3.78 percent of the revenue side of their budgets.

The median value of the budget deficit was 2.1 percent of the budget's revenue side. The highest level of deficit was observed in the Evenki Republic: 30.6 percent of the revenue side (covered out of bank loans); Sakhalin Oblast: 11.5 percent; Nentsi Autonomous Okrug: 8.4 percent; Voronezh Oblast: 7.5 percent; Moscow: 7.4 percent, and Komi Republic: 6.1 percent (*See Table 20*).

*Table 20*

**Implementation of Consolidated Budgets of RF Entities (percent)**

	Budget revenues (RUR thousand)	Budget Surplus (deficit) (RUR thousand)	Surplus (deficit) to revenues	Attracted borrowed funds	Net Borrow- ing to Reve- nues	Interest expenses to reve- nues	Balances in budget accounts to revenues	Net bor- rowings to surplus
<b>Central Federal Superregion</b>								
Belgorod Oblast	12 216 882	-325 092	-2.66	10.42	4.80	6.15	3.62	-180.6
Bryansk Oblast	10 323 730	-180 550	-1.75	3.39	2.06	1.44	0.90	-117.7
Vladimir Oblast	13 504 225	48 793	0.36	4.07	1.26	2.92	3.66	349.0
Voronezh Oblast	16 159 220	-1 300 065	-8.05	23.89	8.48	16.14	2.01	-105.4
Ivanovo Oblast	10 373 746	-49 791	-0.48	1.28	-0.41	1.71	0.92	86.1
Kaluga Oblast	10 050 638	-108 831	-1.08	3.84	1.21	2.86	1.47	-111.4
Kostroma Oblast	6 845 743	-58 894	-0.86	8.49	0.61	8.53	1.44	-70.6
Kursk Oblast	7 713 682	-168 091	-2.18	5.77	2.45	3.69	1.20	-112.4
Lipetsk Oblast	11 944 195	1 270 731	10.64	6.66	-0.70	8.01	11.99	-6.5
Moscow Oblast	71 285 558	-3 355 974	-4.71	30.55	9.14	22.56	5.58	-194.2
Oryol Oblast	7 032 636	-231 530	-3.29	5.68	4.77	0.91	2.54	-144.9
Ryasan Oblast	11 210 363	-152 181	-1.36	2.93	1.23	1.83	2.43	-90.6
Smolensk Oblast	8 156 596	-147 301	-1.81	5.65	1.08	4.80	0.88	-59.6
Tambov Oblast	9 970 166	-200 157	-2.01	3.22	1.93	1.34	0.42	-96.3
Tver Oblast	12 650 858	-462 536	-3.66	12.42	7.41	5.56	4.48	-202.5
Tula Oblast	15 458 952	-545 912	-3.53	7.17	1.90	5.79	0.83	-53.8
Yaroslavl Oblast	16 298 052	-29 451	-0.18	6.11	-1.32	8.08	1.00	733.0
Moscow	281 781 422	-22 392 245	-7.95	11.82	6.23	7.20	5.64	-78.4
<b>Total</b>	<b>532 976 664</b>	<b>-28 389 077</b>	<b>-5.33</b>	<b>12.88</b>	<b>5.33</b>	<b>8.68</b>	<b>4.60</b>	<b>-100.0</b>
<b>Northwest Federal Superregion</b>								
Republic of Karelia	9 781 915	-503 278	-5.14	11.64	6.55	5.68	1.83	-127.3
Republic of Komi	18 157 028	-1 186 749	-6.54	24.05	8.50	16.73	0.82	-130.0
Arkhangelsk Oblast	14 455 261	-109 292	-0.76	4.99	1.14	4.40	1.16	-150.5
Vologda Oblast	14 936 510	6 258	0.04	6.29	-0.24	7.02	3.40	-567.3
Kaliningrad Oblast	9 434 136	-136 702	-1.45	4.87	1.35	3.68	2.00	-93.2
Leningrad Oblast	18 985 134	818 993	4.31	3.11	-2.60	7.00	5.85	-60.3
Murmansk Oblast	13 003 840	-469 491	-3.61	14.16	7.16	7.24	3.52	-198.2
Novgorod Oblast	5 830 199	-190 401	-3.27	5.04	2.18	3.07	1.42	-66.8
Pskov Oblast	8 202 664	197 986	2.41	4.07	-2.96	8.19	1.51	-122.7
St.-Petersburg	67 026 698	1 061 370	1.58	18.70	-1.06	22.15	5.27	-66.9
Nentsi Autonomous Okrug	2 643 545	-243 420	-9.21	1.62	0.63	1.02	4.50	-6.8
<b>Total</b>	<b>182 456 930</b>	<b>-754 726</b>	<b>-0.41</b>	<b>12.75</b>	<b>1.13</b>	<b>12.95</b>	<b>3.63</b>	<b>-273.9</b>



*Table 20 (cont'd)*

	Budget revenues (RUR thousand)	Budget Surplus (deficit) (RUR thousand)	Surplus (deficit) to revenues	Attracted borrowed funds	Net Borrow- ing to Reve- nues	Interest expenses to reve- nues	Balances in budget accounts to revenues	Net bor- rowings to surplus
<b>Southern Federal Superregion</b>								
Republic of Adygea	5 390 950	72 178	1.34	8.66	2.21	6.46	4.60	164.8
Republic of Daghestan	22 882 591	-173 656	-0.76	0.44	0.01	0.44	2.32	-0.8
Republic of Ingushetia	6 260 157	-31 672	-0.51	4.31	0.30	4.06	1.46	-60.0
Kabardin-Balkar Re- public	7 711 489	-453 888	-5.89	13.07	4.84	9.14	0.86	-82.2
Republic of Kalmykia	3 462 065	-51 561	-1.49	5.92	2.17	4.39	1.38	-146.0
Karachaevo-Cherkessk Republic	4 917 007	173 353	3.53	4.55	1.28	3.29	6.07	36.3
Republic of North Ossetia - Alania	7 353 791	-40 900	-0.56	8.04	1.65	6.73	4.66	-297.2
Chechen Republic	7 555 418	466 713	6.18	2.12	0.00	2.12	11.06	0.0
Krasnodar Krai	50 349 054	1 300 936	2.58	5.41	1.38	4.14	5.10	53.5
Stavropol Krai	19 657 429	-417 396	-2.12	8.95	3.47	5.50	4.34	-163.6
Astrakhan Oblast	7 896 187	-339 758	-4.30	7.51	3.21	4.47	1.26	-74.7
Volgograd Oblast	18 244 890	-351 330	-1.93	12.87	2.48	12.03	1.22	-129.0
Rostov Oblast	34 776 622	105 823	0.30	3.03	0.39	2.98	2.31	127.1
<b>Total</b>	<b>196 457 650</b>	<b>258 842</b>	<b>0.13</b>	<b>5.86</b>	<b>1.52</b>	<b>4.64</b>	<b>3.57</b>	<b>1155.9</b>
<b>Volga Federal Superregion</b>								
Republic of Bashkiria	44 909 825	-514 003	-1.14	3.98	1.50	3.07	5.36	-131.1
Republic of Mari-El	6 195 871	-191 132	-3.08	8.28	2.72	5.71	0.52	-88.0
Republic of Mordovia	9 642 981	-542 595	-5.63	13.89	5.67	8.56	0.73	-100.8
Republic of Tatarstan	62 499 716	-187 083	-0.30	3.72	-0.61	4.44	1.95	204.7
Udmurt Republic	17 106 448	-772 546	-4.52	4.75	2.74	2.10	3.54	-60.8
Chuvash Republic	12 322 960	-205 428	-1.67	3.85	2.72	1.37	2.01	-163.2
Kirov Oblast	12 853 073	-323 636	-2.52	5.84	2.36	3.68	0.66	-93.9
Nizhny Novgorod Oblast	28 250 894	-395 997	-1.40	15.65	2.58	14.14	4.45	-184.2
Orenburg Oblast	17 971 704	-290 017	-1.61	4.47	1.67	3.16	1.25	-103.4
Penza Oblast	9 848 732	55 669	0.57	1.68	-1.44	3.86	1.84	-254.3
Perm Oblast	30 244 110	-774 439	-2.56	5.17	3.19	2.14	4.11	-124.4
Samara Oblast	32 464 002	208 718	0.64	5.33	0.78	4.88	5.56	121.0
Saratov Oblast	18 711 929	118 511	0.63	6.34	-1.92	9.36	0.44	-302.6
Ulyanovsk Oblast	9 319 622	-537 260	-5.76	8.77	6.01	2.95	2.30	-104.3
Komi-Permyak Autonomous Okrug	2 452 381	28 772	1.17	1.81	-1.35	3.39	0.54	-115.0
<b>Total</b>	<b>314 794 248</b>	<b>-4 322 466</b>	<b>-1.37</b>	<b>5.95</b>	<b>1.39</b>	<b>4.96</b>	<b>3.08</b>	<b>-101.5</b>
<b>Ural Federal Superregion</b>								
Kurgan Oblast	9 480 396	-42 501	-0.45	3.59	0.61	3.17	0.83	-136.6
Sverdlovsk Oblast	38 609 833	-379 542	-0.98	2.38	-0.47	3.57	1.78	48.0
Tyumen Oblast	29 851 331	665 485	2.23	0.52	-1.69	2.74	5.75	-75.7
Chelyabinsk Oblast	30 615 923	693 010	2.26	1.22	-0.35	1.58	3.76	-15.6
Khanty-Mansi Autonomous Okrug	116 500 471	-5 229 815	-4.49	4.44	1.41	3.18	2.87	-31.5
Yamal-Nentsi Autonomous Okrug	51 246 923	2 326 058	4.54	12.51	-3.84	17.05	2.92	-84.5
<b>Total</b>	<b>276 304 877</b>	<b>-1 967 305</b>	<b>-0.71</b>	<b>4.84</b>	<b>-0.38</b>	<b>5.58</b>	<b>3.07</b>	<b>53.6</b>

**RUSSIAN ECONOMY in 2002**  
trends and outlooks

*Table 20 (cont'd)*

	Budget revenues (RUR thousand)	Budget Surplus (deficit) (RUR thousand)	Surplus (deficit) to revenues	Attracted borrowed funds	Net Borrow- ing to Reve- nues	Interest expenses to reve- nues	Balances in budget accounts to revenues	Net bor- rowings to surplus
<b>Siberian Federal Superregion</b>								
Republic of Altai	5 078 798	72 145	1.42	1.21	-1.30	2.75	0.90	-91.2
Republic of Buryatia	16 159 292	-813 537	-5.03	29.43	9.16	21.45	0.44	-181.9
Tyva Republic	6 630 974	-90 742	-1.37	2.56	1.49	1.07	0.43	-109.0
Republic of Khakassya	5 373 442	-101 136	-1.88	8.95	2.14	7.05	1.16	-113.9
Altai Krai	24 399 905	-83 150	-0.34	3.15	-0.97	4.12	0.57	283.9
Krasnoyarsk Krai	45 649 093	-2 756 977	-6.04	19.63	8.01	12.29	2.29	-132.6
Irkutsk Oblast	26 845 721	-740 695	-2.76	7.16	3.11	4.24	2.90	-112.8
Kemerovo Oblast	34 067 810	-155 646	-0.46	5.99	0.32	5.72	2.75	-70.6
Novosibirsk Oblast	26 481 996	-1 050 088	-3.97	140.89	10.68	133.20	2.24	-269.2
Omsk Oblast	15 934 118	-164 477	-1.03	35.97	2.64	34.84	0.66	-255.9
Tomsk Oblast	13 737 001	218 908	1.59	23.36	0.19	24.89	2.28	12.1
Chita Oblast	15 395 419	41 863	0.27	0.31	0.18	0.13	1.71	65.6
Aginsk Buryat Autonomous Okrug	1 403 452	24 506	1.75	3.00	3.00	0.00	5.33	171.7
Taimyr (Dolgan - Nentsi) Autonomous Okrug	4 018 959	-90 507	-2.25	0.00	0.00	0.00	10.60	0.0
Ust-Orda Buryat Autonomous Okrug	2 341 159	9 244	0.39	1.07	0.41	0.66	1.23	103.9
Evenki Autonomous Okrug	2 322 467	-1 025 234	-44.14	142.03	85.77	86.31	5.40	-194.3
<b>Total</b>	<b>245 839 606</b>	<b>-6 705 523</b>	<b>-2.73</b>	<b>28.00</b>	<b>4.61</b>	<b>24.42</b>	<b>2.05</b>	<b>-169.1</b>
<b>Far Eastern Federal Superregion</b>								
Republic of Sakha (Yakutia)	35 634 038	-1 332 367	-3.74	10.10	3.07	7.24	2.45	-82.0
Primorsky Krai	26 357 485	82 564	0.31	7.27	0.78	6.67	1.41	248.3
Khabarovsk Krai	23 444 193	-924 339	-3.94	7.41	1.76	5.79	1.83	-44.5
Amur Oblast	13 107 451	-177 051	-1.35	4.35	1.49	3.14	1.28	-110.4
Kamchatka Oblast	10 119 323	-281 694	-2.78	13.08	3.35	10.13	1.25	-120.4
Magadan Oblast	8 802 916	-49 323	-0.56	4.95	2.74	2.23	2.68	-489.3
Sakhalin Oblast	11 519 640	-221 605	-1.92	11.21	0.04	11.30	1.34	-2.2
Jewish Autonomous Oblast	3 447 347	91 710	2.66	0.75	-0.71	1.74	5.07	-26.7
Koryak Autonomous Okrug	1 895 213	-246 883	-13.03	16.20	12.09	4.71	0.87	-92.8
Chukotka Autonomous Okrug	9 496 626	822 782	8.66	2.63	2.47	0.16	12.21	28.6
<b>Total</b>	<b>143 824 232</b>	<b>-2 236 206</b>	<b>-1.55</b>	<b>7.96</b>	<b>2.04</b>	<b>6.11</b>	<b>2.58</b>	<b>-131.0</b>
<b>Total Federal Super- regions</b>	<b>1 892 654 207</b>	<b>-44 116 461</b>	<b>-2.33</b>	<b>11.40</b>	<b>2.70</b>	<b>9.45</b>	<b>3.44</b>	<b>-115.7</b>

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

Over 61 percent of the total deficit fell to the share of four entities of the Russian Federation: Moscow with 40,6 percent of the total deficit, or RUR 22.4 billion, the Khanty-Mansi Autonomous Okrug with 9.5 percent or RUR 5.2 billion, Moscow Oblast with 6.1 percent, or RUR 3.4 billion, and Krasnoyarsk Krai with 5.0 percent, or RUR 2.8 billion. Consequently, it is the policy of debt management in Moscow that continues to have the greatest influence over the resulting picture of the balance of the regions' consolidated budget in Russia on the



whole. One year before, in 2001, Moscow implemented the budget with a surplus of RUR 8.9 billion, which accounted for more than 44 percent of the total surplus of the Russian regions' budget.

#### Changes in the Structure of the Accumulated Debt

In 2002 the accumulated debt of the regions' consolidated budget grew RUR 51.1 billion, or 0.47 percent of the GDP. Practically all of the growth amount resulted from an increase of the internal debt (i.e., the debt nominated in Roubles). The external debt of regional consolidated budgets decreased RUR 4.2 billion and the internal debt grew RUR 55.3 billion.

Alongside with a growth of the debt on securities in the amount of RUR 17.7 billion, the debt on loans from the federal budget and on internal bank lending grew RUR 12.8 billion; the debt on other borrowings, including bank lending, grew RUR 20.1 billion.

The considerable increase in the debt of regional government agencies, supported by a growth in the offer of free credit funds, results from the surplus of the federal budget and lower credit risks. On the one hand, favourable market conditions allow to expand the volume of potentially effective investments into modernisation of public infrastructure facilities; on the other hand, it creates the obvious risks of preserving an inefficient structure of budget expenses coupled with providing funds for investment projects known to bring low returns and realised only in the selfish interests of representatives of regional government agencies.

#### Interest Expenses

The total interest expenses of regional budgets reached RUR 178.9 billion, or 9.45 percent of the revenue side of the regional consolidated budget. Debt service costs were RUR 14.15 billion, or 0.75 percent of the revenue side of the consolidated budgets. In the Evenki Autonomous Okrug the costs of debt servicing reached a menacing value of 30.05 percent of the total revenues of the consolidated budget (including grants). In all other regions debt service costs did not exceed 3 percent of budgetary revenues.

#### Structure of Borrowings

In 2002 the total borrowings of the consolidated regional budget were RUR 215.8 billion, including RUR 4.7 billion in external borrowings (received by: St.Petersburg, RUR 4.674 billion, and Kaliningrad, RUR 2.4 million). The total internal borrowings by regions and municipalities were RUR 211.1 billion. The largest borrowers were the Novosibirsk Oblast with RUR 37.3 billion, Moscow with RUR 33.3 billion, the Moscow Oblast with RUR 21.8 billion, St.-Petersburg with RUR 12.5 billion and Krasnyarsk Krai with RUR 9.0 billion.

The largest net borrowings to budget revenues ratio was observed in the regions with a pronounced budget deficit, namely: the Evenki Autonomous Okrug (in which the amount of net borrowings exceeded the amount of the revenue side of the budget, including transfers from the federal budget) with 85.8 percent, Koryak Autonomous Okrug with 12.1 percent, Novosibirsk Oblast with 10.7 percent and the Republic of Buryatia with 9.1 percent.

The largest net borrowers were: Moscow with RUR 17.5 billion, the Moscow Oblast with RUR 6.5 billion, Krasnodar Krai with RUR 3.7 billion, Novosibirsk Oblast with RUR 2.8 billion, Evenki Autonomous Okrug with RUR 2.0 billion, Khanty-Mansi Autonomous

Okrug with RUR 1.6 billion, Republic of Komi with RUR 1.5 billion, Voronezh Oblast with RUR 1.4 billion and Republic of Sakha (Yakutia) with RUR 1.0 billion.

The following borrowers take first place in reducing the accumulated debt: the Yamal-Nentsi Autonomous Okrug: RUR 2.0 billion; St. Petersburg: RUR 0.7 billion; Tyumen Oblast: RUR 0.5 billion; Leningrad Oblast: RUR 0.5 billion; Tatarstan: RUR 0.4 billion; and, to smaller extents: the Yaroslavl, Ivanovo, Vologda, Pskov, Penza, Saratov, Sverdlovsk and Chelyabinsk Oblasts, the Altai Krai, Republic of Altai, Jewish Autonomous Oblast and Komi-Permyak Autonomous Okrug.

Security issues accounted for 13.8 percent, loans from the federal budget for 11.9 percent and other borrowings (primarily, bank loans) for 74.2 percent in the total internal borrowings of the consolidated budget.

*Table 21*

**Structure of Internal Borrowings by Subnational Budgets in 2002 (percent).**

	Year 2002			Year 2001		
	Regional Consolidated Budget	Regional Budgets	Municipal Budgets	Regional Consolidated Budget	Regional Budgets	Municipal Budgets
Total (RUR million)	194 001.7	148 424.1	89 726.2	100 803.9	77 432.0	54 113.2
Security Issues	15.0	19.0	1.1	15.0	18.4	1.7
Loans from the Budget	13.0	17.4	48.5	15.6	20.5	56.5
Other Borrowings	72.0	64.6	51.4	69.4	61.1	41.8

*Table 22*

**S & P International Credit Rating**

Russia's Ratings on the International Scale			
Name of Issuer	Date of Assignment (Latest Revision)	In Foreign Currency / Forecast	In Local Currency / Forecast
<b>Sovereign Rating</b>			
Russian Federation	05.12.2002	BB/Stable	BB+/Stable
<b>Ratings of Regions and Municipalities</b>			
Bashkiria	13.11.2001	B/Positive	--/--
Vologda Oblast	04.02.2003	B/Stable	--/--
Irkutsk Oblast	04.10.2002	B-/Positive	--/--
Moscow	06.12.2002	BB/Stable	--/--
Moscow Oblast	24.01.2003	B/Stable	--/--
Nizhny Novgorod Oblast	06.09.1999	<i>Rating withdrawn</i>	
Rostov Oblast	31.07.2000	<i>Rating withdrawn</i>	
Samara Oblast	21.10.2002	B+/Stable	--/--
St. Petersburg	06.12.2002	BB/Stable	BB/Stable
Sverdlovsk Oblast	14.11.2002	B-/Positive	B-/Positive
Surgut	20.12.2002	B/Stable	B/Stable
Tatarstan	09.10.2001	CCC+/Positive	--/--
Khanty-Mansi Autonomous Okrug	20.12.2002	BB-/Stable	--/--
Yamal-Nentsi Autonomous Okrug	22.10.2002	B-/Positive	--/--

Source: Standard & Poor's.

In the course of 2002 the total balances in budget accounts of the regional and local budgets nominally increased only by RUR 5.1 billion (a growth of 8.5 percent), which, in real terms, means a decrease of almost 7 percent. This is explained both by increasing salary expenses in the public sector and by improving financial resource management upon transfer to the treasury system of budget implementation.





Owing to the economic growth, steady debt servicing by the federal government and stable condition of the budget, Standard and Poor's have upgraded the Russian Federation's international rating to BB, which has led to subsequent growth of the credit rating of federation entities that have been servicing their debts on time. (See Table 22).

The upgrading of credit ratings improves the prospects for attracting borrowed assets by subnational government agencies. At the same time, efficient application of the borrowed assets remains a crucial issue.

### Internal Bonded Loans

In 2002 bonded loans of 20 RF constituent entities and five municipal entities were registered (compared to 11 regional and three municipal loans in 2001). The issuers were: Moscow, St.-Petersburg, Republic of Karelia, Republic of Bashkiria, Chuvash Republic, Republic of Sakha (Yakutia), Komi Republic, Republic of Mordovia, the Volgograd, Irkutsk, Kostroma, Kursk, Tomsk, Tver, Murmansk, Moscow, Belgorod, Sakhalin Oblasts, the Khabarovsk Krai, Khanty-Mansi Autonomous Okrug, the cities of Ufa, Volgograd, Ekaterinburg, Nizhny Novgorod and Yuzhno-Sakhalinsk (See Table 23).

The largest issuers were as follows: Moscow, RUR 11.85 billion, or 40.7 percent of the total issues of subfederal and municipal securities; St.-Petersburg, RUR 7.86 billion, or 27.0 percent; the Khanty-Mansi Autonomous Okrug, RUR 1.33 billion, or 4.6 percent, and the Republic of Bashkiria, RUR 1.27 billion, or 4.4 percent.

Table 23

### Placement of Subfederal and Municipal Securities in 2002

Constituent Entity of the Federation	Amount of Issue (RUR Million)	Amount of Issue to Total Internal Borrowings (percent)	Share in Total Amount of Issue (percent)
Belgorod Oblast	300.0	50.0	1.0
Voronezh Oblast	2.0	0.1	0.0
Kostroma Oblast	3.4	0.6	0.0
Kursk Oblast	95.5	22.2	0.3
Moscow Oblast	2 705.1	12.6	9.3
Tver Oblast	532.6	33.9	1.8
Moscow	11 847.8	35.6	40.7
Republic of Karelia	178.7	16.6	0.6
Komi Republic	836.6	19.3	2.9
Arkhangelsk Oblast	15.0	6.7	0.1
Murmansk Oblast	250.0	13.6	0.9
St.-Petersburg	7 858.8	62.7	27.0
Stavropol Krai	4.8	0.3	0.0
Volgograd Oblast	317.1	14.0	1.1
Republic of Bashkiria	1 270.3	100.0	4.4
Republic of Mari-El	7.9	1.5	0.0
Chuvash Republic	254.0	54.7	0.9
Nizhny Novgorod Oblast	200.0	4.6	0.7
Sverdlovsk Oblast	92.5	10.7	0.3
Khanty-Mansi Autonomous Okrug	1 331.5	25.7	4.6
Yamal-Nentsi Autonomous Okrug	206.8	6.3	0.7
Irkutsk Oblast	257.2	13.7	0.9
Tomsk Oblast	30.2	1.0	0.1
Republic of Sakha (Yakutia)	450.9	13.0	1.5
Sakhalin Oblast	100.0	7.8	0.3
<b>Total</b>	<b>29 141.8</b>	<b>13.8</b>	<b>100.0</b>

Source: IET calculations on the basis of data provided by the RF Ministry of Finance

Borrowings in the form of securities grow more slowly than the total borrowings by cities and regions. While the volume of municipal and subfederal security issues almost doubled, growing from RUR 29.1 billion in 2002 compared with RUR 15.1 billion in 2001, the percentage of securities in the total internal borrowings by cities and regions reduced from 15.0 percent to 13.8 percent, which is far below the market capacity. E.g., the ratio of the current amount of subfederal securities in circulation to the GDP is less than 30 percent of the 1997 level (*See Table 24*).

*Table 24*

**Volume of Subfederal and Municipal Security Issues (percent of GDP)**

Year	1996	1997	1998	1999	2000	2001	2002
Issue	0.63	0.77	0.47	0.31	0.19	0.17	0.27
Redemption	0.47	0.56	0.48	0.36	0.46	0.23	0.10
Net Financing	0.16	0.22	-0.01	-0.05	-0.27	-0.07	0.16 <sup>19</sup>

*Source:* IET calculations on the basis of data provided by the RF Ministry of Finance

It should be noted that there is a negative balance between the number of issuers increasing their debt issued in the form of securities and the number of regions reducing such a debt. Only in 16 constituent entities of the Federation have issuers been able to attract via the market for subfederal and municipal securities the funds exceeding the nominal value of the bonds to be redeemed. These issuers are as follows: Moscow (the amount of borrowings less expenses on repayment of debt on securities was RUR 8.6 billion); the Moscow Oblast, RUR 2.7 billion; St.-Petersburg, RUR 2.5 billion; Khanty-Mansi Autonomous Okrug, RUR 1.3 billion; Republic of Komi, RUR 0.8 billion; the Tver Oblast, RUR 0.5 billion; Republic of Sakha (Yakutia), RUR 0.4 billion; the Murmansk Oblast, RUR 0.3 billion, Belgorod Oblast, RUR 0.3 billion, and others (*See Table 23*).

At the same time, a reduction of the debt granted in the form of securities was observed in 28 regions, including: the Omsk Oblast, RUR 0.2 billion; Volgograd Oblast, RUR 0.1 billion; Novosibirsk Oblast, RUR 0.1 billion. While, owing to the overall growth of borrowings by cities and regions, the prospects for expanding the market for subfederal and municipal bonds are good, the market expansion is contained by a relatively high level of transaction costs related to primary offerings. Therefore, the regions give preference to bank loans, and two thirds of the market fall to the share of Moscow and St.-Petersburg.

Against this background the share of securities placed by municipalities in the total issues by territorial government agencies is continuing to diminish. E.g., in 2001 the percentage of municipal bonds was almost one quarter of the 2000 amount, 5.9 percent compared to 22.6 percent, respectively, of the total issue of subfederal and municipal securities. In 2002 it again reduced to almost a half of the previous amount, falling to 3.3 percent.

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<sup>19</sup> The amount of net funding does not equal the difference between the issue and redemption due to approximation error.



Table 25

**Net Borrowings on the Market for Internal Subfederal and Municipal Securities, RUR thousand**

	Consolidated Regional Budget	Regional Budgets	Municipal Budgets
<b>Year 2002</b>			
Net Borrowings	17 696 530	17 153 760	542 770
Attracted Funds	29 141 777	28 169 158	972 619
Repayment of the Principle Amount	11 445 247	11 015 398	429 849
<b>Year 2001</b>			
Net Borrowings	6 601 447	6 667 592	-66 145
Attracted Funds	15 123 785	14 226 931	896 854
Repayment of the Principle Amount	8 522 338	7 559 339	962 999
<b>Year 2000</b>			
Net Borrowings	- 1 877 328	-2 286 175	408 847
Attracted Funds	13 042 220	10 090 208	2 952 012
Repayment of the Principle Amount	14 919 548	12 376 383	2 543 165

Source: RF Ministry of Finance

In the course of the past four years only 25 constituent entities of the Russian Federation and 10 cities have used security market instruments to borrow funds. Moscow, St.-Petersburg, the Republic of Chuvashia, Volgograd Oblast and city of Volgograd have been issuing bonds every year following the crisis, and the Tomsk Oblast, Republic of Komi and city of Ekaterinburg in the course of the past three years (See Table 26).

Table 26

**Issues of Subfederal and Municipal Securities in 1999 - 2002**

Russian Federation Issuers: Constituent Entities of the	Date of Registration			
	1999	2000	2001	2002
Moscow	*	*	*	*
St.-Petersburg	*	*	*	*
Republic of Chuvashia	*	*	*	*
Volgograd Oblast.	*	*	*	*
Tomsk Oblast.		*	*	*
Republic of Komi		*	*	*
Republic of Bashkiria			*	*
Leningrad Oblast.			*	*
Irkutsk Oblast.			*	*
Moscow Oblast.				*
Belgorod Oblast.				*
Tver Oblast.				*
Khanty-Mansi Autonomous Okrug				*
Khabarovsk Krai				*
Murmansk Oblast.				*

*Table 26 (cont'd)*

Russian Federation Issuers: Con- stituent Entities of the	Date of Registration			
	1999	2000	2001	2002
Kostroma Oblast.				*
Republic of Sakha (Yakutia)				*
Republic of Mordovia				*
Kursk Oblast				*
Sakhalin Oblast				*
Stavropol Krai			*	
Primorye Krai		*		
Kabardin-Balkar Republic		*		
Republic of Mari-El		*		
Novosibirsk Oblast.	*			
<b>Municipal Entities</b>				
Volgograd	*	*	*	*
Ekaterinburg		*	*	*
Ufa				*
Nizhny Novgorod				*
Yuzhno-Sakhalinsk				
Novocheboksarsk	*		*	
Kostroma	*	*		
Cheboksary	*			
Arkhangelsk	*			
Dzerzhinsky	*			

Source: RF Ministry of Finance

In December, 2002, Standard & Poor's upgraded the ratings of Moscow and St.-Petersburg to BB, practically simultaneously with the rating of the Russian Federation; thus, these ratings have exceeded the pre-crisis level of BB- (1997) and, as before, correspond with the sovereign rating (*See Table 22 above*).

It should be noted that, in the period from February to December, 2002, both the sovereign rating and the rating of Moscow and St.-Petersburg jumped two levels at one stroke (starting from B+), and now there remain only two steps to the investment-level rating of BBB-, which makes it possible to attract funds from the largest foreign institutional investors.

Despite the relatively high rating of some federation entities, the problems of restructuring past-due debts on a number of previously issued subfederal securities still remain to be solved. E.g., according to Rosbank's depository, as at 1 November, 2002, 19 constituent entities of the Federation did not even begin their payments under the 3<sup>rd</sup> tranche of the 'agricultural' bonds<sup>20</sup> due as long ago as 2000 - 2001 (*See Table 27*). Other regions have redeemed their agricultural bonds only partially.

It is noteworthy that the available funds in accounts of those regions that have past-due debts on the 'agricultural' bonds are sufficient to redeem the bonds. E.g., as at the end of 2002 the amount of all three tranches of the unredeemed agricultural securities issued by the Arkhangelsk Oblast was RUR 52.27 million, and the balances in the Oblast's budget accounts were RUR 168.0 million. The situation is similar in the Kostroma Oblast: the amount of three tranches of agricultural bonds that have not been redeemed at least partially is RUR 22.08 million, and the amount of budgetary balances is RUR 98.7 million.

<sup>20</sup> Agricultural bonds were issued in accordance with Resolution of the RF Government No. 224 of 26 February, 1997, "On Economic Conditions of the Functioning of the Agroindustrial Complex in 1997".



Thus, even if one considers the necessity for these regions to pay the interest income due in the amount of 10 percent p.a., the refusal by many regions to redeem their bonds at least partially testifies to the weakness of enforcement in respect of borrowings by subfederal level government agencies.

*Table 27*

**Constituent Entities of the Russian Federation that Have Not Started  
to Redeem the Nominal Value of the Third Tranche of their 'Agricultural'  
Bonds (as at 01 November, 2002)**

Komi-Permyak Autonomous Okrug, Taimyr Autonomous Okrug, Republic of Tyva, Republic North Ossetia - Alania, Ulyanovsk Oblast, Primorye Krai, Kurgan Oblast, Pskov Oblast, Republic of Adygeya, Kabardin-Balkar Republic, Republic of Altai, Novosibirsk Oblast, Evenki Autonomous Okrug, Belgorod Oblast, Arkhangelsk Oblast, Kursk Oblast, Kostroma Oblast
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*Source:* Rosbank Depository

**The Issues of Improving Legislative Regulation of the Market  
for Subfederal and Municipal Loans**

Development of the market for subfederal and municipal securities is related to two issues; their solution will determine further directions and dynamics of the market's development.

Issue No. One relates to the remaining relatively high level of credit risk on the liabilities of cities and regions.

On the one hand, this is determined by objective reasons. These include unstable municipal entities' revenues from regulated taxes; the authorities of constituent entities of the Russian Federation have a right to redistribute these taxes between municipalities as often as they like and to a very large extent.

At the same time, the amount of expense liabilities of the federal constituent entities and municipal entities remains undefined. E.g., federal government agencies still apply the practice of establishing the so-called 'non-funded mandates'. As a result, a territorial government agency's wish to repay its debts on time may contradict the demand by federal authorities – just as binding – to increase social expenses (e.g., in respect of increasing salary to public sector workers).<sup>21</sup>

On the other hand, there is a risk that the borrower would act in irresponsible, 'opportunistic' manner. The history of the market for 'agricultural' bonds has demonstrated that, due to lack of the mechanism of compulsory collection (restructuring) of past-due debts of federal and municipal entities an investor may spend an indefinite time on unsuccessfully trying to realise its right to collect the debt through the court, even if the respective court ruling has been positive and the region has got the necessary funds.

However, even subject to full realisation of the reform of interbudgetary relationship aimed at balancing and strengthening the regional government agencies' power over the ex-

<sup>21</sup> The reform of salaries in the public sector related to abolition of the single tariff scale implies granting greater rights to regions in respect of establishing the salary amount.

penses and revenues<sup>22</sup>, and to formation of a working normative base for collecting past-due debts, the extremely important issue of *efficient* application of the attracted funds remains a priority both for creditors and taxpayers.

Due to low transparency and efficiency of the system of budget expenses, including budgetary investments, the risk of inefficient application of budget funds is too great. In this connection one understands the requirements of the Budget Code that has introduced strict constraints on borrowings by regions and municipalities, relating them to the amount of their revenues, and has almost banned any external borrowings.

At the same time, against a background of low real interest rates in the internal market, the need for investments in the territorial social and economic infrastructure (road building, modernisation of the housing and communal services infrastructure, etc.) makes it necessary to analyse the possibility of changing the market regulation priorities.

Budgetary planning, budget implementation and control remain the main means of fighting inefficient application of borrowed funds; this is true first of all for capital expenditure and government purchases, and, besides, for the modernisation the system of funding housing and communal services that is one of the largest (12.9 percent of the regions' consolidated budget) and least efficient items of expenditure in territorial budgets.

It is obviously unpractical to support debt increases by the territorial budgets that 'have a hole' on the expense side. It would be expedient to considerably reduce limitations on territorial borrowings only upon increasing the efficiency of budgetary policy related to expenses and implementing structural reforms at the regional and municipal levels.

Against this background one could propose a plan implying that the regions and municipalities, which have adopted and realised a programme of budgetary finance restructuring, would be granted a right to borrow in excess (to a certain extent) of the current limitations and to issue external loans<sup>23</sup>.

### **2.4.3. The Stock Market**

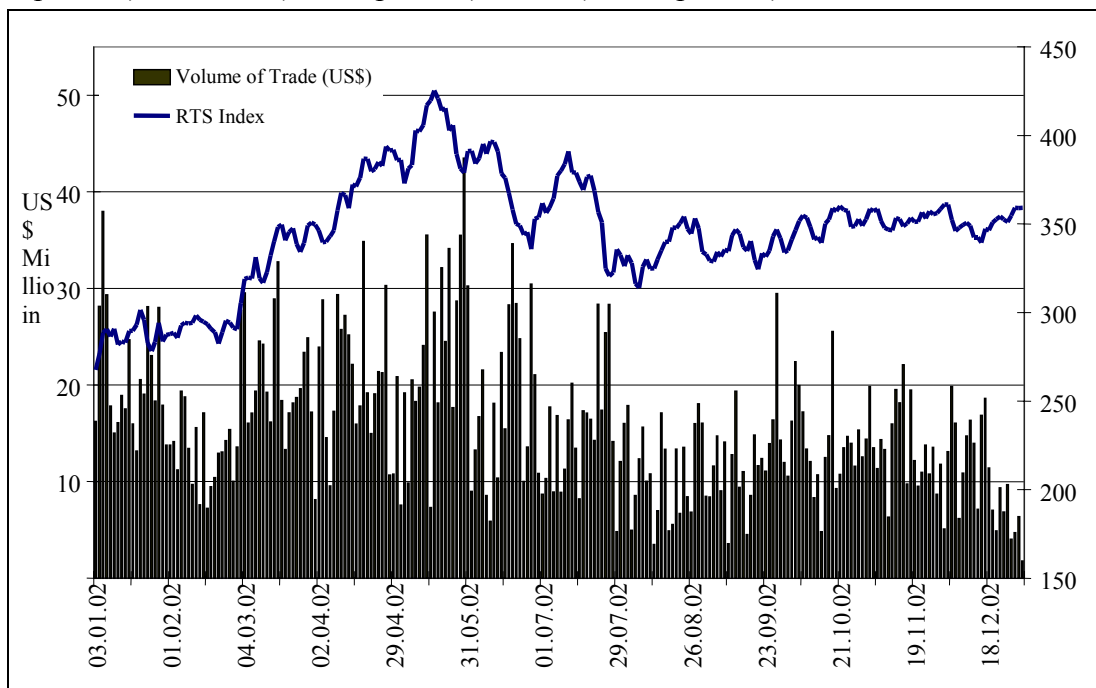
In 2002, despite persisting negative trends, the Russian stock market again demonstrated steady growth. Insignificant economic growth rates in the USA, Japan and the European Union, financial and political crises in a number of developing countries (e.g., Argentina and Venezuela) could not make investors any more optimistic, either. Among the factors that have supported the Russian stock market one should note high prices in the oil market, the continuing growth of the Russian economy, on-time external debt payments, recognition of Russia as a market economy and its exclusion from the FATF blacklist. Further steps aimed at reforming the Russian legislation in accordance with the requirements of the market economy have without doubt attracted investors to the Russian market. However, one cannot help noting a number of negative factors. Lack of considerable structural changes in the economy (such as reforms of natural monopolies and the housing and communal services, public service, banking and stock markets), frequent cases of opacity of corporate and financial management systems, significant influence of the so-called 'political factors' in solving economic disputes has impeded the normal functioning of the market of corporate securities.

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<sup>22</sup> The Programme of Budget Federalism Development in the RF for the Period up to 2005. Approved by Resolution of the RF Government No. 584 of 15 August, 2001.

<sup>23</sup> The formalised criteria used in selecting the regions applying for funds from the Fund for the Reform of Regional Finances may be used as a basis for developing the methodology for determining the region complying with the conditions for abating limitations on the size of borrowings.

In 2002 the Russian stock market demonstrated excellent results compared with other markets. Consequently, the Morgan Stanley index calculated for the Russian market (MSCLRU) grew 16.2 percent during the year, while the similar index for emerging markets (MSCLEMGLF) dropped 7.97 percent and the world index dropped 16.94 percent. In Quarter One of the current year the RTS index retained its second position in the list of the fastest growing stock indices of the world published by Merrill Lynch, with only Merval (Argentina) in front of it. During the year the Russian stock indicator became more than one third heavier (38.07 percent); compare with the indices of other emerging markets: Bovespa (-24.22 percent); IPSA (-25.11 percent); IPC (-10.03 percent); KOSPI (- 0.12 percent); Strait Times (-12.45 percent); and the indices of developed countries: DJIA (-13.14 percent); NASDAQ (-26.09 percent); NIKKEI (-16.79 percent); DAX (-35.64 percent).



*Fig. 30. Dynamics of the Russian Stock Market*

During the year the RTS index grew 101.1 points (38,88 percent), and the trade volume was cca. US\$ 3.8 billion. It should be noted that, compared to last year, it has remained practically unchanged. In describing the RTS index dynamics several periods could be pointed out. In January the stock index grew 10.57 percent and the trade volume grew 51.48 percent. In February the stock indicator remained practically unchanged (1.12 percent) and the trade volume fell 41.12 percent. Then a growth followed until mid-May. On 20 May the market reached a new historic high: 425.43<sup>24</sup> points with the trade volume of cca. US\$ 450 million during that month. It should be noted that on 30 May, 2002, the turnover was US\$ 43.5 million, the highest value of the day in that year. In mid-May a recession began that lasted until 26 June, when the index dropped 89.54 points down to the value of 335.89 points. Then a new "increase-decrease" cycle followed: by 10 July the RTS index grew up to 391.17, and by 6 August the index fell to the levels observed in March: 313.99 points. In August market participants were traditionally inert: the trade volume was the least, US\$ 239 million, and on 12

<sup>24</sup> The maximum value since 6 November, 1997.

August the turnover hit the year's lowest value of US\$ 3.49 million. A slow growing trend was observed in the market until late November, and by 29 November the index grew up to 361.15 points. A greater index growth was prevented by the fact that the consideration of the key legislation on reforms in the Russian power industry was postponed until next year and by alarming rumours pertaining to Gazprom's capability to service its enormous debt. By the end of the year the index somewhat decreased; on 31 December it was 359.07 points.

During the year almost all of Russian 'blue chips' (with the exception of the companies in the power sector) demonstrated positive dynamics. Last year's growth leaders demonstrated excellent results this year as well. Income leaders were the shares of Sibneft (176.10 percent), Sberbank (159.71 percent) and Yukos (74.04 percent). The shares that changed to a lesser degree in value were: Tatneft (46.55 percent); Lukoil (36.80 percent); Rostelekom (35.69 percent) and MMC Norilsk Nickel (21.97 percent). As we have already mentioned, quotations of power sector companies diminished in value during the year: Mosenergo, -17.07 percent, and RAO UES of Russia, -20.87 percent. In the 'second tier' the maximum growth was demonstrated by privileged shares of Rosneft-Stavropolneftegas (1587.50 percent), ordinary shares of Rosneft-Stavropolneftegas (863.86 percent) and privileged shares of Tverenergo (548.15 percent); however, the trade activity was very low: only three deals have been struck with each of the aforementioned securities during 2002. One should also note privileged shares of Krasnoyarskenergo (185.91 percent), Slavneft-Megionneftegaz (144.1 percent) and ordinary shares of Orenburgneft (104.94 percent), the Chelyabinsk Tube Works (103.90 percent) and Slavneft-Megionneftegaz (103.22 percent). AvtoVAZ, last year's growth leader, grew only 46.99 percent in 2002.

The percentage of RAO UES's ordinary shares in the total turnover of RTS slightly decreased to 26.3 percent as compared to 32.86 percent in 2001; Lukoil's share grew up to 19.31 percent (16.65 percent); that of Surgutneftegas reached 10.65 percent (9.02 percent). Yukos that so rapidly entered the top five last year, retained its positions this year, growing up to 10.41 percent (13.2 percent); and OAO Tatneft grew 5.51 percent (5.06 percent). Thus, in 2002 the securities of the five issuers accounted for 72.18 percent of RTS's total turnover (in 2001: 76.91 percent).

In 2002 the volume of trade in Gazprom shares carried out via RTS terminals at the St.-Petersburg Stock Exchange amounted to approximately US\$ 1.01 billion (cca. 1.22 billion shares); a total of 111.9 thousand deals with the gas concern's shares have been concluded. The value of the gas concern's securities grew 46.8 percent.

The largest number of deals, cca. 11.4 thousand, have been noted for the securities of RAO UES circulating in the RTS; Lukoil followed these with 6.2 thousand.

According to RTS, at the end of December the five Russian companies leading by capitalisation changed compared to 2001. Oil Company OAO Yukos took the top position (US\$ 21,038 million); OAO Gazprom (US\$ 18,039 million) and OAO Lukoil (US\$ 13,099 million) followed. Surgutneftegas, last year's capitalisation leader, came only the fourth (US\$ 11,409 million), and OAO Sibneft brings up the rear (US\$ 10,478 million). It should also be noted that the share of oil companies in the total RTS capitalisation is cca. 60 percent. The fact that all largest Russian companies belong to the oil and gas sector testifies to the remaining structural distortions in the Russian economy and its orientation toward exporting raw materials. Let us compare: OAO Sberbank, the capitalisation leader among the companies not belonging to the oil and gas sector or power sector, has US\$ 3.629 billion; OAO Rostelekom has the





lowest aggregate value (US\$ 870 million) among the blue chips, and the total capitalisation share of blue chips in the total RTS capitalisation is cca. 78 percent.

To explain the above-mentioned dynamics of Russian security quotations, let us examine in greater detail the following groups of factors:

- internal political situation;
- relationship with international financial organisations;
- situation in international financial markets;
- FORTS market of term contracts;
- corporate news; and
- dynamics of oil prices in the world's markets.

We will examine the first five factor groups in this section. The last (but not least) factor, the dynamics of oil prices in the world's markets, has been surveyed comprehensively in the section "The Macrostructure for Preparation of this Survey"<sup>25</sup>.

## Internal Political Situation

It is important to note that the strengthening of political stability in Russia, the Government's steady economic policy and adoption of a number of key legislative acts by the legislative authorities have played a positive role in the successful growth of the Russian economy on the whole and the stock markets in particular. These factors have resulted in greater appeal of the Russian economy both for domestic and foreign investors. On 13 September the State Duma of the Russian Federation adopted in the third hearing amendments to the Federal Law "On the Stock Market". The new edition of the Law is aimed at making the Russian stock market more transparent. We would like to note that a notion of price manipulation has been introduced in the Law, which enables to protect the market from such schemes. Furthermore, the Law now contains tougher requirements to the contents of the prospectus and the issuer's quarterly report.

## Relationship with International Financial Organisations

The Government has been servicing the external debt according to the payment schedule and in full. A total of US\$ 12.5 billion have been paid to creditor nations, banks, companies and international organisations and as interest on Eurobonds (including: US\$ 6.2 billion as the principal and US\$ 6.3 billion as interest). In 2003 the payments on external debt will amount to US\$ 17.3 billion.

On 15 November, 2002, Mikhail Kasyanov, the Chairman of the RF Government, signed a Decree "On Introducing Changes in the Financial Terms and Conditions of Exchanging the Debt of the Former USSR Approved in Decree of the RF Government No. 931 of 29 December, 2001 "On Regulating the Commercial Debt of the Former USSR to Foreign Commercial Creditors".

Last year Russia was excluded from the blacklist of the countries that are not active enough in preventing money laundering. Russia was included in that list in June, 2000, since it had no laws on preventing the legalisation of criminal incomes. Since that time the Russian Federation entered the international convention, passed a law on prevention of criminal income legalisation, established an authorised body, the Committee for Financial Monitoring,

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<sup>25</sup> Макроструктура производства настоящего обзора

created a system for fighting the laundering of dirty money and was admitted into Egmont Group – the association of international financial intelligence services.

The upgrading of the Russian Federation's sovereign ratings reflects the positive changes in the Russian economy and the rating agencies' growing confidence in Russia's ability to ensure the servicing and repayment of the government's external debt in 2003 even in the event of a sharp drop in prices for energy carriers.

On 2 May, 2002, FITCH IBCA upgraded the long-term rating of the Russian Federation on borrowings in foreign and domestic currencies to BB-; the forecast for long-term ratings has been upgraded from stable to positive. The short-term rating has been confirmed on the B level.

In December international rating agencies upgraded sovereign ratings of the Russian Federation. On 5 December Standard & Poor's announced that it upgraded Russia's long-term ratings from BB- to BB+ on the liabilities in the national currency, and from BB- to BB on the liabilities in foreign currency on the international scale. Thus, the appraisals of the Russian economy have drawn near the investment rating that starts from BBB on the S&P scale. Russia's rating on the national scale has been confirmed on the ruAA+ level. The agency's analysts note that the reasonable tax policy and improving debt management system make it impossible to return to a large budget deficit even in case of cuts in oil prices. The new management of the Central Bank of Russia has promoted banking reform. Still, S&P does not intend to upgrade the ratings of RF any further due to forthcoming parliamentary elections in late summer and the related slowing down of structural economic reforms.

On 17 December, Moody's Investors Service also upgraded Russian foreign currency liabilities from Ba3 to Ba2. The revision was based on the assessment of Russia's financial and macroeconomic indicators and on the data about on-going structural reforms, in particular, the reforms of natural monopolies.

### Situation in International Currency Markets

In contrast to the Russian market, the situation in the largest international markets was not as favourable. Following 11 September, a series of corporate scandals related to forged financial reporting by leading US companies swept over the USA, which affected investor confidence negatively.

By early July Dow Jones and NASDAQ fell below 8000 and 1300, respectively. At the end of June, pressed by negative news from international markets, quotations of Russian shares that had been demonstrating enviable stability throughout the period also experienced a sharp drop. Some European indices fell to 1997 levels. In order to stabilise the situation, the two Chambers of the US Congress approved a new law aimed at fighting corporate fraud. Investors have found this news, and positive financial reports of a number of large corporations, such as 3M, McDonald's, DuPont, very positive. On 24 July, the closing values of the leading indices grew sharply: the Dow increased 6.4 percent; NASDAQ grew 5 percent, and S&P's grew 5.7 percent.

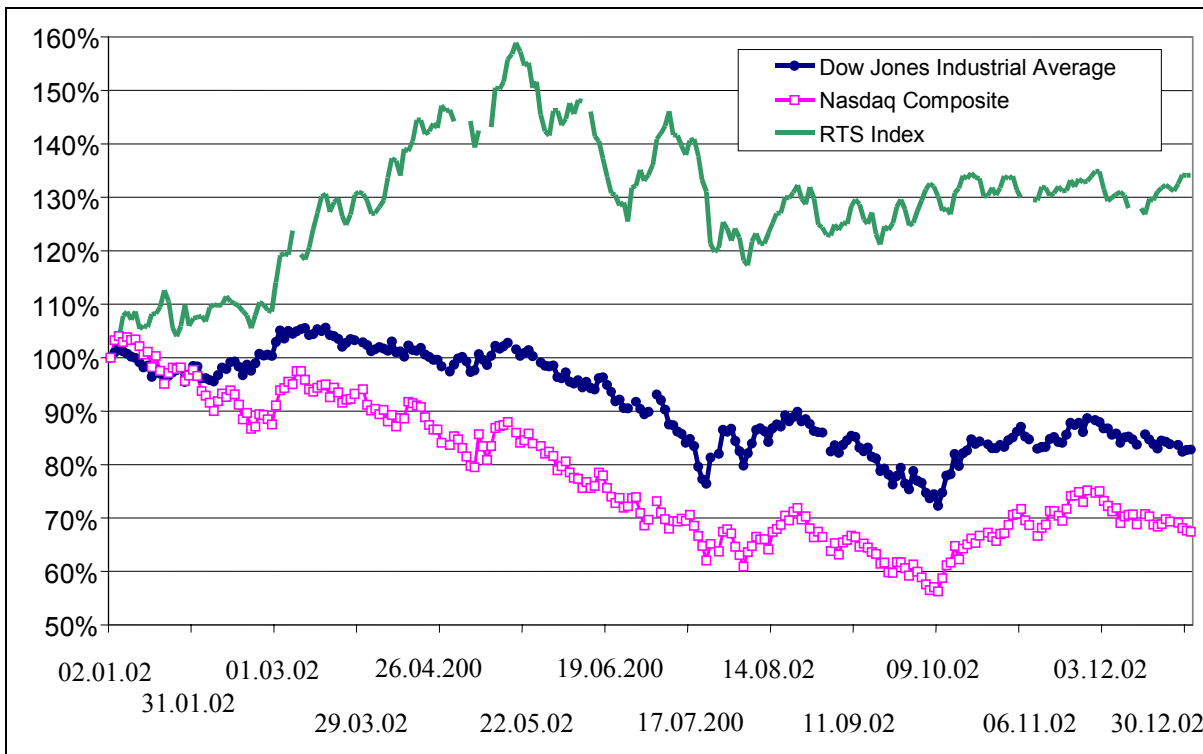


Fig. 31

However, the player's optimism did not last long, and a recession on the largest international trade floors continued until the first half of October. DJ's resulting values in Quarter 3 were the weakest since 1987 (-17 percent), and NASDAQ lost cca. 20 percent. In the course of the trade session on 9 October the Dow fell to the level of 1997 (7286.27), and NASDAQ, to the level of 1996 (1114.11). Such dynamics resulted from negative corporate news and the uncertainty in respect of military actions against Iraq. However, by the end of the month the US stock indices partially regained the lost positions. By 23 October DJ and NASDAQ had grown to 8494,27 (+16.6 percent growth from the minimum level) and 1320.23 (+18.5 percent), respectively. On the whole, DJ grew 11.89 percent and NASDAQ 12.64 percent during the month. The increase in asset quotation was above all brought about by positive financial reports by the largest corporations. E.g., the performance of Yahoo!, the insurance company Aetna, IBM, Microsoft and Citicorp exceeded experts' forecast and General Electric, the world's capitalisation leader, completed the quarter according to the experts' expectations. Performance of the largest companies was better than the respective forecast, which allows to assume that the period of recession in corporate revenues is nearing its end.

Despite the alarming situation in the US economy, the US Federal Reserve has kept its interest rate at 1.75% in the course of almost the entire year; only on 6 November the US did the Fed Open Market Committee announce a reduction of the discount rate by 50 percentage points at one stroke (forecast: 25 points). On the one hand, the US Fed's management admitted that its previous steps aimed at bringing the economy out of the recession were not efficient enough, but, on the other hand, it demonstrated its determination to bring the economy out of the crisis by any available means. The US stock market reacted by increasing stock indices because a reduction of the discount rate will lead to growing consumption and invest-

ment volumes. Moreover, good reports of HP and General Electric also influenced the growth of the US indices. As at 22 November DJIA grew more than 20 percent compared to the historic minimum of 09 October, and NASDAQ, more than 31 percent. However, by the end of the year DJIA and NASDAQ had again dropped, reaching by 31 December 8341.63 and 1335.51 points, respectively.

In December 2002, the European Central Bank, for the first time since November 2001, lowered the discount rate 0.5 percent to the level of 2.75 percent. The US Fed left the key rate at 1.25 percent – the lowest level in the past 41 years. In its statement the FOMC noted that the risk of inflation increase and the risk of a further weakening of the economy are equally possible. The Bank of England has also decided to leave the discount rate unchanged at the level of 4 percent.

In Asia the situation in stock markets could not fill one with optimism, either. The growth in problem loans in Japan poses a real threat of bankruptcy for many large credit institutions. The value of NIKKEI-225 fell to its 19-year minimum.

### The Market for Term Contracts

On 19 September, 2002, a year passed since the beginning of trade in the FORTS market for term contracts. During the period, turnover in this segment of the stock market exceeded RUR 70 billion; market participants concluded cca. 420 thousand deals and the monthly growth rate of trade volume was cca. 30 percent.

On the whole, in 2002 participants of the term contract market concluded 546 thousand deals for RUR 94.9 billion (22 million contracts). The average daily volume of trade increased 3.45 times compared to 2001 up to RUR 378 million, or 3.1 times in terms of concluded contracts, which amounts to 87.5 thousand contracts per day. Activity of the participants almost tripled, growing to 2168 deals per day, compared to 746 deals in 2001. At the end of the period, on 31 December, the total open positions on standard contracts reached RUR 1.191 billion, or 292 thousand contracts, growing 2.3 times in Rouble terms and 3.5 times in contract terms (as at 29 December, 2001: RUR 514 million and 83 thousand contracts).

By the end of 2002 the FORTS market had reached new levels. On 26 November the trade volume was RUR 795.47 million (188.5 thousand contracts, 3785 deals), which is the highest figure in the market's history.

On 16 September, 2002, September futures contracts totalling cca. RUR 194 million were executed. The highest execution volume in the floor's history, RUR 74.98 million, was registered on the futures contract on the price of OAO Lukoil shares.

On 15 December, 2002, December futures contracts totalling RUR 209 million were executed. The greatest amount of contracts presented for execution, 20,896 contracts totalling RUR 88 million, fell on the futures contract on the price of shares RAO UES of Russia (EESI: 12.02).

### Corporate News

In 2002 the largest international rating agencies assigned new ratings and upgraded old ratings of Russian companies, thus noting positive changes in their performance. E.g., S&P's upgraded the corporate governance rating of the telecommunications operator OAO North-west Telecom from 5.0 to 5.6. However, the practice of corporate governance is characterised



by negative features related to the increased influence exerted by a single majority shareholder and its dominating role in the decision-making process, and also due to underdeveloped independent control mechanisms.

S&P's also assigned a corporate governance rating of 6.0 to another telecom operator, OAO Uralsviazinform.

OAO Mobile Telesystems has the highest rating among Russian companies: 7.4. In its reports the rating agency notes that, compared to the majority of Russian companies, MTS has high corporate governance standards that conforms with the practice accepted in the leading international companies. Such corporate governance policy is a result of observation of the requirements posed by SEC to the companies whose shares are listed at NYSE.

Standard & Poor's upgraded Tatneft's rating from stable to positive and confirmed the company's long-term rating at the B- level. The company's rating reflects its considerable exports, reasonable financial policy, significant assets and the insufficient diversification of operations, shortage of processing facilities, delays in the development of the main fields, high levels of short-term debts and influence of the Tartar Republic's government. S&P's has also noted the success of Russia's sixth largest oil company OAO Sibneft, assigning it a B+ long-term credit rating, forecast: developing. Standard & Poor's also assigned Sibneft a credit rating on the national scale at the level of ruAA.

Standard & Poor's has also upgraded Lukoil's long-term credit ratings from BB- to B+. The upgrading is explained by the company's leadership in the amounts of reserves, production and exports in Russia. The limiting factors include a high level of mid-stream costs and a considerable debt.

S & P's have upgraded the ratings for six Russian banks, which reflects the improving economic situation in Russia.

In November RAO UES published its financial results for the current year. According to the Russian accounting standards, the energy holding net income for 9 months grew to RUR 39.98 billion, and the IAS net income grew to RUR 17.8 billion. According to the statement by V. Sinyugin, Chairman of the Board of Directors, made during his meeting with investors in Boston, the corporation also intended to increase dividend payments approximately two times.

During eight months of 2002 Surgutneftegas produced 32.15 million tons of oil, which is 11.7 percent over last year's level. Gas production reached 8.7 billion cubic meters. The drill meterage grew to almost two million meters, or 13 percent more than in the corresponding period of 2001 (including the growth in exploration drilling by 9 percent, or 191 thousand meters). 613 new wells were commissioned. OAO Surgutneftegas was licensed to explore and develop the Severo-Labatyugansk area. According to the current legislation, the company received the license upon exploration work on risk conditions, without any bidding.

Sberbank presented its RAS financial report for Quarter 3 of 2002. The net income grew 95 percent up to RUR 28.7 billion compared to last year. Besides, according to the bank's officials, the income for 2002 can reach RUR 30 billion, which exceeds the previous forecast of RUR 27.2 billion, and the dividends can double.

US GAAP earnings of Sibneft from January till June 2002 grew 19 percent, reaching US\$ 1.984 billion (US\$ 1.663 billion in the corresponding period of 2001). The EBITDA were US\$ 786.1 million (US\$ 870.5 million in the corresponding period of 2001). Net income fell from US\$ 615.8 million in the first six months of 2001 to US\$ 457.5 million.

In 2002 Russian companies pursued the policy aimed at acquisition of new assets, including foreign assets, and establishing long-term partnership relations.

MMC Norilsk Nickel acquired 100 percent of the largest Russian gold producing company Polyus. In 2002 the company plans to produce 25 tons of gold, which will bring it earnings of cca. US\$ 250 million and a profit of cca. US\$ 75 million. The MMC paid US\$ 226 million in cash for 100 percent of Polyus's shares. In addition to purchasing domestic assets, Norilsk Nickel is actively operating abroad: MMC is buying a controlling block of Stillwater Mining Company, the only US producer of platinum group metals, for US\$ 341 million; US\$ 100 million will be paid in cash and the remaining US\$ 241 million in 876,000 ounces of palladium.

The trading company Norimet, Ltd., a full subsidiary of the MMC, has entered into a long-term contract with General Motors on delivering platinum group metals. Since the beginning of 2002 Norilsk Nickel has not been delivering platinoids to the international market, and the conclusion of a contracts with a leading US company gives hope for the improvement of the metal holding's overall performance.

Russian companies continue to enter international markets and take active measures aimed at improving their image with foreign investors.

After the Securities and Exchange Commission toughened its requirements to financial reports of the companies whose shares are traded in the USA, on 4 September Rostelekom announced it would revise its financial accounts for 2001 due to the situation with its former auditor Arthur Andersen. As a result of a second audit carried out by Ernst & Young a number of financial performance indicators were reduced. However, the company must have only gained from this action since it has demonstrated the business community a responsible approach to the issuer's financial information.

The UK Listing Authority included the company's securities in the official list; thus Lukoil obtained a full secondary listing at the London Stock Exchange. All ordinary shares and Level 1 ADRs of the company have been listed. The shares will trade in the form of ADRs. On 6 August the ADRs started to trade at US\$ 55 per ADR. As the first Russian company to receive a full secondary listing, Lukoil will be subject to more onerous requirements than those, which currently apply to it as an issuer of securities. The new requirements imply more detailed disclosure of information on the operations of the Lukoil group and regular reporting to the holders of its securities.

In early February Wimm-Bill-Dann Foods OJSC, Russia's leading producer of dairy and juices, completed an IPO of American Depository Shares. The company floated 10,62 million ADSs at a price of US\$ 19.50 per share totalling US\$ 207.1 million. The demand exceeded the offer five times. Thus, US investors valued the company's market capitalisation at US\$ 828.4 million. This is the first large listing by a Russian company operating in the market of the basic consumer products. ADSs of only four Russian companies traded at NYSE until recently, three of them in the telecom sector – Vimpelcom, Rostelekom and MTS – and Tatneft. Undoubtedly, the successful placement of WBD's American Depository Shares has positively influenced the dynamics of the Russian market and allows to hope for inflow of investments into other national issuers' shares.

Lukoil's President Vagit Alekperov, President of OAO Sibneft Yevgeni Shvidler, Executive Director of OAO TNK German Khan and Chairman of the Board of Directors Mikhail Khodorkhovski have signed a "Memorandum on Mutual Understanding on the Issue of Constructing an Oil Pipe-line System for the Transportation of Oil through an Offshore Oil-



Loading Terminal in the Murmansk Area". The construction of the Murmansk oil pipeline is the first Russian joint project in the field of hydrocarbon raw material transportation carried out by the largest national oil companies. The parties have agreed to develop a co-ordinated version of a Declaration of Intent on the Project as soon as possible. After that they will decide on further projections, select the best route for the pipeline, co-ordinate the main requirements to pipeline facilities and prepare a detailed schedule of project realisation.

In December one of the key events was the auction, in which the RF Government sold its block of shares of the Oil and Gas Company Slavneft. Before the beginning of the auction representatives of the RF Accounting Chamber estimated the selling price of the 74.95 per cent block of Slavneft shares at US\$ 3 to 3.2 billion. However, on 18 December, in the course of the auction the oil company was sold to TNK and Sibneft for a far smaller amount of US\$ 1.86 billion. According to A. Kudrin, Minister of Finance of the RF, privatisation of the Government's block of Lukoil and Slavneft shares allowed to create a necessary financial reserve.

However, this acquisition worsened the financial state of both companies, resulting in downgrading of their ratings by the largest agencies. E.g., Standard & Poor's revised Sibneft's rating from developing to negative and excluded TNK from the CreditWatch list where it had been put in December 2002 with positive forecast. Sibneft's rating on the national scale was downgraded from ruAA to ruA+.

## **Appendix 2. A Review of Changes in the Legislation Regulating Taxation Issues in the Russian Federation**

### **Changes in the Legislation Approved in the End of 2001 and Enacted in 2002**

#### Federal Laws

Federal law No. 179-FZ of December 28, 2001, amended Articles 149 and 164 of the RF Tax Code concerning the introduction of VAT at the rate of 10 per cent in relation to medicines (including medicinal substances, among them those produced in pharmacies), products intended for medicinal purposes, as well as periodicals (except periodicals of advertising or erotic nature).

Federal law No. 187-FZ of December 29, 2001, amended Section 2 of the RF Tax Code and other legislative acts concerning taxes and charges. The RF Tax Code was supplemented with subsection VII.1 "Special tax regimes. The system of taxation of agricultural producers (the single agricultural tax)."

The single agricultural tax (SAT) shall be enacted by a law of a subject of the Russian Federation introducing this tax. Organizations, farms, and individual entrepreneurs shall become subjects of SAT not depending on the number of employed.

The object of taxation shall be the area of agricultural lands owned, tenured, and (or) used. The SAT tax base shall be the area of agricultural lands comparable in terms of the cadaster value defined in accordance with the methods set forth and approved by the Government of the Russian Federation.

Transition to SAT shall be carried out on condition that a share of proceeds from sales of agricultural produce from the farm lands made not less than 70 % of the total proceeds in the preceding calendar year and shall mean that this tax replaces all taxes and charges payable

in accordance with Articles 13, 14, and 15 of the Code, with the exception of the following taxes and charges:

- 1) value added tax;
- 2) excises;
- 3) charges for abuse of the environment;
- 4) tax on purchase of foreign currency and payment documents denominated in foreign currency;
- 5) state duty;
- 6) custom duty;
- 7) tax on property owned by individuals (as concerns residential buildings, facilities, and structures owned by individual entrepreneurs);
- 8) tax on property transferred as succession or gift;
- 9) license charges;
- 10) insurance fees related to mandatory pension insurance (shall be paid in accordance with the legislation of the Russian Federation on pension security).

The definition of agricultural producers shall exclude agricultural organizations of industrial type (poultry plants, greenhouse integrated works, state fur farms, animal industry agri-businesses, etc.), as determined in accordance with the list approved by the legislative (representative) authorities of RF subjects in order prescribed by the Government of the Russian Federation.

The tax period of this tax shall be one quarter. The tax rate shall be determined in Rubles and kopecks in relation to one hectare of farm lands. It is also stipulated that the substitution of several taxes with one is not the introduction of a new tax, but a special regime.

Federal law No. 190 FZ of December 29, 2001, amended the RF law "On Customs Tariff" and the second section of the RF Tax Code.

The law stipulates the procedures governing the determination of export duties on crude oil. For instance, according to the law, the Government of the Russian Federation shall monitor the prices of Urals crude oil on world markets of oil raw materials (Mediterranean and Rotterdam) aiming at the determination of the average price over the period of monitoring (2 months).

The rates of the export duties shall be introduced by the RF Government for 2 calendar months and shall be below the amount of the maximal duty rate calculated as follows:

In the case the average price of Urals crude oil was below US \$ 109.5 per metric ton (inclusive) over the period of the monitoring the rate shall be 0 per cent;

In the case the price was US \$ 109.5 to 182.5 per metric ton – 35 % of the difference;

In the case the price was above US \$ 182.5 per metric ton the duty shall be below US 25.53 and 40 % of the excess over US \$ 182.5.

Federal law No. 195 FZ of December 30, 2001, enacted the RF Code of Administrative Offences (CAO RF).

The Code regulates issues relating to administrative fines imposed for defaults on taxes (charges). According to Article 3, an administrative fine is a pecuniary penalty and its amount may be set forth in multiples of unpaid taxes and charges. The amount of an administrative fine calculated proceeding from the amount of unpaid taxes and charges shall not exceed the triple value of the respective object, or the amount of unpaid taxes and charges.

Article 15 stipulates the amounts of fines imposed on public officials for infringements upon financial legislation (tax, banking legislation, laws concerning accounting and reporting,





as well as legislation relating to the stock market). The law sets forth concrete amounts of fines for infringements upon the tax legislation, including the failure to register for tax purposes, untimely tax registration, failure to timely submit information about opening or closing of an account with a bank or another credit organization, etc. to tax authorities or an agency of a state extra-budgetary fund. The same article sets forth administrative fines imposed on bank officials for failures to execute their duties relating to keep taxpayers' accounts, etc. Article 16 stipulates fines for administrative violations of customs regulations. Articles 23 and 28 set forth the procedures governing the consideration of administrative offences by tax authorities, federal agencies of tax police, and customs authorities.

Federal law No. 198-FZ of December 31, 2001, amended the RF Tax Code and certain other legislative acts concerning taxes and charges. The law more precisely formulates a number of key provisions of the RF Tax Code Article 24 "Single Social Tax" in particular those concerning the definition of the taxpayer, the object of taxation (integrated with Articles "Profit Tax" and "Income Tax on Individuals," the procedure governing determination of the taxable base), and the tax base.

As concerns individual entrepreneurs subject to the simplified system of taxation, the tax base is defined as the product of gross proceeds and coefficient 0.1.

There were more precisely defined the rules concerning the implementation of the descending tax scale. In the case at the moment the advance payment is made the average amount of tax base accumulated since the beginning of the year per individual divided by the number of preceding months in the current tax period makes less than Rub. 2500, the tax shall be paid at its maximal rate independently of the actual amount of the tax base per individual. Such taxpayers shall not have the right to use the descending tax scale until the end of the tax period.

The calculation of the amount of the average tax base per employee for taxpayers employing more than 30 persons shall not take into account payments to 10 of the employees per cent with largest incomes, while for taxpayers employing less than 30 persons (inclusive) – payments to 30 per cent of employees with largest incomes.

The calculation of the average tax base per employee shall be based on the average number of employees.

In order to calculate the amount of tax (advance tax payment) the applicable rates of the tax due to the federal budget shall be reduced by the tariff rate of the mandatory pension insurance charges due to the Pension Fund of the Russian Federation.

The RF Ministry of Defense, the RF Ministry of Interior, and a number of other agencies shall be exempt from this tax.

## Governmental Resolutions

Resolution of the RF Government No. 915 of December 29, 2001, sets forth rates of the advance payments made in relation to the purchase of regional special stamps relating to goods liable to excise duties:

- alcohol beverages containing up to 25 per cent of ethyl alcohol in terms of volume inclusively – Rub. 0.3 per one stamp;
- alcohol beverages containing over 25 per cent of ethyl alcohol in terms of volume – Rub. 0.8 per one stamp.

Resolution of the RF Government No. 920 of December 29, 2001, sets forth the list of goods produced and (or) sold by non-governmental organizations of disabled persons, enterprises solely owned by non-governmental organizations of disabled persons, and organizations employing disabled persons (where disabled persons make not less than 50 per cent of the total number of employees and the share of remuneration due to disabled persons in the total labor costs makes not less than 25 per cent), production and sale related costs of which shall not include funds expended for social security of disabled persons and (or) functioning of non-governmental organizations of disabled persons for purposes of calculation of the profit tax base, including:

- car tires;
- hunting guns;
- yachts, boats (except special purpose ones);
- production of ferrous and non-ferrous metallurgy (except secondary scrap ferrous and non-ferrous metals and hardware)
- jewels and precious metals;
- fur articles (except children clothes);
- high quality articles made of crystal and porcelain;
- sturgeon and salmon caviar;
- ready-made delicacy fish and sea products;
- securities.

Resolution of the RF Government No. 926 of December 29, 2001, sets forth the minimal and maximal rates of regular payments for the use of mineral resources.

The exact amount of the regular payments for the use of mineral resources as broken down by all areas situated on the continental shelf of the Russian Federation, within the exclusive economic zone of the Russian Federation, or outside the Russian Federation in the territories under the jurisdiction of the Russian Federation, as well as those leased from foreign states or used on the base of an international treaty, shall be determined by the RF Ministry of Natural Resources within the aforesaid minimal and maximal rates. The rates are in terms of Rubles per square meter. The resolution determines maximal rates of regular payments for the use of mineral resources: a) for purposes of surveying and evaluation of mineral resources; b) for purposes of prospecting of mineral resources.

#### Acts of Ministries and Agencies Developing the RF Tax Code

Letter of the State Customs Committee No. 01-06/50748 of December 24, 2001, explains that according to Article 151 of the RF Tax Code the taxation of import is carried out in accordance with the chosen tax regime. In the case the regime of temporary importation is applied, a partial tax exemption is granted, while in the case the goods are imported under the customs regime of release for free turnover, the tax shall be paid in full. According to Articles 78 and 79 of the Tax Code, the excessively exacted or paid amounts of taxes and charges may be used as offsets against the tax payments. These articles can not be applied to periodical customs payments stipulated by Article 72 of the RF Tax Code. The aforesaid payments shall be made in the framework of the customs regime of temporary importation for the time the goods are under this customs regime and are not defined as excessively paid or exacted. Therefore, the offset of periodic customs payments made for the time the goods are under the customs regime of temporary importation in the case this regime is substituted by the customs



regime of release for free turnover is stipulated neither in the Tax Code, nor in the Customs Code.

Letter of the State Customs Committee No. 01-06/51165 of December 26, 2001, explains the procedure governing the exaction of VAT on certain categories of goods imported in the customs territory of the Russian Federation. Since January 1, 2002, the tax privileges related to import of the following goods in the customs territory of the Russian Federation shall be abolished:

- medicines, products intended for medicinal purposes, medical equipment, as well as raw materials and completing parts for production thereof;
- raw materials and equipment purchased by handicraft enterprises for production of handicraft articles (sub-item 12 of item 13 of the Instruction);
- technological equipment (completing and spare parts) thereof are not manufactured in the Russian Federation;
- products of mass media and books relating to education, science, and culture.

At the same time, federal law No. 179 FZ of December 28, 2001, introduces VAT at the rate of 10 per cent in relation to medicines, including medicinal substances, as well as products intended for medicinal purposes and periodicals (except periodicals of advertising or erotic nature) imported in the customs territory of the Russian Federation since January 1, 2002.

## **Changes in the Legislation Approved in 2002**

### Federal Laws

Federal law No. 83 FZ of July 9, 2002, "On financial rehabilitation of agricultural producers" sets forth a procedure (outside the RF Tax Code) of restructuring of tax arrears of organizations in a separate economic sector.

The decision on restructuring shall be taken by the territorial commission with participation of creditors of the debtor. The commission shall calculate the indicators characterizing the financial standing of the debtor in accordance with the prescribed calculation methods. The territorial commission shall determine the respective option depending on the indicators of the debtor's financial standing and in accordance with the base terms of restructuring of debts.

The restructuring of debts envisages the full write-off of the amount of penalties and fines, granting of deferments (for periods up to 5 years) relating to the principal debt and interest charges, as well as write-off of the principal and interest charges. The amount of payment for deferred debts related to payments to the federal budget and budgets of the state extra-budgetary funds makes 0.5 per cent per annum.

Article 8 of federal law No. 147 FZ of July 31, 1998, "On enactment of section one of the Tax Code of the Russian Federation," according to which the provisions of the first section of the Code should not be applied to the relations regulated by the federal law "On financial rehabilitation of agricultural producers" was respectively amended in relation to the enactment of this law.

According to federal law No. 104 FZ of July 24, 2002, there were amended Section 2 of the RF Tax Code and other legislative acts concerning taxes and charges, while certain legislative acts concerning taxes and charges were abolished. For instance, the RF Tax Code was

supplemented with Articles 26.2 (simplified system of taxation) and 26.3 (single tax on imputed income)<sup>26</sup>.

Federal law No. 106 FZ of July 24, 2002, amended Article 7 of the RF law “On property tax on enterprises.” The amendments stipulate that property tax on enterprises included in the United natural gas supply system shall be transferred to the budgets of RF subjects proportionally to the value of the property located in the territory of the respective subjects of the Russian Federation and evenly distributed between the budget of the RF subject and local budgets of territories where the property is located. As concerns Moscow and St. Petersburg, the tax shall be transferred to the budgets of RF subjects in full.

Federal law No. 110 FZ of July 24, 2002, amended Section 2 of the RF Tax Code and other RF legislative acts. For instance, the amendments regulate the payment of VAT and excises relating to sales of ores, scrape, and refining of precious metals, and operations relating to precious metals and gems.

According to the aforesaid amendments, the persons engaged in operations related to oil products shall be subject to registration and be granted respective certificates, including those allowing production, wholesale trade, wholesale and retail trade, retail trade. The amendments set forth that the procedure governing the issuance of certificates shall be determined by the RF Tax Ministry. According to the new procedure of payment of excises on oil products, both the reception and entry in the balance sheet shall be subject to taxation. The amounts of charged excises may be offset against the sellers’ liabilities related to the tax in the case both sellers and buyers are licensed persons. Liabilities originating from purchase of oil products from retail traders shall not be subject to offsets.

In accordance with the new system of taxation there was introduced the mechanism of operations of customs offices carrying out the system of measures of customs control over production and (or) sale (transfer) of oil products.

There was regulated the problem concerning tax exempts relating to taxpayers selling excisable goods outside the territory of the Russian Federation. The tax exempt shall be granted only in the case excisable goods are sold outside the RF territory under the customs regime of exportation. As concerns transfers of give and take raw materials, tax exemptions shall be granted upon the presentation of a bank guarantee to the tax authorities. In the case no bank guarantee is submitted, the taxpayer shall pay the excise in accordance with the procedure of sale of excisable goods on the territory of the Russian Federation.

There were introduced new rates of excises on alcohol and alcohol beverages, tobacco products, vehicles, gasoline, etc.

As concerns profit tax, there were made amendments relating to the mechanism of determination of replacement value of depreciated assets for taxation purposes as concerns re-evaluation (depreciation, appreciation) of fixed assets. Besides, there are set forth proportions of the distribution of the profit tax rate (24 per cent) among budgets of different levels (the tax revenues collected at the rate of 6 per cent are due to the federal budget, at the rate of 16 per cent – to budgets of the RF subjects, at the rate of 24 % - to local budgets).

RF subjects have the right to adopt laws reducing the tax rate (not below the 12 per cent rate) for different categories of taxpayers as concerns taxes due to the budgets of RF subjects.

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<sup>26</sup> For more detailed review of the simplified system of taxation and single tax on imputed incomes see the section concerning taxation of small business.



The mechanism of tax accounting carried out by budgetary organizations was introduced in the RF Tax Code. It is set forth that accounting related to operations of calculation of proceeds from commercial activities and expenditures related to carrying out these activities shall be conducted by budgetary organizations separately from the funds of targeted financing. The tax base of budgetary organizations is determined as the difference between the received amount of proceeds from the sold of goods, completed works, rendered services, the amount of proceeds not related to sales (without VAT, sales tax and excises on excisable goods) and the amount of actual expenditures related to commercial activities.

The excess of proceeds over expenditures related to commercial activities before taxes can not be utilized to cover expenditures related to the targeted financing earmarked in the balance of proceeds and expenditures of the budgetary organization.

For taxation purposes, expenditures for public utilities, communication services, transport expenditures related to the servicing of the administrative and managing staff are set forth in proportion corresponding to the share of funds received from entrepreneurial activities in the total amount of proceeds (including targeted financing). At the same time, for taxation purposes, the total amount of proceeds do not include proceeds not related to sales (proceeds received as bank interests on funds at current and deposit accounts, lease revenues, differences in rates of exchange, etc.).

In relation to the abolishment of the tax on motor road users, there were made amendments to RF law No. 1759-1 of October 18, 1991, "On road funds of the Russian Federation." According to the amendments, the following sources were set forth to finance territorial road funds at the expense of targeted budget funds: transport tax; excises on oil products (50 per cent of proceeds); land tax (100 per cent of proceeds) due to the budgets of the subjects of the Russian Federation; proceeds from repayment of debts related to the tax on motor road users generated before January 1, 2003; fines and penalties for untimely payment of the aforesaid tax; final settlement of payments related to the tax on motor road users for year 2002; subventions to the budgets of RF subjects granted at the expense of the federal budget funds earmarked for financing of road construction, etc.

In relation to the aforesaid amendments, Article 28 setting forth the procedure governing the payment of the transport tax was included in the RF Tax Code.

The article recognizes motor vehicles, motorcycles, motor scooters, buses and other pneumatic tired and caterpillar tracked motor vehicles and mechanisms, airplanes, helicopters, motor ships, yachts, sail boats, boats, snow going vehicles, etc. as the object of taxation. The tax base is determined as the motor horsepower of the vehicle. At the same time, the tax base relating to not self propelled (towed) vessels shall be defined as their gross tonnage in metric tones; as concerns other water vessels and air planes – as one vessel or aircraft. Tax rates shall be set forth respectively depending on the motor horsepower, tonnage, or per one vessel or aircraft.

Federal law No. 127 FZ of October 26, 2002, "On Insolvency (Bankruptcy) changed the order of repayment of debtor indebtedness.

In contradistinction to the previous version of the law, the new law stipulates that indebtedness relating to mandatory payments shall be included in the general (third) group. At the same time, the law stipulates that in the case the debtor fails to make mandatory payments in full in the period between the arbitration court issues the decision to consider the claim to declare the debtor's bankruptcy and the initiation of bankruptcy proceedings, the claims not

cleared off before the arbitration court declares the debtor bankrupt and starts bankruptcy proceedings shall be repaid first.

## **Governmental Resolutions**

### Tax Administration

Resolution of the RF Government No. 319 of May 17, 2002, stipulates that in order to execute Article 2 of the federal law "On state registration of legal entities" the RF Tax Ministry shall be the authorized federal executive agency carrying out the state registration of legal entities since July 1, 2002.

Resolution of the RF Government No. 818 of November 11, 2002, approves amendments to governmental resolutions concerning restructuring of creditor indebtedness of legal entities related to taxes, charges, insurance contributions to state social extra-budgetary funds, and penalty and fine arrears.

Resolutions of the RF Government No. 1002 of September 3, 1999, No. 458 of June 8, 2001, "On the priority and terms of restructuring of outstanding indebtedness (principal debt and interests, penalties and fines) of agricultural producers and organizations relating to federal taxes and charges, as well as insurance contributions to budgets of state extra-budgetary funds," No. 699 of October 1, 2001, "On the priority and terms of restructuring of indebtedness relating to insurance contributions to state social extra-budgetary funds, taxes, and charges of organizations as on January 1, 2001, shall be supplemented with a provision that the right to restructure the indebtedness of a restructured organization granted in accordance with this Resolution, shall be retained by the legal successor (successors) of the organization.

Resolution of the RF Government No. 765 of November 6, 2001, "On the restructuring of indebtedness relating to taxes and charges due to the federal budget and indebtedness relating to penalties and fines of federal state unitary enterprises within the penal system" and No. 890 of December 25, 2001, "On the restructuring of indebtedness of federal railway transport organizations relating to taxes and charges, and indebtedness relating to penalties and charges due to the federal budget" were amended.

### Profit Tax

Resolution of the RF Government No. 1 of January 1, 2002, approves the Classification of fixed assets included in amortization groups for the purposes of enforcement of Article 258 of the RF Tax Code. The classification may also be used for accounting purposes.

Resolution of the RF Government No. 68 of January 30, 2002, approves the rules governing the contribution of funds to reserves earmarked to maintain the safety of nuclear power plants at all stages of their operation and development by exploiting organizations. The contributions to reserves shall be accounted for as costs of exploiting organizations for the purposes of determination of the profit tax base. The reserves are earmarked to finance expenditures ensuring:

- nuclear, radiation, technical, and fire safety of nuclear power plants;
- physical protection, accounting, and control of nuclear materials;
- development of nuclear power plants;



- removal from service of nuclear power plants and conduct of research and development and works aimed at the substantiation and increase of safety of objects removed from service.

The resolution also sets forth the rates of contributions the exploiting organizations shall make to the reserves:

- up to 10 per cent of proceeds of the exploiting organization from the sale of goods (works, services) relating to the use of nuclear power shall be contributed to the reserve earmarked for nuclear, radiation, technical, and fire safety of nuclear power plants;
- up to 1 per cent of proceeds shall be contributed to the reserve earmarked for physical protection, accounting, and control of nuclear materials;
- the contributions to the reserve earmarked for the development of nuclear power plants shall be made on the basis of the list of capital construction objects in accordance with the investment program annually approved by the RF Ministry of Atomic Energy in coordination with the Ministry of Economic Development and Trade of the Russian Federation and the Federal Energy Commission of the Russian Federation;
- the contributions to the reserve earmarked for removal from service of nuclear power plants and conduct of research and development and works aimed at the substantiation and increase of safety of objects removed from service shall be at 1.3 per cent of the proceeds.

Resolution of the RF Government No. 92 of February 8, 2002, sets forth the rates of expenditures, which organizations may assign as compensation for the use of personal cars for business purposes. The expenditures within the approved rates shall be included in other expenditures related to production and sale of goods (works, services) for determination of the organization's profit tax base.

Resolution of the RF Government No. 93 of February 8, 2002, sets forth the rates of expenditures, which organizations may assign for payment of daily and field allowances. The expenditures within the approved rates shall be included in other expenditures related to production and sale of goods (works, services) for determination of the organization's profit tax base. The following rates were set forth:

- a) for each day of a business trip within the territory of the Russian Federation the daily allowance shall make Rub. 100;
- б) for each day of a business trip outside the territory of the Russian Federation the daily allowance shall make an amount according to the annex (US \$ 67 per day as concerns business trips to the USA);
- c) daily field allowances paid to employees of exploration and topographic and geodetic organizations, employees of forest management organizations, prospecting crews, etc (Rub. 50 to 200 depending on the area and objects).

Resolution of the RF Government No. 748 of October 4, 2002, abolishes resolution of the RF Government No. 216 of April 4, 2002, "On the procedure governing determination of the marginal limit of fluctuation of market price of works (services) relating to development of natural resources."

The aforesaid resolution was abolished due to the more exact definition introduced by federal law of the RF No. 57 FZ of May 29, 2002 in the text of item 6 of Article 261 of the RF Tax Code. According to the new version of the item, for the taxation purposes expendi-

tures related to purchase of works (services), geological and other data from third parties, including state agencies, as well as expenditures for independent works related to the development of natural resources shall be defined as the actual amount of such expenditures. The clarified version abolished the constraints on the taxpayers' right to exempt all substantiated and confirmed by documents expenditures.

Resolution of the RF Government No. 814 of November 12, 2002, sets forth the procedure governing the approval of rates of natural loss related to storage and transportation of goods and materials. For the purposes of enforcement of Article 254 of the RF Tax Code, the Government of the Russian Federation has determined the list of ministries having the right to approve the rates of natural loss and stipulated that the rates of natural loss applicable for determination of permitted amount of irretrievable loss due to the shortage and (or) damage of goods and materials shall be reviewed from time to time, but at least once in 5 years.

#### Value Added Tax

Resolution of the RF Government No. 19 of January 17, 2002, in accordance with Article 149 of Section 2 of the RF Tax Code approves the list of most important and vitally necessary medical equipment to be exempted from VAT in the case such equipment is sold in the territory of the Russian Federation.

Resolution of the RF Government No. 283 of April 29, 2002, for purposes of enforcement of the VAT exemption set forth in sub-item 3 of item 1 of Article 150 of the RF Tax Code, approved the list of materials for manufacturing of medical immunobiological compounds for diagnostics, preventive and (or) medical treatment of infectious illnesses, import of which in the customs territory of the Russian Federation shall be subject to VAT exempt.

In accordance to the changes introduced in Article 149 of the RF Tax Code, resolution of the RF Government No. 661 of September 6, 2002, amended Resolution of the RF Government no. 251 of March 31, 2001 as concerns more precise definition of religious items included in the list of items exempt from VAT in the case such items are sold or transferred for own needs.

#### Taxation of the Mineral and Raw Materials Sector

Resolution of the RF Government No. 180 of March 23, 2002, approves the new version of the Regulations governing the formation and utilization of the liquidation funds in the course of implementation of production sharing agreements.

In accordance with Article 261 of the RF Tax Code, Resolution of the RF Government No 216 of April 4, 2002, approves the Rules governing the determination of the marginal market prices of works and services relating to the development of natural resources.

The Rules set forth the procedure governing the determination of the limits of the market price band related to works (services) aimed at the development of natural resources relating to the geological surveying of mineral resources, prospecting of mineral resources, preparatory works, and appoint federal authorities responsible for the determination of the determination of the limits of the market price band related to specific works and services.

Resolution of the RF Government No. 282 of April 29, 2002, in accordance with article 346.2 of the RF Tax Code sets forth the criteria making agricultural organizations eligible for





the status of agricultural organization of industrial type. The agricultural organizations of industrial type do not enjoy tax preferences granted to enterprises engaged in agriculture. Agricultural organizations of industrial type include agricultural organizations (poultry farms, greenhouse integrated works, state fur farms, animal industry agri-businesses, etc.):

- those not using farm lands for agricultural production;
- those where the share of forage raised at farm lands owned and (or) used and utilized for own agricultural production makes less than 20 per cent of the total volume of utilized forage.

## Excises

Resolution of the RF Government No. 723 of October 1, 2002, approves the general requirements relating to the Regulations and terms applicable to the issue of permits to establish excise warehouses and the Procedure governing the issuance of regional stamps.

The procedure governing the issuance of permits to establish excise warehouses and terms of the issuance of the permits shall be determined by the subjects of the Russian Federation as approved by the RF Tax Ministry. Permits shall be issued by territorial tax agencies of the RF Tax Ministry. The key condition, on which permits are issued, is that the organization has the license to produce, store, and sell alcohol products or the license to purchase, store, and sell alcohol products (in the case it indicates the location of the excise warehouse). Executive authorities of a RF subject shall have the right to introduce additional terms, on which the permit may be granted. Information on the issued permits shall be reflected in registers of permits to be kept by territorial agencies of the RF Tax Ministry. The consolidated register shall be kept by the RF Tax Ministry. The procedure governing the manufacture and purchase of excise stamps, as well as their price shall be determined by RF subjects where is carried retail trade with alcohol products.

The rules determine technical characteristics of stamps (size, color, the procedure of product stamping, protection measures – line code). The contents of the code and the procedure governing the coding shall be determined by the RF Tax Ministry, which shall take into account the proposals about additional information submitted by RF subjects. The issuance of stamps to organizations establishing excise warehouses shall be vested with territorial tax agencies after such organizations transfer advance payments relating to excises on alcohol products.

The price of stamps shall included the costs related to their manufacturing, storing, delivery, VAT, etc. The price of stamps shall be below 1 % of the tax rate related to alcohol products where the volume share of ethyl alcohol exceeds 25 per cent, as stipulated by Article 193 of the RF Tax Code. The price of stamps shall be entered in expenditures deductible for profit tax purposes.

## Taxation of Small Businesses

Decision of the RF Government No. 1590-r of November 13, 2002, stipulates that according to Article 346.27 of the RF Tax Code information relating to the cadaster value of land used for the calculation of the amount of the single tax on imputed income as concerns certain types of activities shall be presented to taxpayers via respective official sources of information not later than on November 30 of the current calendar year.

Resolution of the RF Government No. 828 of November 15, 2002, amended resolutions of the RF Government No. 92 of February 8, 2002, and No. 93 of February 8, 2002, and stipulated that the provisions of these resolutions shall be also applied to the simplified taxation system since January 1, 2003.

Resolution No. 92 of February 8, 2002, extended to motorcycles the regulations concerning the determination of expenditures borne by organizations to compensate for the use of personal cars for business trips eligible for exemption for purposes of determination of the profit tax base.

Resolution of the RF Government No. 93 of February 8, 2002, amended the procedure of inclusion of the expenditures for payment of daily and field allowances (according to respective standards) in expenditures eligible for determination of the profit tax base. The amended procedure stipulates that either daily or field allowances may be included in such expenditures, but not both these types of allowances.

### **Acts of Ministries and Agencies Developing the RF Tax Code**

#### Tax Administration

Letter of the RF Tax Ministry No. ShS-6-14/252 of March 5, 2002, explains the Ministry's position as concerns the issue of defining information about taxpayers' arrears as confidential tax information.

According to sub-item 3 of item 1, Article 102 of the RF Tax Code (hereafter referred to as the Code), confidential tax information shall be defined as any data on taxpayers obtained by a tax authority excluding information relating to offenses against the tax laws and measures of responsibility for such offences.

Failure to pay or promptly pay taxes, according to the RF Tax Ministry, is a tax offence (as defined in Article 106 of the Code), or an infringement on the procedure of tax payment set forth by the tax legislation. Therefore, information about any infringements on the procedure of tax payment on the part of taxpayers shall not be defined as confidential tax information.

Order of the RF Tax Ministry No. BG-3-32/169 of April 2, 2002, approves the Procedures governing the submission of tax declarations in electronic form via telecommunication channels. The submission of tax declaration in electronic form shall be carried out at taxpayers discretion in the case the respective tax agency has technical capacity to receive and proceed such declarations in accordance with standards, formats, and procedures approved by the RF Tax Ministry.

Letter of the RF Tax Ministry No. FS-6-10/555 of April 26, 2002, in accordance with Article 88 of the federal law "On the Federal Budget for 2002," provided information about and instructions concerning the implementation of Resolution of the RF Government No. 251 of April 18, 2002, "On writing off debts generated in relation to non-prompt payments to main contractors and contractors of works related to the state defense procurement in 1994 through 1999 as concerns penalties as charged on January 1, and outstanding tax payments due to the federal budget and extra-budgetary funds."

According to the Regulations approved by the aforesaid Resolution, arrears of penalties charged for outstanding tax payments due to the federal budget, i.e. the arrears of penalties relating to federal taxes and charges, which should be transferred to the federal budget in full,



are eligible for the write-off. As concerns federal taxes to be shared among the levels of the budgetary system, only penalties relating to the federal share shall be written off.

Joint letter of the RF Central Bank (No. 85-T of July 2, 2002) and the RF Tax Ministry (No. 24-2-02/252 of July 1, 2002) explains the issues relating to cash payments among legal entities. For instance, it was clarified that the approved limit of such payments as concerns one contract between legal entities (notwithstanding the number of payment documents relating to payments under this contract).

Letter of the RF Tax Ministry No. MM-6-09/922 of July 2, 2002, explains that according Article 83 of the RF Tax Code, organizations shall be registered with tax agencies responsible for the territories where they have their separate units and territories where their unmovable property and transport vehicles subject to taxation are located. At the same time, according item 2 of Article 23, taxpayers defined as organizations have to within 10 days report in writing to the tax agencies responsible for territories where such organizations are registered and where they have their separate units and territories where their unmovable property and transport vehicles subject to taxation are located in the case they open (close) bank accounts.

In the case organizations infringe on this procedure, they shall be subject to sanctions stipulated by Article 118 of the Code.

The RF Tax Ministry issued the address "On state registration of legal entities" explaining that since July 1, 2002, all territorial tax agencies of the Russian Federation start to register legal entities in the case they are established, reorganized, liquidated, amend their founding documents, and amend information on such legal entities not related to their founding documents.

Applicants for the state registration may present respective documents in person or by mail attaching the list of contents.

In the case a legal entity fails to submit information to the respective registering agency until January 1, 2003, it shall be liquidated by a court ruling based on the application of the registering agency.

Order of the RF Tax Ministry No. BG-3-29/404 of July 31, 2002, approves the methodological recommendations concerning the procedure of arrest of taxpayers' property as security against tax obligations, which were also approved by the General Prosecutor office. Property may be arrested only as approved by a prosecutor and is a temporary limitation of the ownership rights of a taxpayer or a tax agent for purposes of ensuring compliance with tax obligations.

Arrest of property as a means to ensure tax collection shall be carried out if two conditions coincide:

- failure to promptly pay a tax;
- justified grounds to believe that a taxpayer is going to take measure to flee and conceal the property.

The methodological recommendations determine the grounds conclusive of a taxpayer or a tax agent to flee and conceal the property, which include: movable property on the balance sheet (including securities) sufficient to repay over 25 per cent of the tax arrears if sold; debtor indebtedness in the case no measures have been taken to recover the respective debts in accordance with the procedures stipulated by law in time exceeding one quarter; the total amount debts relating to taxes and other mandatory payments (including fines and penalties), which include deferred payments, exceed 50 per cent of the property value as per balance

sheet; systematic failure to appear in the tax agency; hasty sell-out of property or transfer of property to dummies, participation of intermediary firms in payments for products; accumulation of funds of a taxpayer (payer of charges) or a tax agent on accounts of other legal persons; failure to comply with decisions taken by a tax authority basing on the results of a tax inspection; facts demonstrating the concealment of proceeds from realization of goods (works, services) derived in the preceding tax periods; information on facts demonstrating failure to pay excises in preceding tax periods or unjustified recovery of excises from the budget obtained by tax authorities; location of the debtor's property at addresses different from the debtor's legal address; establishment of a new legal entity by the director of the taxpayer organization and transfer of the taxpayer's property as the authorized capital of the new entity, etc.

The decision about the arrest shall be taken by the head or deputy head of a tax authority, who shall issue a special resolution to this effect. The resolution shall be submitted to the prosecutor office supervising the respective tax agency for approval of the arrest not later than one day after the date the resolution was issued. The arrest shall be carried out by the tax agency not later than three working days after the receipt of the prosecutor's approval. Only property necessary and sufficient to fulfil the respective tax obligations shall be arrested. Property valued as per the balance sheet equally to the amount of tax debt shown in the resolution is subject to the arrest.

Joint letter of the RF Central Bank and the RF Tax Ministry No. 151-T; FS-18-10/2 of November 12, 2002, explains that taxpayers defined as organizations shall pay taxes and charges independently in the form of transfer from their bank accounts opened with crediting organizations, subsidiaries of crediting organizations, and offices of the Bank of Russia. Taxpayers-organizations shall have no right to deposit with banks cash for direct transfer to accounts monitoring revenues of respective budgets in the case the legislation of the Russian Federation does not stipulate otherwise.

### Income Tax

Letter of the RF Tax Ministry No. SA-6-04/60 of January 22, 2002, explains that Articles 227 and 229 of Section 23 of the RF Tax Code "Income Tax on Individuals", and subitem 4 of item 1 of Article 23 of the RF Tax Code stipulate that individual entrepreneurs shall submit income tax declarations to the respective tax agencies where they are registered (reside) notwithstanding they possess an object of taxation.

Letter of the RF Tax Ministry No. SA-6-04/124 of February 4, 2002, explains the procedure governing the granting of social tax exemptions as stipulated by Article 219 of Section 23 of the RF Tax Code (hereafter referred to as the Code). Besides, it explains that social tax exemptions may be granted to taxpayers receiving incomes taxable at a 13 per cent rate in preceding tax periods.

Letter of the RF Tax Ministry No. SA-6-04/341 of March 22, 2002, explains the procedure governing the granting to individuals of the property tax exemption as stipulated by subitem 2 of item 1 of Article 220 of the Code.

The taxpayers who started to use the tax relief stipulated by law of the Russian Federation No. 1998-1 of December 7, 1991, "On Income Tax on Individuals" but had not utilized this relief to the full extent before January 1, 2001, shall have the right to use tax exempt relating to the same object (apartment of a residential house) according to the procedure stipu-



lated by the RF Tax Code. All previously borne expenditures shall be taken into account in the process of determination of the tax base.

Tax exemptions shall be granted to taxpayers basing on the declaration for the preceding tax period, applications in written form, and documents confirming the right of ownership as concerns purchased (built) houses or apartments, as well as property executed payment documents confirming payments made by taxpayers.

## Value Added Tax

Letter of the RF Tax Ministry No. VG-6-23/72 of January 23, 2002, amends the list of states whose diplomatic missions and respective staffs are subject to VAT at zero rate.

In order to implement the provisions of Resolution of the RF Government No. 19 of January 17, 2002, which approved the list of most important and vitally necessary medical equipment to be exempted from VAT in the case such equipment is sold in the territory of the Russian Federation, the RF Ministry of Healthcare issued letter No. 2510/2698-02-23 of March 25, 2002, explaining the methods to be applied in order to determine the eligibility of certain types of medical equipment for the inclusion in the list of most important and vitally necessary medical equipment.

Letter of the RF Finance Ministry No. 16-00-14/112 of March 27, 2002, explains the procedure governing the determination of the VAT base in the case goods are sold below cost in the case organizations export goods in the framework of intergovernmental agreements. In the course of sales of goods (works, services) involving subsidies from budgets of different levels not increasing returns of organizations, but are assigned to compensate for actual losses related to the use of state fixed prices by taxpayers, the value added tax base shall be determined as the cost of sold goods (works, services) calculated basing on the actual sale prices.

## Profit Tax

Letter of the RF Tax Ministry No. VG-6-02/1 of January 3, 2002, explains the procedure governing the calculation and making of advance profit tax payments due to the budget as concerns advance payments related to the profit tax in the first quarter of 2002 and transition to cash basis accounting method in 2002.

Taxpayers making monthly advance profit tax payments shall calculate the amount of monthly advance payments due in the first quarter of 2002 proceeding from one third of the amount of the tax due to the budget in the third quarter of 2001.

The amount of tax due to the budget in the third quarter of 2001 shall be determined basing on the Calculations (tax declarations) of the tax from profit results for nine months and first six months of 2001 (Supplement No. 9 to Instruction of the RF Tax Ministry No. 62 of June 15, 2000, "On the procedure governing the calculation and payment to the budget of the tax on profits of enterprises and organizations").

Calculation of the tax proceeding from the profit results in the first quarter, first six months, nine months, and 2002, shall be carried out in accordance with the Tax declaration as approved by Order of the RF Tax Ministry No. BG-3-02/542 of December 7, 2001 (registered with the RF Ministry of Justice, registration No. 3084 of December 17, 2001).

Not all organizations shall employ this procedure. The procedure shall not be applicable to organizations, which completed the transition to the calculation of monthly advance payments proceeding from their profit results, organizations financed from the budget, foreign

organizations operating in the Russian Federation via their permanent agencies, not for profit organizations, organizations whose proceeds from sales were on the average below Rub. 3 million in each quarter over the preceding four quarters, etc.

As concerns the possibility to apply the cash basis method, according to item 1 of Article 273 of the RF Tax Code, organizations shall have the right to apply this method in the case the amount of proceeds from sales of goods (works, services) of such organizations (without taking into account VAT and sales tax) were on the average below Rub. 1 million in each quarter over the preceding four quarters.

Letter of the RF Tax Ministry No. VB-6-21/87 of January 25, 2002, explains the procedure governing the payment to the budget of advance payments related to the tax on the mining of minerals in the first quarter of 2002. The tax on the mining of minerals (hereinafter referred to as the tax) and respective advance payments shall be paid by an organization (individual entrepreneur) in the subject of the Russian Federation, where mining operations are conducted. In the first quarter of 2002, advance tax payments shall be calculated as one third of the amount of payments for the use of mineral wealth and fees assigned for reproduction of the mineral and raw materials resources charged in the fourth quarter of 2001 and indicated in the Calculations of payments for the right to use mineral wealth and the Calculations of fees assigned for reproduction of the mineral and raw materials resources submitted to the tax agency responsible for the territory where mineral resources were used.

As concerns oil and gas condensate from oil and gas condensate deposits, advance tax payments shall be calculated as one third of the amount of such payments, as well as the amount excise charged in the fourth quarter of 2001 (as a share proportional to the volume of oil and gas condensate from oil and gas condensate deposits in the territory under the jurisdiction of the respective tax authority in the fourth quarter of 2001).

Personal accounts relating to the tax on the mining of natural wealth shall be kept by the tax authority having jurisdiction over the seat (place of residence) of the taxpayer-organization (individual entrepreneur). Tax authorities having jurisdiction over territories where taxpayers are registered as payers of the tax on the mining of mineral wealth shall provide information on the advance payments made by the taxpayer for purposes of its registration on personal accounts of taxpayers.

Directive of the Bank of Russia No. 1103-U of January 28, 2002, abolishes directive of the Bank of Russia No. 810-U of June 29, 2000, "On taking into account the amount of reserves for probable losses relating to loans for tax purposes" formed by crediting organizations in accordance with the requirements set forth by instruction of the Bank of Russia No. 62a of June 30, 1997, "On the procedure governing the formation and utilization of reserves for probable losses relating to loans" and sets forth the definition of loan-related and similar debts for the purposes of enforcement of Article 292 of the RF Tax Code (as concerns credits, including inter-bank credits; bills of exchange discounted by crediting organizations; balances of bank guarantees; operations carried out under agreements of financing against assignment of cash claims (factoring); funds transferred to correspondent accounts of crediting organizations).

Letter of the RF Tax Ministry No. VG-6-02/160 of February 8, 2002, explains the procedure governing the making of advance profit tax payments. The calculations are illustrated with numerical examples. The RF Tax Ministry points out that since the calculation of advance payments is carried out proceeding from the quarterly advance payment for the quarter preceding the quarter in which the payment is made, no grounds for charging of penalties for



non-prompt monthly advance payments exist as concerns the enactment of Article 25 of the RF Tax Code.

Letter of the RF Tax Ministry No. VG-6-02/203 of February 22, 2002, clarifies the issue of submission of tax reports and terms of payment of the profit tax for year 2001.

The profit tax for year 2001 shall be determined basing on the calculation (tax declaration) of the tax on profit results according to the form set forth in Supplement No. 9 to Instruction of the RF Tax Ministry No. 62 of June 15, 2000 and attached references and calculations.

The calculation shall be submitted and the charged amount of the tax shall be made according to the procedure and in time stipulated by Article 8 of law of the Russian Federation No. 2116-1 of December 27, 1991, and item 5 of Instruction No. 62.

Order of the RF Tax Ministry No. BG-3-02/98 of February 26, 2002, approves the Methodological recommendations concerning the enforcement of Article 25 of Section 2 of the RF Tax Code "Profit tax on organizations."

Letter of the RF Tax Ministry No. VG-6-02/392a explains the procedure of making monthly advance profit tax payments due on April 15, 2002. According to Article 286 of the RF Tax Code, taxpayers shall make monthly advance payments over the reporting period (quarter). The monthly advance payments shall be made in equal installments (one third of the quarter advance payments charged in the quarter preceding the quarter, in which the monthly advance payments is made).

Since no declarations confirming the amount of the quarterly advance payments for the first quarter of 2002 will be submitted to tax authorities, taxpayers shall make advance payments (due on April 15) proceeding from the operative data of taxpayers on their revenues and expenditures in the first quarter of 2002.

Letters of the RF Tax Ministry No. VG-6-02/401 and the RF Finance Ministry No. 01-MM-17 of April 2, 2002, explain the procedure governing the determination of the profit tax base and calculation methods pertaining to the tax in relation to amendments to Article 10 of federal law No. 110 FZ of August 6, 2001 (Article 10 concerns profits generated in relation to the transition to the accrual basis accounting method since January 1, 2002, the amount of tax charged in relation to this tax base shall be payable since the second reporting period of 2002).

In 2002, taxpayers shall pay the tax on these profits not later than 30 days after the end of the first half-year. The payments shall be made in equal installments in time set forth for the payment of respective quarter advance payments, i.e. not later than in 30 days after the closing date of the respective reporting period and not later than on March 31, 2003.

The taxpayers who completed the transition to monthly advance payments shall pay the tax on these profits in equal installments in time set forth for the payment of monthly advance payments relating to profit results starting the term of advance payments for the first six months of 2002, i.e. not later than on the 30<sup>th</sup> of each month following the preceding month. For these taxpayers, January 30, 2003, shall be the last valid date of the payment.

### Single Social Tax

Letter of the RF Tax Ministry No. SA-6-05/415 of April 4, 2002, explains certain issues relating to the payment of the single social tax.

For instance, it has been explained that payments and remuneration (notwithstanding of the form) shall not be objects of taxation in the case taxpayers-organizations do not include such payments in expenditures diminishing the organizations' profit tax base in the current (tax) period.

Therefore, payments and remuneration in the form of full or partial redemption of goods (works, services, property or other rights) for individuals (employees or members of employees' families) including payments for public utilities, food, recreation, education, and voluntary forms of insurance shall be excluded from the tax base for purposes of calculation of the single social tax in the case the taxpayers-organizations do not include such payments in expenditures diminishing the organizations' profit tax base in the current (tax) period.

Letter of the RF Tax Ministry No. ShS-6-14/1201 of August 7, 2002, explains that it is necessary to act according to judicial practice deciding if payers of the social tax shall be hold liable for respective tax offenses.

According to the Tax Ministry, taxpayers may be hold liable for such tax offenses as non-submission of estimates of advance single social tax payments as defined in Article 119, in the case taxpayers fail to comply with the terms of submission of estimates (since the calculation of employers' advance payments is based on real financial results of taxpayers' operations). At the same time, in the case there is formed judicial practice indicating unjustified enforcement of Article 119 of the RF Tax Code, taxpayers may be hold liable according to Article 126 of the RF Tax Code for failure to submit documents and (or) other information as stipulated by the RF Tax Code. The article sets forth a penalty at Rub. 50 per each not submitted document.

It is justified to hold taxpayers liable for failure to pay or non-prompt payment of the single social tax in accordance with the results of reporting periods as stipulated by Article 122 of the RF Tax Code.

### Excises

Telephone message of the RF Tax Ministry No. BK-6-07/18 of January 10, 2002, explains that until a new Resolution of the RF Government on the procedure and terms of issuance of permits to establish excise warehouses and the procedure of granting of regional special stamps by the subjects of the Russian Federation, it shall be acted in accordance to the requirements set forth in Resolutions of the RF Government No. 1026 of December 30, 2000 and No. 1023 of December 30, 2000.

Letter of the RF Tax Ministry No. BK-6-07/244 of February 27, 2002, explains the procedure governing the operation of excise warehouses. According to Article 197 of the RF Tax Code, storage of alcohol products before shipment (delivery) to other buyers in locations other than excise warehouses and vehicles transporting such products in conformity with the transportation regime shall be prohibited.

Delivery (transfer) of alcohol products from excise warehouses of organizations to their structural units not granted the excise warehouse status shall not be carried out since it is not stipulated by the RF Tax Code.

Order of the RF Tax Ministry No. BG-3-03/478 of September 4, 2002, (registered with the RF Ministry of Justice, registration No. 3805 of September 17, 2002) is issued to enforce federal law No. 110 FZ of July 24, 2002, "On amendments to the second part of the Tax Code of the Russian Federation and certain other legislative acts of the Russian Federation," ap-





proves the Regulations governing issue of certificates for registration of persons engaged in operations related to oil products worked out in accordance with provisions of Article 22 of the RF Tax Code.

The regulations set forth the procedure governing the issuance of certificates for registration of persons engaged in operations related to oil products and shall be extended to organizations and individual entrepreneurs carrying out operations related to production, wholesale, wholesale and retail, and retail sale of oil products.

Certificates shall be documents justifying excise exemptions in order set forth by Article 22 of the RF Tax Code.

Separate certificates termed for 1 year shall be issued for each type of activities, including the following operations:

- Production of oil products;
- Wholesale trade with oil products;
- Wholesale and retail trade with oil products;
- Retail trade with oil products.

Decisions on granting, refusal to grant, suspension, renewal, annulment of certificates for registration of persons engaged in operations related to oil products shall be vested with the heads (deputy heads) of the Tax Ministry territorial offices in the RF subjects and the Interregional Inspection of the RF Tax Ministry for largest taxpayers No. 1.

The same order approves the list and forms of documents required to issue certificates.

## Tax on the mining of minerals

Order of the RF Tax Ministry No. BG-3-21/220 of April 22, 2002, (registered with the RF Ministry of Justice, registration No. 3398 of April 23, 2001, tax agencies informed by letter of the RF Tax Ministry No. NA-6-21/528 of April 23, 2002) approves the forms of calculation of regular payments for the use of mineral wealth and the Procedures governing the completion thereof. Regular payments shall be made in accordance with Section V of the law of the Russian Federation No. 2395-1 of February 21, 1992, "On Mineral Wealth" and Resolution of the RF Government No. 926 of December 29, 2001.

Regular payments for the use of mineral wealth shall be exacted only for the types of use included in Resolution of the RF Government No. 926 of December 29, 2001, which approved the minimal and maximal rates of regular payments for the use of mineral wealth.

Letter of the RF Tax Ministry No. NA-6-21/524 of April 23, 2002, explains the procedure governing the payment of the tax on the mining of minerals with coefficient Kts. This coefficient is applicable in relation to the rate of the tax on mining of minerals as concerns oil and gas condensate from gas condensate deposits and allows to take into account the dynamics of world oil prices. The coefficient shall be applied in accordance with Article 5 of federal law No. 126 FZ of August 8, 2001, and is defined as the ratio between the average US \$ exchange rate and the average level of prices of Urals oil over the respective period.

According to federal law No. 126 FZ of August 8, 2001, in order to calculate coefficient Kts, there shall be used the average US \$ / Rub. exchange rate as set by the Central Bank of the Russian Federation (to be determined as the sum of values of the US \$ / Rub. exchange rate set by the Central Bank of the Russian Federation at each day auctions were held divided by the total number of auction days in the respective tax period) and the average level of Urals oil prices over the tax period (to be determined as the sum of arithmetic mean purchase

and sale prices registered on world oil markets (Mediterranean and Rotterdam) at all days of auctions and divided by the number of auction days in the respective tax period).

Order of the RF Tax Ministry No. VG-3-21/475 of September 3, 2002, amends the Methodological recommendations on the enforcement of Article 26 "Tax on the mining of minerals" of the RF Tax Code.

Letter of the RF Tax Ministry informs and instructs tax agencies about Order of the Tax Ministry No. BG-3-21/448 of August 19, 2002, "On approval of the form of calculation of regular payments for the use of mineral wealth and the procedure governing its completion" (registered with the RF Ministry of Justice, registration No. 3739 of August 26, 2002) as follows.

In the case the deposit of mineral wealth is located in the territory under jurisdiction of several tax agencies, the user of the mineral wealth shall submit the calculation to one tax agency as determined by the Tax Ministry office in the respective subject of the Russian Federation.

Regular payments for the use of mineral wealth shall be made for the whole period of the validity of the license for the certain type of use of mineral wealth notwithstanding the actual amount of works relating to the respective type of use of mineral wealth. The regular payments shall be ceased basing on the reference issued by the territorial fund of geological information confirming the acceptance of the final report on completion of surveying and prospecting of mineral resources indicated in the license.

The fact of discovery of a mineral resources deposit shall be set since the date of the issuance of the certificate confirming the discovery of the mineral resources deposit by the RF Ministry of Natural Resources or one of its territorial offices.

#### Taxation of Small Businesses

Letter of the RF Tax Ministry No. SA-6-05/150 of February 6, 2002, explains that the use of single tax on imputed income derived from certain types of activities shall be defined as a special tax regime presupposing the replacement of the totality of taxes and charges with the single tax.

Letter of the RF Tax Ministry No. SA-6-22/1497 explains the procedure governing the payments made by taxpayers as concerns the single tax on imputed income in relation to the enactment of federal law No. 104 FZ of July 24, 2002, abolishing the obligation to pay the single social tax for organizations, which completed the transition to the payment of the single tax on imputed income.

Taxpayers are allowed to diminish the amount of the single tax on imputed income calculated for the respective tax (reporting) period in 2002 by the amount of insurance payments relating to mandatory pension insurance made in 2002. However, the amount of the single tax shall not be diminished by more than 35 per cent. The excessively paid amounts of the single tax on imputed income detected in the course of recalculation shall be offset or repaid in accordance with the procedure stipulated by Article 78 of the RF Tax Code.

Decisions concerning the offset or repayment of excessively paid amounts of the single tax on imputed income shall be vested with tax authorities.



## Transport Tax

Letter of the RF Tax Ministry No. NA-6-21/1704 of November 6, 2002, explains the procedure governing the enactment of Article 28 of the RF Tax Code "Transport Tax." Article 28 "Transport Tax" shall be enacted on January 1, 2003.

The transport tax shall be introduced and carried into force by the RF Tax Code and laws on transport tax approved by the legislative (representative) bodies of RF subjects.

In order to enact transport tax on January 1, 2003, RF subjects shall approve and officially publish respective laws before December 1, 2002. The respective laws of RF subjects on the transport tax shall define the following elements of taxation: tax rate, procedure, order, and terms of payment. The laws of RF subjects may either set forth, or not set forth tax privileges.

The respective laws of RF subjects shall determine the procedure and terms relating to the payment of the tax. The laws may stipulate either single payment of the whole amount of the tax after the completion of the tax period, or advance payment(s) during the tax period to be recalculated after the end of the tax period. It is a mandatory requirement that respective laws of RF subjects shall determine terms of advance payments and terms of payment of tax balances (according to recalculation taking into account advance payments) after the completion of the tax period.

## Court Determinations and Rulings

Letter of the RF Tax Ministry No. ShS-6-14/166 informs and instructs tax agencies about Ruling of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 1322/01 of December 18, 2001. According to the Ruling, provisions of item 2, Article 45 of the RF Tax Code stipulating that tax obligations shall be deemed completed on the date the taxpayer submits to the bank the order to pay the respective tax in the case this taxpayer's cash balance is sufficient, shall be extended only to *bona fide* taxpayers.

Letter of the RF Tax Ministry No. ShS-6-14/163 of February 8, 2002, informs territorial tax agencies about determination of the RF Constitutional Court No. 257-O. It is pointed out that due to insufficient delimitation of formal components of tax offenses items 1 and 2 of Article 135 shall not be enforced simultaneously.

Besides, provisions of Part 2 of Article 136 of the Tax Code concerning the exaction of penalties defined in Articles 133 and 135 in accordance with Article 60 of the Tax Code are similar to provisions the Constitutional Court ruled to unconstitutional by its Ruling No. 20-P of December 17, 1996. Due to this fact, courts, other authorities, and officials shall not use Part 2 of Article 136 of the RF Tax Code.

Letter of the RF Tax Ministry No. ShS-6-14/436 of April 8, 2002, informs and instructs tax agencies about Ruling of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 2635/01 of January 1, 2002, concerning the claim of the taxpayer whose tax payment was written off the account as indicated in the account record but not transferred to the budget due to the insufficient balance on the bank's correspondent account.

The rulings of the lower court and appellate instance of the Novosibirsk oblast Arbitration Court holding the head of the RF Tax Ministry Inspection liable of inaction (failure to diminish the tax indebtedness on the taxpayer's account) were reversed.

Letter of the RF Tax Ministry No. ShS-6-14/470 of April 15, 2002, informs and instructs tax agencies about Ruling of the Presidium of the Supreme Arbitration Court of the

Russian Federation No. 9111/01 of January 30, 2002, according to which tax agencies shall have the right to submit claims for adjudication in bankruptcy of absent debtor notwithstanding the amount of debt.

The RF Supreme Court by its determination No. KAS 02-361 of July 25, 2002, concluded that the RF Government had exceeded its legal authority by approving its Resolution No. 8 of January 14, 2002, as concerns the changes in patent fees relating to inventions, useful models, industrial designs, registration of trademarks and service marks as approved by Resolution of the Council of Ministers – the Government of the Russian Federation No. 793 of August 12, 1993.

The Supreme Court proceeded from the fact that after the enactment of the RF Tax Code the amount of patent fees for actions relevant in law may be determined only by a federal law and not by a resolution of the RF Government, since these fees should be defined as tax payments.

The court ruled that the RF Government had no right to increase the amount of patent fees set by the legislation, since federal taxes are within the exceptional jurisdiction of the legislature and not the RF Government. The law defines that payments of patent fees are made in relation to actions relevant in law and are clearly defined as fiscal payments on the part of the applicants, and are included in such tax obligations as fees and duties (what is confirmed by the title of the payment).

The Ruling of the Moscow Arbitration Court of December 13, 2001, on case No. A40-41151/01-12-241 renders unlawful the decision of the Chief Directorate for Federal Customs Revenues of the RF State Customs Committee (CDFCR SCC) as concerns the prohibition to offset amounts of recurrent customs payments made over the time goods are under the customs regime of temporary import.

Letter of the RF Tax Ministry No. ShS-6-14/1353 informs and instructs tax agencies about Resolutions of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 11654/01 of June 4, 2002, and of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 58/02 of July 9, 2002, concerning the repayment of VAT related to export operations.

1) The RF SAC dismissed the claim of an organization to repay it the amount of VAT charged to (written off) costs of purchased goods paid in excess over the amount of VAT charged in the course of the consequent export sale of these goods to customers outside the CIS member countries. The difference generated in relation to such operations should normally be offset against next payments of taxes or repaid within 10 days since the date of receipt of the calculation for the respective tax period.

The dismissal of the claim based on the fact that the organization was located at a place different from that as per founding documents according to which it was registered with a tax agency. This is the justified ground to hold the registration of a legal entity null and void.

Since taxpayers must submit tax calculations to the respective tax agencies, and the address indicated in the application for the repayment of VAT was in fact neither the location of the taxpayer's operations, neither the location of the taxpayer's bodies, the claim was dismissed.

The RF SAC also pointed out that lower courts had not paid attention to the fact that the claimant and the company, which transferred goods to the claimant, were established on the same date and that the claimant did not carry out any operations other than organization of transactions relating to the goods being the subject of litigation.



2) The RF SAC reversed the ruling to dismiss a claim for repayment of VAT paid for goods shipped to a foreign buyer by the commissioner from the federal budget basing on the fact that respective documents had not been signed by the chief accountant.

The RF SAC pointed out that according to item 6, Article 169, of the RF Tax Code the invoice should be signed by the head of organization and its chief accountant, or other officials authorized to sign such documents, and sealed with the organization's seal. According to the federal law "On Accounting," heads of organizations may keep accounting personally depending on the amount of respective work. Therefore, the absence of the chief accountant's signature should not be justification to refuse the repayment of VAT.

The RF SAC Presidium (Ruling No. 10335/01 of July 4, 2002) dismissed the claim filed by a tax inspection to exact a fine from a bank failing to inform about the opening of a taxpayer's transit foreign currency account for entering forex denominated proceeds.

According to the law of the Russian Federation "On foreign currency regulation and foreign currency control" and Presidential Decree No. 629 of June 14, 1992, "On certain amendments to the procedure of mandatory sale of part of forex denominated proceeds and exaction of export duties," there was approved Instruction of the Bank of Russia No. 7 of June 29, 1992.

According to the instruction, legal persons opening current forex accounts shall simultaneously open transit forex accounts in order to enter the full amount of forex denominated proceeds, including those not mandatory salable.

Therefore, the transit forex account shall be opened in parallel to the current forex account, therefore, notwithstanding the organization's will, notice of the opening of the current forex account is at the same time, the notice about the opening of the transit forex account.

The RF SAC explained that there are no grounds to hold the bank liable for offenses as defined in Article 132 of the RF Tax Code.

The RSFSR law of December 19, 1991, "On protection of natural environment" (Article 6) authorizes the RF Government to determine maximal payments for abuse of environment, pollution, and other harmful actions (the law was invalidated as the federal law "On environmental protection" was enacted on January 10, 2002). In order to enforce this stipulation, the RF Government adopted Resolution No. 632 of August 28, 1992, "On the approval of the procedure governing determination of amounts of maximal payments for abuse of environment, pollution, and other harmful actions" (hereinafter referred to as the Resolution).

The open joint stock company "Kolskaya Mining and Smelting Company" filed with the RF Supreme Court a claim to render the Resolution (as amended on June 14, 2001) unlawful referring to the fact that it did not comply with the current legislation since it unlawfully set forth a tax payment.

The Supreme Court ruled that in terms of law the payment for abuse of environment should be defined as a tax in accordance with Article 8 of the RF Tax Code (it was mandatory, not individually repayable, transferred by payers to finance the state).

The representatives of the RF Government admitted that the payment for abuse of environment is a federal tax in a written response to the claim (application) and in the course of proceedings. The court also took into account the fact that according to Supplement 2 to the law "On the Budget Classification of the Russian Federation," where payments for abuse of environment were included in the section of tax budgetary revenues (code 1050600, what corresponds to the sub-group of payments for the use of natural resources of the group of tax

revenues), and Supplement 2 to the RF law “On the Federal Budget for 2002,” where payments for abuse of environment were included in the list of federal taxes and charges.

However, all substantive elements of the aforesaid tax payments were determined not by a federal law, but by a resolution of the RF Government and regulatory acts of the federal executive authorities.

The Supreme Court satisfied the claim of the open joint stock company “Kolskaya Mining and Smelting Company” substantiating the ruling by the following facts: proceeding from Article 17 of the RF Tax Code, a tax due to the federal budget should be deemed as lawfully set forth only in the case the respective payers and elements of taxation are directly defined in a federal law, and ruled the Procedure and Resolution unlawful as not complying with Article 6 of the RF Tax Code and infringing upon the rights of the claimant making the claimant pay a tax not stipulated by a federal law.

The representatives of the RF Government argued that the Resolution complied with the current tax legislation, since according to Article 7 of the law of 1998 “On Enactment of Section One of the RF Tax Code” normative and legal acts of the RF Government concerning the issues which according to Section One of the RF Tax Code might be regulated only by federal laws should remain in force until respective federal laws were approved.

However, the Supreme Court did not agree with this argument and ruled as follows:

“According to the legal standing of the Constitutional Court of the Russian Federation as expressed in Ruling No. 16-P of November 11, 1997, in relation to the “Case of verification of compliance of Article 11.1 of the Russian Federation law of April 1, 1993, ‘On the State Border of the Russian Federation’ with the RF Constitution,” authorization of the RF Government to determine substantive elements of tax obligations do not comply with the legislatively set delimitation of power between the legislative and executive authorities...

Taking into account the fact that the challenged Resolution and Procedure contain legal provisions similar to those ruled non-constitutional by Ruling of the RF Constitutional Court No. 16-P of November 11, 1997, the court has no right to rule these provisions lawful even in spite of Article 7 of the federal law of July 31, 1998, “On Enactment of Section One of the RF Tax Code.”

The Court also pointed out that at present the challenged Resolution of the RF Government runs counter to the federal law of January 10, 2002, “On environmental protection” since according to item 1 of Article 16 negative influence on environment shall be paid for, while concrete forms of such payments shall be set forth by federal laws. The Supreme Court considered this provision as an additional confirmation of the conclusion that payments for abuse of environment may be set only by a federal law and not by an act of the RF Government.

According to Determination of the Supreme Court No. KAS 02-232 of June 4, 2002, this ruling remained in force, while the appeal of the Russian Government was repudiated.

Later the RF Government requested the RF Constitutional Court to verify if the Resolution complied with the Constitution claiming that payments for abuse of environment were not tax payments and could not be defined as tax obligations in terms of constitutional law, therefore being outside the system of payments set forth by laws as stipulated by Articles 57 and 75 (section 3) of the RF Constitution. According to the claimant, the Resolution had been approved in compliance with the constitutional powers of the RF Government and did not in-



fringe upon stipulations of federal laws, therefore it should be enforced in contravention to the ruling of the Supreme Court.

The Constitutional Court having examined the relevant normative and legal complex issued its Determination No. 284-O of December 10, 2002, as concerns the request of the RF Government to verify the compliance with the RF Constitution of the RF Government Resolution “On the approval of the procedure governing determination of amounts of maximal payments for abuse of environment, pollution, and other harmful actions” and Article 7 of the law “On Enactment of Section One of the Tax Code of the Russian Federation,” pointing out that:

“... payments for negative influence on environment as a necessary condition under which legal persons and individual entrepreneurs may be granted the right to carry out economic and other activities negatively affecting the environment shall be defined as mandatory public law payments (in the framework of financial legal relations) for the measures undertaken by the state in order to protect and restore environment as concerns the consequences of economic and other activities negatively affecting the environment within limits set forth by the state. These payments are of individually payable and compensatory nature and therefore, in legal terms, are not a tax but a fiscal charge. The general principles of exaction of such charges, a number of substantial features thereof, i.e. payers, object of taxation – types of harmful (negative) influence on the environment, as well as the tax base in general form – standards of pollution, waste disposal, etc., and the list of standards of maximal acceptable negative impact on the environment and respective substantial characteristics shall be directly set forth by a federal law. As concerns the procedure governing the determination of maximal amount of payments, the federal legislature has granted this right to the RF Government.

This authorization of the RF Government shall not be viewed as arbitrary or unsubstantiated, since, according to the RF Constitution, the Government of the Russian Federation shall execute its authority by ensuring (including the issuance of normative legal acts) the pursuit of single financial and ecological policies in the Russian Federation; the rights and freedoms of citizens (including their right for favorable environment, what requires to ensure environmental protection and ecological security) and execute other powers vested with it by federal laws regulating the spheres within the jurisdiction of the Russian Federation and its subjects (items “b,” “c,” “f,” and “g” of Section 1, Article 114 in relation with Article 42, items “c” and “f” of Article 71, items “b” and “e” of Section 1, Article 72, Section 1 of Article 110, Article 115, and item “a” of Section 2, Article 125, of the RF Constitution) (paragraphs 6 and 7 of item 5 of the justificatory section).

However, we find the argument that the RF Government shall have the right to set forth the procedure governing determination of maximal amounts of payments for abuse of environment, pollution, and other types of harmful influence because according to the RF Constitution the RF Government “undertakes measures ensuring rights and freedoms of citizens (therefore, including the right for favorable environment, what requires to ensure environmental protection and ecological security) is too vague and arguable.”

Finally, the Constitutional Court ruled as follows:

- “Resolution of the RF Government No. 632 of August 28, 1992, “On the approval of the procedure governing determination of amounts of maximal payments for abuse of environment, pollution, and other harmful actions” (No. 463 as amended on June 14, 2001), since it was adopted by the RF Government to enforce the authority vested with it by the federal law and stipulated exaction of payments of

non-tax nature, shall remain in force and be enforced by courts, other agencies, and officials as an act being in compliance with the RF Constitution as concerns the delimitation of jurisdiction between the Federal Assembly and the Government of the Russian Federation” (item 1 of the judicial disposition);

- “The constitutional and legal purport of this Determination concerning the Resolution of the RF Government “On the approval of the procedure governing determination of amounts of maximal payments for abuse of environment, pollution, and other harmful actions” shall be compulsory, what excludes any other interpretation of this Resolution by enforcement agencies including general jurisdiction courts (item 2 of the judicial disposition).

### **Appendix 3. Reforming the Taxation of Small Businesses**

The new articles of the Tax Code setting forth special taxation regimes of small businesses and introducing imputed income for certain types of activities were approved in July of 2002 and should be enacted in 2003. The first outcomes of the reform will become clear only in a year. However, at present it is possible to advance some hypotheses about the prospects of further development of small businesses and the possible effect of the reform on tax revenues, including other taxes and taxes on other enterprises, not only small businesses and enterprises<sup>27</sup> operating under simplified regimes.

In order to analyze the special taxation regime, it is necessary to establish what the introduction of the special regime is aimed at.

Different countries aim to achieve different goals working out the procedures of taxation of small businesses, what to the greater extent determines the differences in applied regimes. The goals depend on the environment small businesses have to operate in, their contribution to GDP production, sectoral structure of the economy, size of tax evasion in the society and specific forms of this evasion across countries. Besides, the specifics of regimes of taxation of small businesses may be generated due to differences in both tax and non-tax legislation, and the institutional structure of a concrete society. In the countries where small businesses make greater contribution to GDP production due to the specifics of the structure of production the fiscal component aimed to minimize tax evasion of small businesses *per se* may prevail, since in this case the contribution of small businesses in budget revenues may be considerable. In other cases the circumstances may determine that different rates of taxation of revenues from different sources make taxpayers seek to derive revenues in the forms taxed at lower rates. It is often more feasible at the level of small businesses, therefore special regimes may aim at establishing rules tightly regulating classification of incomes as derived from specific sources. Certain countries seek to lower the tax burden on small businesses, since there are specific types of economic costs, which primarily affect small enterprises. In this case small businesses either are taxed at lower rates, or granted certain privileges. In a number of cases there are introduced simplified regimes allowing to more or less precisely evaluate obligations pertaining to different types of taxes and (or) exempt small businesses of certain taxes in order to decrease alternative costs of taxation, which are higher for small enterprises due among other factors to the lack of internal need to use a developed accounting system. In Russia, small businesses do not constitute a developed sector of the economy gen-

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<sup>27</sup> Hereinafter understood as a legal entity or individual legally carrying out entrepreneurial activities rather than the property complex as defined in the RF Civil Code.





erating a considerable share of revenues. The insignificant share of small businesses (in comparison with many other countries) and their insufficient contribution to the size of employment, as well as unsatisfactory dynamics of output and investment lead to the conclusion that small enterprises in the Russian economy are in an unfavorable situation. For instance, although the share of employment in small businesses increased from 12 per cent to 12.9 per cent in 1997 through 2001 (remaining rather low), the share of respective output declined from 8 per cent to 5.6 per cent, while investment in fixed assets fell from 5.4 per cent to 2.7 per cent<sup>28</sup>. The real situation may be even worse: in certain cases medium sized and large enterprises are prompted to use the special regime of taxation of small businesses in order to minimize their tax obligations conducting certain transactions via small businesses, sometimes established specifically to perform this function. For instance, the procedure of taxation of individuals using the simplified system of taxation, which was in force in Moscow until 2003, was rather favorable. This regime was especially favorable in the case the taxpayers' expenditures relating to purchase of goods, works, and services from third parties were low or absent. Therefore, large and medium sized enterprises often used this regime to make payments under civil law contracts instead of employing and remunerating (or additionally remunerating) their own workforce. In other cases it might be feasible to overstate costs of services rendered to enterprises using simplified or imputed regimes. For instance, it is difficult to verify the costs of transportation services rendered by an enterprise paying the tax on imputed income, at the same time, the consumer overstating the cost of such services may be granted larger exemptions from the profit tax base, what does not affect the tax obligations of the producer. Therefore, it may be assumed that the aggregate indicators of real small businesses are even lower than statistics demonstrate as concerns officially registered small businesses. Apparently, the situation of small businesses is determined not only by their tax environment. However, the effect of taxation on the distribution of resources among the branches and sectors of the economy may be significant.

In this connection, the priorities of the tax reform as concerns small businesses in Russia should include, first, new incentives for development of small businesses, and, second, measures aimed to decrease tax evasion on the part of relatively large enterprises related to operations via small businesses. The second goal is important not only in fiscal terms, but also as a means to create normal competitive environment for small businesses. Tax evasion by concluding transactions between enterprises subject to different rules determining their tax bases allows to minimize tax obligations as compared with any other, even preferred, regime. However, the real small enterprises in the sense that they bear high alternative costs of taxation can not use this form of minimization of tax payments and therefore risk to operate in even worse competitive environment than in the case no special regimes were applied in the economy. At the same time, in order to facilitate rapid development of small businesses, form a competitive economic environment, and facilitate employment and self employment, it seems feasible to somewhat reduce budget revenues generated by small businesses on condition that the decrease in the tax burden shall be extended only to real small enterprises. Besides, it would be feasible to permit small enterprises keep tax accounting according to a simplified system.

The key problems encountered in the course of elaboration of special tax regimes for small businesses were more thoroughly analyzed in the IET survey for 2001. In the same pub-

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<sup>28</sup> Source: Goskomstat, collection "Maloye predprinimatelstvo v Rossii (Small Businesses in Russia)", 2002.

lication, there were offered respective feasible options. This section focuses on the analysis of the new articles of the Tax Code approved in 2002 and certain draft laws submitted to the State Duma.

As it was noted above, proceeding from the declared priorities of the reform the main criterion of evaluation of recommendations aimed to simplify taxation is the real reduction of the tax burden and minimization of tax related costs of small enterprises at the same time preventing tax evasion on the part of enterprises other than small businesses. Unfortunately, the majority of materials concerning the reform of present system did not answer this requirement<sup>29</sup>. The systems proposed for discussion provided considerable opportunities to evade taxes (to a considerable extent these opportunities remain available in accordance with approved articles 26.2 and 26.3 of the Tax Code): for instance it is the opportunity to mask a business as a small enterprise or formally divide an enterprise into several small businesses, or create small businesses as profit generating units within a controlled group of enterprises. The considerable opportunities to evade taxes contained in drafts proposed for discussion resulted from the very wide sphere subject to the new regime, while no tight constraints were put on the scope of enterprises' operations. The list of admissible operations included retail trade, household and transport services, construction and repairs, other services, agriculture, industry, the sphere of science and technology, etc. While household services and retail trade are natural spheres of small entrepreneurship, where the risk in terms of tax evasion is reduced to the division of enterprises in smaller businesses and the use of different regimes by enterprises engaged in similar types of activities and belonging to the same owner, in the case services are provided to other enterprises the risk of tax evasion increases considerably. At the same time, these systems fail to create serious incentives for development of small businesses in Russia.

It seems not feasible to include in priorities relating to the systems of taxation of small businesses the reduction of tax evasion in the sectors where it is difficult to control parameters forming the tax base. The current system of taxation of imputed incomes and respective proposed legislation attempt to settle this problem by introducing this regime as mandatory for certain types of activities. This decisions seems to be wrong and will result in a sharp limitation on the scope of implementation of simplified taxation systems and losses borne by bona fide taxpayers. As concerns the types of activities where tax evasion is prevalent and difficult to detect in the course of ordinary tax inspections, it is possible to apply minimal imputed tax significantly lower than in the framework of a voluntary chosen system.

Articles 26.2 "Simplified taxation system" and 26.3 "Taxation system in the form of single tax on imputed incomes as concerns certain types of activities"<sup>30</sup> of the RF Tax Code approved by federal law No. 104 FZ of July 24, 2002, are not free of the shortcomings charac-

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<sup>29</sup> It concerns, for instance, the package of draft laws elaborated by the RF Tax Ministry and Ministry for Trade and Economic Development, which includes following draft articles of the RF Tax Code: Charge for the right of trade; Simplified system of taxation of individual entrepreneurs operating on the base of patents; Single tax on imputed income as concerns certain types of activities; Simplified system of taxation of organizations and individual entrepreneurs; as well as a draft federal law "On amendment of the Tax Code of the Russian Federation" (as concerns the simplified taxation system applicable to small businesses) introduced by I. D. Grachev and O. G. Dmitrieva, State Duma deputies (June 27, 2001).

<sup>30</sup> For a brief summary of these articles, see this survey, section "A Review of Changes in the Legislation Regulating Taxation Issues in the Russian Federation." The provisions not presented in this section or being of special interest from the viewpoint of this section are described below.



teristic of taxation regimes applicable to small businesses in force before 2003. Many provisions of the taxation regime introduced by these articles infringe upon the neutrality of taxation, while failing to create favorable conditions for the majority of small businesses. At the same time, they provide considerable advantages to those able to create several enterprises using different regimes and distributing different types of incomes and expenditures among enterprises under different regimes in order to minimize tax obligations.

At the same time, some of the provisions of this taxation regime, although criticized, are acceptable compromise allowing to reduce tax evasion via small businesses, while not hindering those in real need of the simplified system.

Thus, the provision substituting VAT with the single tax on the results of economic activities is justified in the case there is no mechanism of detection and punishment of abuses taking advantage of different terms of determination of incomes and expenditures following the cash basis accounting method applied under the simplified regime and the accrual basis accounting method. For instance, the fact that those taking advantage of the simplified regime can not be payers of VAT, what renders unprofitable to create artificial intermediaries (or organizations making insignificant changes in products for sale to enterprises using these products as factors of production) in order to delay tax payments by utilizing the delays in payments of entities using the accrual method to entities using the cash method.

The constrains on the direct share of other organizations in those using the simplified system (25 per cent) are important factors partly mitigating the problem of tax evasion on the part of groups of affiliates, however, their effect is limited (Article 246.12, item 3, sub-item 14). For instance, two enterprises operating under different tax regimes may belong to the same owner. It is also possible that the same person indirectly participates in different organizations (the share of such a person may be rather considerable). Besides, there remain the possibility to substitute dividends from a large enterprise with income from a small enterprise (a legal entity or an individual). At the same time, in the case enterprises where the shares of the same owner are even larger are not engaged in similar activities and do not conclude mutual transactions, the possibilities to minimize taxation via small businesses are limited. It shall not be excluded that there may be introduced limitations solving a number of problems relating to tax evasion and abuse of specific tax regimes. For these purposes, the eligibility of an enterprise for the simplified regime shall be determined basing not only on the income of and the number of employees at the enterprise applying for the special regime, but also on the aggregate income of and the number of employees at all enterprises affiliated with the applicant enterprise, concluding mutual transactions with this enterprise, or were engaged in similar types of activities. It is more difficult to administer this regulation than limitations set forth by the Code, however, such advantages as, first, the possibility to simplify a number of other terms of the regime, and, second, to use in the future the automated information system of the RF Tax Ministry thus considerably reducing the costs of administration, outweigh the difficulties.

It is very important to introduce limitations concerning the amount of gross income. Article 26.2 sets the respective amount at Rub. 15 million a year. This parameter gave rise to the most heated debate. Different options were argued, including the abolition of the limitation. The Government originally proposed to set the limit at Rub. 10 million. However, it seems that limitation can not be reviewed separately from other limitations and the ability of tax authorities to administer such limitations. The limit of gross income at Rub. 15 million might be considered as acceptable for enterprises under the simplified regime taking into account the

Russian realities in the case there were introduced some other regulations preventing the creation of several affiliated enterprises all or some of which using the simplified regime in order to minimize tax obligations. In the case no such limitations are introduced, the limit should be set at the amount rendering the use of the simplified regime less suitable to evade taxation, since constraints on the amount of income making enterprises eligible for alternative regimes at the same time limit the amount of transactions such enterprises may conclude and, therefore, minimize the possible gains resulting from the decrease in tax obligations achieved via such transactions. Creation of affiliates in order to evade taxes has its costs, therefore, in the case these costs are comparable with the potential gain resulting from the decrease in taxes, it becomes less advantageous to use this form of evasion. It seems feasible to initially set the limit at Rub. 4 million a year (the amount making taxpayer eligible for exemption from VAT). Later, the limit may be increased as possible shortcomings of the regime are detected and corrected.

The limitations on the number of employees make enterprises employing up to 100 workers eligible for the simplified regime (Article 246.12, item 3, sub-item 15). It is difficult to imagine that such enterprises do not employ professional accountants. Therefore, it may be assumed that such enterprises will take advantage of the simplified regime not to simplify accounting, but rather to minimize taxes. In the case it is taken into account that there are no sufficient barriers to pay wages and salaries at large enterprises via small enterprises, this limit seems to be set too high.

The value of assets set at Rub. 100 million (Article 246.12, item 3, sub-item 16) could become a serious constraint. However, this provision concerns only depreciable assets, i.e. fixed and intangible assets. In the case an eligibility criterion for simplified regimes is the limitation on property, it would be more feasible to limit the amount of inventory holdings, since the aforesaid limitation on the depreciable assets only rarely may be significant for real small businesses, while possible misuse of assets for the purposes of tax evasion may be prevented by other means. Besides, in order to determine if an enterprise is eligible according to this requirement it would be necessary to evaluate the residual cost of depreciable assets at the end of each reporting period, i.e. to keep accounting of depreciable assets, what significantly increases the tax related costs borne by small businesses. Moreover, the amendment introduced by federal law No. 191 FZ of December 31, 2002, sets forth the requirement to evaluate residual costs "in accordance with the laws of the Russian Federation on accounting," i.e. introduces additional accounting of fixed assets. However, the accounting of fixed assets is a most difficult component of accounting and it shall be noted that double-entry accounting is easier than keeping income and expenditure ledger.

An important factor is the limitation on the taxpayers' right to choose between the simplified and general regime (Article 346.13, item 7). At the same time, in order to curb possible abuse it would be feasible to increase the period after which it is permitted to turn to the simplified regime again up to three year. However, the original version of the article permitted to turn again to the simplified regime only after two years of using the general regime, while federal law No. 191 FZ of December 31, 2002, amended this provision permitting to return to the simplified regime after one year.



A considerable limitation is that the “taxpayer shall have no right to change the object of taxation over the whole period when the simplified system of taxation is used”<sup>31</sup> (Article 346.14, item 2). However, the possibility of simultaneous coexistence of several simplified regimes *per se* creates opportunities to evade taxation, especially taking into account the fact that taxation at lower rates makes it more effective to use simplified regimes for these purposes. It may be expected that in 2003 and 2004 payment of wages and salaries via such small enterprises will acquire massive character. It seems that this regime will be hardly abolished before 2005, when it is to be abolished in accordance with the Tax Code; however, it is important to prevent its prolongation.

It seems dangerous that there are no limitations on the use of simplified regimes for participants of external economic activities. Although the complete prohibition seems to be an excessive measure, at the same time the complete absence of constraints does not seem feasible. First, it may result in evasion practices relating in considerable losses of the budget (what may be facilitated by vague definitions of the Tax Code as concerns VAT imposed on imports; however, it shall be noted that federal law No. 191 FZ of December 31, 2002, amends this provision stipulating that VAT exemptions shall not concern VAT payable on goods imported to the customs territory of the Russian Federation in accordance with the Tax Code (see Article 346.11, item 3). Second, as a rule participants of external economic activities have forex accounts, what requires regular professional accounting, i.e. such enterprises would less benefit from simplified accounting, moreover, professional accountants would be more comfortable with double-entry accounting.

The incomes as defined for the purposes of the simplified system include proceeds from sales and proceeds other than those from sales as defined in Articles 249 and 250 of the RF Tax Code. The consistent use of cash flow tax of type R<sup>32</sup> requires taxation of only real cash flows, i.e. proceeds relating to goods, works, and services shall be included in the tax base, while borrowings and interest shall be excluded. Payments for purchased factors of production shall be also excluded from the tax base, while payments relating to interest and principal debt shall be taken into account. In order to correctly define such a base it would be feasible either make a separate list of incomes and expenditures for small businesses, or refer to respective articles of Chapter 25. In the latter case, it would be necessary to take into account the specifics of the structure of the RF Tax Code, which includes a part of proceeds from sale of foreign currency, proceeds from leased property, payments for the right to use the results of intellectual activities, property acquired free of charge, and some other types of incomes in a

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<sup>31</sup> It concerns rather the possibility to choose between objects of taxation in the framework of the simplified regime as set forth in the Code, i.e. income and income reduced by the amount of expenditures taxable, respectively, at 15 per cent and 6 per cent, rather than the possibility to choose the simplified or general regime. The right to choose income as the object of taxation shall be valid until January 1, 2005.

<sup>32</sup> Economists have worked out several types of cash flow taxes, all of which are investment-neutral in the sense that such taxes do not distort marginal investment decisions. Each tax has its merits and shortcomings. From our point of view, the tax on Real (R-based) cash-flows is best suited for taxation of small businesses. Other cash-flow taxes include the tax of RF type (real plus financial) imposed on all real and financial flows, i.e. the base of which includes all cash inflows (proceeds, borrowings, and interest) minus all expenditures (payments related to purchase of goods, works, services, repayment of borrowings and interest) and the S type tax imposed on net cash flows to shareholders, i.e. dividends plus purchase of shares minus cost of newly issued shares. The two latter taxes are practically similar (in the first case the tax base includes the tax itself, while in the second case the tax is excluded since in legal terms the tax shall be paid by an enterprise from the amounts paid to shareholders) (See: Tax Policy Handbook, IMF, 1995. P. 169).

separate article “proceeds other than those from sales” (Article 250). The same article concerns received interest. Therefore, it would be feasible to specifically refer to this rule in order to exclude received interest from the tax base. A symmetrical procedure should be introduced in relation to payable interest, i.e. such interest payments shall not be excluded from the tax base.

However, the State Duma took the decision to include received interest in incomes and deduct paid interest from the expenditure component of the tax base. This decision ensures neutrality, however, only on condition that incoming cash flows are included in the tax base alongside with interest, while all cash outflows are excluded, i.e. in the case the RF tax from the cash-flow group is imposed. In this case the principal debt should be included in the tax base, and be deducted from the tax base after repayment. Therefore, the tax as defined in Article 26.2 of the Tax Code is not a cash-flow tax. However, definitions are irrelevant. The point is that the main advantage of cash-flow taxes, investment neutrality, is not ensured under the new Russian simplified regime. Besides, this regime ensures the advantage of the enterprises receiving credits over those having to rely on own resources, while small businesses are most interested in deduction of costs relating to financing of investment at the expense of own funds, since real small businesses seldom have an opportunity to use borrowed funds. Apparently, all reflections on the neutrality of cash flow taxes make sense only in the case there are no limitations on transfer of losses (this issue is analyzed below).

At the same time, it is necessary to note that in reality not all taxpayers are eligible for the immediate deduction of expenditures for fixed assets in accordance with Article 26.2. As concerns fixed assets purchased by an enterprise prior to the introduction of the simplified regime, in fact there is applied depreciation, although according to other rules than those determined by the general regime. As concerns fixed assets operable under 3 years, the deduction shall be made in one year, while assets operable from 3 to 15 years, depreciation shall make 50 per cent, 30 per cent, and 20 per cent in the first, second, and third years under the simplified regime respectively (Article 346.16, item 3). Assets operable for longer periods shall be written off “within 10 years of operation under the simplified system of taxation, in equal shares of the value of fixed assets.” It turns out that no immediate deduction is carried out, depreciation is charged, and, in the case the term of an asset operation makes 16 years, and it has been operated for 15 years prior to the introduction of the simplified regime, its residual cost would be written off over the next 10 years. Although in this case the amounts are probably rather small, accounting becomes more complex nevertheless. This procedure in fact renders the “simplified” system rather complicated for those earlier operating under another regime. The purpose of this is rather vague, since the deliberate acceptance of the general regime at the moment of investment followed by the transition to the simplified regime does not benefit the enterprise as concerns taxes. In the case depreciation is carried out, double-entry accounting is easier and more free of errors than proceeding directly from the income and expenditure ledger. Apparently, enterprises employing professional accountants would prefer the double-entry accounting while reporting in accordance with the “simplified forms.” In these circumstances the abolishment of the requirement to submit balance sheets to tax agencies seems to be unfeasible.

As concerns the enterprises where owners who are not accountants keep books independently, this system is too complicated and does not decrease costs relating to the tax payments, i.e. this regime does not allow to achieve its announced goals.



Moreover, enterprises are required to recalculate depreciation for the time of operation under the simplified regime in accordance with the general procedure in the case the asset is sold. In fact, the budget benefit from the respective penalties. At the same time, the tax base resulting from the sale do not change. Income resulting from the recalculation shall be deducted from the tax base since the residual cost of fixed assets diminishes by the same amount. It seems that this measure was introduced to prevent the potential possibility to write assets off via small enterprises and their consecutive sale to individuals or other persons having no right to deduct expenditures for purchase of fixed assets from the tax base. In the case it is true, it would be more feasible to set forth a special respective clause.

Article 346.18 describes the procedure of collection of the minimal tax (1 per cent of proceeds) applicable to those who chose proceeds minus expenditures as the object of taxation. Generally speaking, this stipulation is justified, however, it may become too tight in combination with the limitations on transfer of losses. Moreover, although the consequent transfer of the paid minimal tax is a feasible measure, it becomes considerably less advantageous because it is subject to all tight limitations on all other losses.

The procedure governing the transfer of losses contains all limitations in force for enterprises operating under the general regime, where they also are unjustified. "A loss shall not diminish the tax base by more than 30 per cent. At the same time, the balance of the loss may be transferred to next tax periods, but not more than 10 tax periods" (Article 346.18, item 7). The role played by the transfer of losses in creating incentives for investment and the destabilizing effect of limitations were repeatedly discussed in works by different authors. It shall be noted that limitations have the most serious destabilizing impact on small businesses. Alongside with the general limitation, those using the simplified system are subject to an additional limitation – losses accumulated over the term under the general regime are not set off in the course of transition to the simplified regime and vice versa. The first limitation does not make sense at all, since it is better to set off the losses accumulated under the general regime in the framework of the same regime, since the 24 % rate is higher than the 15 % rate applied under the simplified regime. There is no danger that budget revenues decline due to transition to the simplified regime (except the losses directly relating to the use of the simplified regime). As concerns the losses accumulated under the simplified system, the issue is more complex. Nonetheless, the complete prohibition to transfer losses in the course of transition from one regime to another is a too tight measure destroying enterprises' development incentives. The potential of tax planning – transition to the simplified system for the moment of investment aimed at the rapid depreciation - may be effectively prevented by capitalizing losses accumulated under the simplified regime in the process of transition to the general regime and write them off over a number of years. In this case it would be feasible to limit acceptance of losses in the case of mergers in order to prevent trade with losses.

The prohibition to transfer losses is not the only too tight limitation relating to the transition from one regime to another. Article 346.25, item 3, stipulates that the value of fixed assets purchased in the period of operation under the simplified system shall be recalculated in accordance with the regulations applicable to the general regime. This measure is too tight and will result in losses both for enterprises and society. The potential of tax planning may be effectively prevented by the simple method mentioned above, i.e. capitalize losses accumulated under the simplified regime in the process of transition to the general regime and write them off over a number of years. At the same time, the approved procedure of recalculation will artificially check development of enterprises and increase accounting costs in cases it be-

comes profitable to expand the capacity of enterprises even exceeding threshold indicators, and increase costs borne by tax agencies in the process of verification of the tax base. At the same time, this measure fails to eliminate major possibilities to evade taxes. Enterprises subject to such limitations may expand by creating new organizations eligible for the general regime, or lease fixed assets from small enterprises owning these assets. These developments will result in even more considerable losses of the budget than in the case enterprises could expand and transit to the general regime without any limitations.

It shall be once more stressed that introduction of the 5 per cent tax on alternative objects of taxation, i.e. an income-related tax will result in massive tax evasion relating to wages and salaries. The most simple scheme of such evasion is to register employees as individual entrepreneurs and conclude respective civil law contracts in stead of paying wages and salaries. The paid amounts, similarly to wages and the single social tax, shall be deducted from the profit tax base, however, in this case in stead of paying the single social tax at the rate of 35.6 per cent (in the case the wage is over Rub. 100 thousand and the enterprise answers a number of requirements) the enterprise has to pay relatively small (in 2002 – Rub. 150 a month) payments to the Pension Fund. Besides, these payments are deductible from the single social tax (up to 50 per cent, however, it is difficult to exceed this limit taking into account the negligible payments to the Pension Fund).

The chief disadvantage for the society which may result from the adoption of this procedure is that real small businesses will be taxed either at 6 per cent of gross incomes or 15 per cent of net incomes. At the same time those able to create several enterprises specifically to misuse the tax base may achieve a decrease in effective rate to 6 per cent of net incomes (in the case that according to documents relate to the enterprise choosing incomes minus expenditures or profits as the object of taxation, while the excess of profits over expenditures is received by the enterprise whose object of taxation is income). Therefore, small enterprises may have to compete with medium-sized enterprises more bitterly than in the case the general regime were extended to all taxpayers. So, these measures fail to ensure the main goal of the reform – creation of favorable environment for small businesses.

Yet another important issue shall be stressed. Rates of simplified taxes on small businesses are low, potential of tax evasion is not eliminated, threshold parameters of eligibility to use simplified regimes are high. Besides, these measures will negatively affect not only revenues from the profit tax, but also income tax and the single social tax. A decline in budget revenues is inevitable both at the federal and regional levels. However, the respective decision was taken by the State Duma, not regional or local authorities. In this situation it would be feasible that the federal budget assumes the greater responsibility for the decision. For instance, the lowered rate could be reviewed as the refusal of the federal budget to receive its share of the tax. Besides, it would be right if the major part of (or all) tax revenues is transferred to local budgets.

Article 26.3 “Taxation system in the form of single tax on imputed incomes as concerns certain types of activities” of the Tax Code introduces the new procedure of collection of the tax on imputed income.

As compared with the previous procedure, the changes may be viewed as positive. There were excluded the types of activities primarily used to sell products to other enterprises. Household services are the major subject of the tax on imputed income. The new procedure may help to prevent tax evasion in the form of rise in expenditures due to purchases of services from enterprises subject to the imputed tax. Besides, there were excluded





the types of activities subject to stricter control not relating to taxation (for instance, gathering and sale of non-ferrous metal scrap). The procedure governing the determination of the imputed tax base was described more thoroughly. At the same time, certain intrinsic shortcomings of imputed taxation remained. The compulsory character of the tax as concerns certain types of activities will result in the impossibility to compare the results of taxation of these types of activities under the imputed and general regimes, thus misleading about the correcting coefficient  $K_2$ <sup>33</sup>. Moreover, the use of such a tax will affect the horizontal equity of the tax system, since the averaging basing on natural indicators results in different taxation of enterprises showing equal results of economic activities. Regional authorities still may arbitrarily determine the tax base, since the coefficient  $K_2$  may be considerably varied from 0.1 to 1, and regional authorities are responsible of its parameters. At the same time, it may turn out that for certain enterprises there may be determined practically individual tax bases (too high or too low) depending on the preferences of regional authorities and their ties with enterprises. This coefficient may be also used to hinder new enterprises to access markets in the case the authorities have interest in or control over businesses subject to the tax on imputed income operating in the region.

In this relation it seems feasible to apply the tax on imputed income only to especially small enterprises on voluntary basis. The considerable efforts the Government made to determine indicators significant for evaluation of profitability may prove useful for the tax authorities. Basing on the imputed methods it is possible to evaluate the potential amount of tax payments of enterprises and in case of considerable differences between the reported results and the evaluation made by tax authorities set inspection priorities. It would allow to minimize tax evasion, increase budget revenues, and render taxation more fair.

Finally, it seems important to once more refer to the statistics reflecting the role small businesses play in the Russian economy. Goskomstat does not publish the data on added value in the sector of small business. However, the volume of output, number of employed and small businesses may increase not only due to the development of real small enterprises, but also due to increasing tax evasion via small businesses. Even the indicator of added value does not adequately reflect the real situation. It would be feasible to survey only small enterprises not affiliated with large businesses or a large number of other small enterprises in order to monitor the consequences of the new tax procedure.

#### **Appendix 4. Analysis of Certain Results of the Personal Income Taxation Reform**

Within the framework of the analysis of certain results of the incomes taxation reform in Russia there was made a study of keys problems related to the income tax functioning in Russia and results of the reform made in 2000<sup>34</sup>.

The reform of the income tax or taxes on incomes of natural persons as it is called in the new version of the corresponding part of the Tax Code, was made in 2000 at the first stage of the tax reform and consisted first of all in establishing a flat single rate at a level close to the

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<sup>33</sup>  $K_2$  is the correcting coefficient of base profitability taking into account the totality of other specifics related to business activities, including the range of goods (works, services), seasonal factors, time of work, amount of incomes, and other specifics (see Article 346.27 of the Tax Code).

<sup>34</sup> S. Sinelnikov-Murylyov, S. Batkibekov, P. Kadochnikov, D. Nekipelov "Otzenka Resultatov Reformy Podokhodnogo Naloga" (see <http://www.iet.ru>).

lowest marginal tax rate of previously effective scale, reduction of tax preferences and simplification of the tax payment and collection procedure. Income tax changes were called forth by the need to enhance its role both in total tax revenues and in tax redistribution processes.

Such a radical income tax reform is being made for the first time in Russia; because of this in contrast to other countries that have already undergone that kind of reforms Russia has practically no experience in studying the changes' influence on the level of taxable incomes, tax proceeds to the budget and the tax's role in the process of redistribution of citizens' incomes.

Among the most important conclusions that follow from the analysis of the situation prior to the reform one can name the following: the income tax played *a little role in the tax system* due to low average incomes of the population, first of all because of small wages, intricate tax legislation and weak administration of this tax, and as a consequence of this - mass tax evasion, the tax possessed *a low redistribution capability*, which followed from an abundant use of different mechanisms to evade it predominantly by taxpayers with high incomes. In such a situation the possibilities to increase tax revenues by using a higher marginal tax rate were limited, as in conditions of poor administration this could lead to a more intensive tax evasion. In those conditions a lower marginal tax rate and a harmonization of the aggregated profit tax rate for enterprises and taxes on wages for employees, alongside with a stronger tax administration according to the fathers of the reform would have promoted a lower concealment of incomes from taxation.

With the aim to form theoretical hypotheses about the reform's influence on the level of income tax revenues there were used models of tax evasion of Allingham-Sandmo type. Bearing in mind the conclusions made on the basis of such models, we formulated three basic hypotheses. The first one is that a lower marginal tax rate shall entail an increase of the taxable basis. The second one is that a lower evasion, first of all among taxpayers with highest incomes, shall lead to a higher taxation of those, and as a consequence to a higher progressiveness of the income tax. And the third one is that in spite of a lower marginal tax rate there will be higher tax revenues.

We studied the model of relation between changes in tax revenues and in the tax income basis in 2000-2001 and changes of the average marginal tax rate on the basis of data on per capita income tax revenues in different regions in Russia, and models aimed at making an assessment of the degree of progressiveness of the income tax in 2000-2001.

When building a model for income tax revenues as an assessment of the effective incomes of the population including "shadow" incomes, we used the factor of consumer expenses, as far as their changes turned out to be less correlated with changes in the average marginal tax rate than changes in incomes. In the model for the tax basis we also used this factor as an indication for an independent real tax basis increment not connected with changes in the marginal rate. Progressiveness of the income tax was assessed by using three tax revenues models – linear, quadratic and logarithmic. The results of the regression analysis that we acquired allowed us to formulate several basic conclusions.

The first conclusion is that following the hypothesis based on an analysis of theoretical models of tax evasion we managed to reveal a negative association between showings of the taxable basis and marginal tax rate as a result of the incomes taxation reform in Russia in 2000-2001. The second conclusion, as was assumed, taking into account the ineffective income tax rate prior to the reform we revealed a negative association between tax revenues and the marginal income tax rate. The third conclusion was that the results of assessments showed



that the income tax is progressive with respect to wages and non-progressive with respect to taxable incomes. Besides, judging by the results of panel assessments for the two years we can talk about a higher progressiveness of the income tax with respect to wages in 2001 as compared to the year of 2000. Similar conclusions can also be made from Kakwani and Musgrave progressiveness indices analysis, which reveals an income tax progressiveness growth. As a corollary we can speak about a higher progressiveness in income taxation of wages when it is not possible with the help of applied methods to reveal a progressiveness of taxable incomes on the whole.

Using the the tax revenues model built up in the course of the research one can define the roles of the actual growth of incomes of the population and of the marginal income tax rate growth with respect to tax revenues. Revenues from the income tax in 2001 as compared to the year of 2000 were higher by 76.4 bln roubles (a 43.9% growth). Model calculations show<sup>35</sup> that due to changes in the tax rate (taking into consideration the opposite effects of the rates that were both lower and higher for different categories of taxpayers, and a decrease in tax evasion) revenues from this tax grew by approximately 42 bln roubles, and revenues due to the overall economic growth in the country and a number of other factors grew by 34 bln roubles. The research allowed to formulate a number of practical recommendations to improve the income taxation.

The presence of a positive dependence between changes in the taxable basis and the marginal tax rate gives us ground to hope about a continuation of the tendency to legalise incomes that started in 2001. The basic conditions for it, as we see it, can be first of all keeping the flat income tax rate for a long-term period and, secondly, a higher effectiveness of tax administration including legislative methods to eliminate possibilities to evade paying taxes and to impose heavier penalties for the evasion. The first condition is the key one, as it is quite evident that in the first year of the flat tax rate the evasion decreased to a considerable degree, but did not change itself from a mass phenomenon to a seldom or an exceptional one. In many respects it is connected with of the taxpayers' certain distrust to innovations, they still think that after they legalise their incomes the tax rate will be sizeably heightened.

There is an important factor that can add to the effectiveness of the second of the above conditions; it is the fact that when the marginal rate of wage taxation is lowered considerably it shall become much less profitable to use different schemes of tax evasion than sticking to the law, the risks of sanctions for the evasion taken into consideration. A certain potential for reduction of tax evasion lies in the sphere of a stronger administration. In this connection instead of a more strict control of big expenditures on the part of natural persons, which is a rather difficult thing to be effectively administered, it is expedient to establish the required legal instruments to provide the tax authorities with a possibility to make their assessments of taxation basis using so-called "external indications" of wealth.

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<sup>35</sup> The presence of a constant (which showed to be not significant) does not allow us to factorise incomes changes with no remainders by two factors: the average marginal income tax rate change and changes in expenditures. For the purpose of analysis of the factors' influence the equation about correlation between changes in tax revenues and changes in consumers' expenditures and changes of the average marginal income tax rate was assessed with no constant. It should be noted that such a calculation is bound to be conditional to a certain degree, as far as changes in expenditures are correlated to changes of the average marginal rate (correlation coefficient is 0.24) and coefficients that were acquired in the model can fail to reflect the true correlation between tax revenues changes and changes in expenditures and average marginal tax rate.

The fact that there is no legible answer to the question as to how effective the income tax is with respect to redistribution of the population's incomes testifies to the effect that it is needed to work out and establish a system of measures to enhance the progressiveness of the tax system on the whole and the income tax in particular. With respect to the taxation of incomes one might possibly suggest abolishing the regressive property deduction from taxes and deductions for charity, working out a system of progressive taxation of interest yields, improving methods of fringe benefits taxation. At the same time it should be taken into consideration that curtailment of income tax concessions can have a rather strong political opposition.

In future other payments from budgets of different levels to different categories of the population can also be included into the taxable basis. One should take into consideration, though, that this may call for additional budget allocations to compensate for the payments that will be reduced as a result of taxation. Besides, in part of those payments that originate in higher authorities (considering that income tax is paid to territorial budgets) elimination of tax concessions may require taking corresponding decisions in the sphere of relations between budgets.

One of the possible ways to enhance the progressiveness of the income tax may be a higher exemption limit. But this measure needs a more thorough analysis from the point of view of possible budget losses and shall in all probability be implemented step by step. Besides, there emerges the problem to organise administration of the big exemption limit. When there are several income sources there will have to be made the choice of which of the sources that kind of exemption can be applied to.

### 3.5. Status of the Research and Development Sphere

A distinctive feature of year 2002 was the adoption of a national conceptual document that defined guidelines for the development of science and technological sphere until year 2010. The document was approved by the President of the Russian Federation (order number 576 of March 30, 2002) and adopted jointly by the Security Council of the Russian Federation, the presidium of the State Council of the Russian Federation and the Presidential Council of the Russian Federation for science and advanced technologies (decision number 2 of March 20, 2002) and is called «Foundations for the policies of the Russian Federation in the sphere of science and technology development for the period until year 2010 and later». This document contains a set of goals for the country's scientific and technological progress, a list of tasks to be accomplished to achieve these goals and major measures and mechanisms to reach them. The «Guidelines...» are now the key document in planning activities for the state bodies that are charged with the science and technology sphere. Using the «Guidelines...» to proclaim some kind of initiative is quite easy as the material used for them is rather eclectic and contains theses from a number of previously adopted analogous documents (such as «Russian Science Reform Concept for the period 1998—2000» or the Doctrine for Russian science development of 1996). The final version of the «Guidelines...» also contains a new list of nine priority lines for the scientific and technological progress and a list comprising 52 crucial technologies. A closer view of the priorities list exposes that the government stays loyal to the idea of a «continuous frontline» of research, as the priorities include all kinds of technologies starting from military and space research and ending with ecology and informational technologies. An up-to-date level of comprehensive research that would follow the provided list can only be possible if the scientific sphere is supported with substantial financial resources – which is not the case. Apart from the proclamation that modern Russian science needs progress in all its sectors, other ingredients of the model of science that the government strives at stay unclear. The «Guidelines...» give neither a vision for the scope of this sphere as to the number of employees in the state-owned sector and its dimensions, nor desirable proportions in financing civil and defence research, nor any other macro indices.

The initial version of the «Guidelines...» envisaged a gradual increase of scientific expenditures to the level of 4 % of federal funds by 2010, that is implementation of provisions provided in the Law «On science and federal science and technology politics». This gave grounds to assume that science would become a state priority only by 2010, in spite of the fact that scientific and technological progress is defined by the «Guidelines...» as «one of the highest priorities in the Russian Federation». The final variant lacks any concrete figures, financing is supposed at «the level that ensures realization of goals in the present «Guidelines...»».

In the past year it became even more urgent to define federal priorities in the broad sense of the word (that is not only priority research activities, but also spheres that the government would focus its attention on) as budget allocations remained limited. According to preliminary estimates in 2002 the science and technology sphere expenditures accounted only for 1.55 % of the state budget expenses as compared to 1.79 % in 2001.

The main goal in the government policies in the sphere of scientific and technological progress was defined as a transition to the country's innovative way of development on the basis of chosen priorities. To achieve this goal it is planned to focus on a wide variety of components and aspects of development and spreading of scientific knowledge – to produce a favourable legislative environment, to advance fundamental research, to reform the state sec-

tor of science, to integrate science and education, to develop the research potential in general and to give support to the leading academic schools in particular, to build and maintain unique scientific facilities, to improve the system for codification of scientific knowledge and implement many other tasks. A separate scheme is connected with the aim of creation of a national innovation system. In this sphere in 2002 there was started practical implementation of several new initiatives.

### Creating Infrastructure for Innovative Activities

Though establishment of a national innovative system was proclaimed a strategic federal goal as far back as in 1997, no considerable changes were happening in this sphere. There were being created separate – more acceptable or less successful – elements of an innovative structure, the attention being focused on direct support to innovative business in form of innovation- technology centres and «technoparks» (technology parks). But no sustainable connections were being built among the key participants of an innovation system – higher education institutions, academic organizations, small innovative enterprises. Therefore the share of enterprises active in innovations remains small. It is very notable that in 2002 the government support of small innovative enterprises was acknowledged ineffective. Official statistics also show that the number of small-sized enterprises active in the «science and scientific services» branch decreases with every year. At the Third venture fair in St. — Petersburg in October 2002 there was given evidence that the experiments by Russian venture funds built up under the auspices of the European Bank for Reconstruction and Development to develop small business gave not a single really successful result. Due to that among the guidelines for government activities were included establishing infrastructure for development of small innovative businesses, venture industry support, and creation of a favourable climate for investments by improving the legislation.

Creation of infrastructure for innovative activities was urged on due to introduction of another organisational form of small business development – establishing «the technology village». Its creation started this summer in Zelenograd. The technology village is a large-scale information and technology centre, which shall have accommodation for about 60 scientific-technological companies. It will also room a public scientific-industrial centre. By its form the technology village is going to resemble the innovative-industrial complexes, an attempt of 2001. Besides, once again attention was concentrated on such an organisational form as technology depots. In the framework of a new draft law «On special economic zones in the Russian Federation» it is planned to create 5-7 such technology depots that will be functioning in the special zones for 20 years with stipulated legal preferences: in the first three years after the date of establishment of the depots the participating enterprises will be released from the profit tax.

Small innovative business got support also in regions including support to «science cities, naukograds» (towns producing scientific knowledge). In Tomsk oblast there was elaborated a programme and in Leningrad oblast a concept for scientific- technological and innovative development until 2005, which means not just isolated efforts but a whole strategy for small business development present in these two regions. In 2002 of more that 70 towns and cities of that type three — Obnisk, Dubna and Korolyov — already had that kind of official status – «naukograd» — and hence direct subsidies from the federal budget. In the nearest future this status will be granted to the town of Reutov and Koltzovo community located in Novosibirsk oblast. Previously science cities of that type were parts of the military-industrial complex of the country, and now after their restructuring they will become «techno-polises». Federal budget subsidies for each of the science cities will amount to 250-300 mln roubles per year, which is three times lower than the calculated requirements. Besides, the subsidies are



granted under budget section 21 («Financial assistance to subjects of the Russian Federation») for support of the social sphere, municipal economies, by no means for innovative development. Thus the status contains no aspects promoting scientific and innovative development. Due to this innovative output in the science cities today does not exceed 20 % and the number of innovative enterprises practically remains the same. Experience gained in Dubna is viewed today as the most successful of all. Scientific enterprises in this city have transferred their redundant premises to the municipality, which were sold or let to entrepreneurs. The town introduced a new simplified registration procedure for small and medium scale enterprises, which immediately resulted in their quick growth. At present half of all revenues in the local budget are originated by small enterprises (compared to 12-15 % in Moscow oblast on the whole), previously subsidised share of the municipal budget fell from 76 to 14 %.

On the whole the idea to transfer idle property, especially with respect to budget institutions, is a feasible one. In particular higher education institutions have good outlooks here. At present when higher education institutions get licensed or certified, the floor space requirement with respect to internal students is 12 sq. meters per student. This figure was calculated in the time of the Soviet Union based upon the average statistics for higher education institutions. There are higher schools that have 40-50 and even 80-90 sq. meters per 1 student. In developed countries this requirement is much lower. Approximate evaluations show that in case of accepting western standards there will be saved considerable amounts – over 10 bln dollars. Money saved in this way could be channelized to renovate the material basis of education and science, promote their IT support, give extra financing to scientific research through a system of funds and to give higher salaries to professors and tutors.

## Venture Industry Development in Russia

Government attention last year was further focused on venture financing of science intensive projects. The Ministry of industry and science have worked out a draft Concept for venture industry development in Russian until 2010, according to which the government will participate with funding in establishing commercial venture funds to compensate for «market gaps». This type of activity is a catalyst and a means of financing most venturesome project stages when money is allocated to turn an idea into a product. There functions already The Venture Innovative Fund (VIF) established with financial aid of the government, there are plans to establish ten more venture funds in different regions of the country. The idea of state participation in venture industry was successfully implemented in a number of countries (Israel, Finland) and there is a hope that this type of government co-financing of venture funds will prove to be productive also in Russia. At the same time the VIF activities have not yet brought about any sizable success, partially because of the fact that the Fund is quite a new creation – less than two years old.

It is proposed to allocate 1 bln roubles in the budget to establish venture funds in a period of 3-4 years. The government share is assessed as 10-20 %, hence the calculation that for development of venture funds from all sources there will be allotted about 200 mln dollars per year. To make the initiative successful in addition to 1 bln roubles of governmental funds, which are not yet present, there is a need to introduce changes to the current Russian legislation, for the role of the government is not just to give financing to science and technologies, but also to establish favourable conditions for investments from off-budget sources. This can first of all be achieved by improving institutional conditions. There is no legislative basis to guarantee (ensure) investments to develop venture industry at present, the Civil Code does not contain any organisational legal forms that would satisfy the standards of venture business.

Rendering priority support to small innovative business is not that easy in conditions when the government's position with respect to forms and mechanism of small business support is not sufficiently clear. In

2002 there continued a discussion about advisability of abolition of the Federal Law on state support of small entrepreneurship (number 88-FZ of June 14, 1995) held mainly between The Ministry for economic development and trade and the Ministry for antimonopoly policies.

Deficiency of legislation about venture industry is not unique in the legislative system that regulates innovative activities in this country. As for innovative activities on the whole, attitude that became predominant last year was that there was no need in working out a special law on innovative activities, instead one should introduce adequate changes into the current legislation, first of all into the Budget Code, the Tax Code, the Civil Code and other legislations.

#### Development of Legislative Basis for Protection of Intellectual Property

Legislative regulation in the sphere of protection, maintenance and distribution of rights on intellectual property (IP) was acknowledged as one of the most urgent lines in the sphere of improvement of legislation, especially in the light of Russia's entry into the WTO. Bringing the legislation on IP in order was named as one of the most urgent tasks as far back as in 2001, but its solving was moved on to 2002, and as the situation is in 2003 legislative basis in the sphere of IP has not been formed yet. At the same time the Ministry of industry and science, being the major coordinator in legal solutions of problems related to IP, has announced about the beginning of realisation of the liberal approach to regulation in the sphere of intellectual property, which is an antithesis to the currently used fiscal approach. The liberal approach supposes that IP rights on property created using budget means will be assigned to the executing organisations, while funds invested in science will come back to the budget in form of taxes originating from new high-tech enterprises. This kind of approach was tested in many countries of the world and acknowledged as a most effective one. According to the draft Concept of venture industry development there will be established agencies for transfer of technologies under Federal Research organisations, thus giving them greater disposal rights for the IP created by these organisations. But the issue of financing establishing and operation of such agencies is not solved in the draft Concept, this can postpone their creation for several years.

As for conceptual approaches apart from practical steps is concerned, a draft law on realisation of government rights on IP has not yet been worked out. In October 2003 the government has approved a document called «Measures to ensure protection of intellectual property», in which in the foreground stand issues of protection and infringement of copyrights.

Concurrently amendments to the Patent law were discussed, but nevertheless have not been fully agreed upon. The most heated debate is still about the issue of ownership of rights on the intellectual property that was created and is being created at the federal budgetary expense, as far as there is still a lot of unsolved questions and contradictions. As per today a single procedure of contracting for research financing from federal budget means is still lacking, which makes it impossible to clearly identify the federal executive body that will impersonate the government as the client. Even when the government as the client has its rights on the results stated in the contract, the Patent law does not envisage the possibility for federal executive bodies to act as patent holders. As a result the government lacks a financial control system at the level of accounting, there is no basis for business intercourse with respect to intellectual property, the efficiency of public investment to create it cannot be measured.





In addition to the fact that the government cannot execute its rights as patent holder there exists a psychological aspect to this problem. Under the conditions when the rights of the producers are not defined, the researchers are not interested in turning the results of a scientific research into an invention. It is much easier in this case to sell the research results abroad.

In cases when the rights on intellectual property belong to the producers there emerges a number of problems when the rights get involved in business circulation. Problems deal first of all with such aspects as introduction of intellectual property into balances as intangible assets. The lists of IP subject to accounting as intangible assets provided by different documents are not identical, the rules prescribing determination of effective usage terms for intangible assets and their depreciation are contradictory. In order to regulate this at the beginning of 2002 the government of the Russian Federation adopted a regulation «On the procedure of inventory and value assessment of rights on results of scientific and technologic activities» (#7 of January 1, 2002) which deals with results acquired in the cause of scientific research and technical research and development works, wholly or partially financed from the federal budget. By this regulation federal executive bodies are charged to make inventory of rights on results of science and technology research when state-owned enterprises are privatised, and when organisations are restructured or liquidated. Inventory shall be initiated and performed at a decision of the owner of the property or the juridical person that possesses this property, has it under its jurisdiction or management. Stating the necessity of such inventory, its aims and procedure the Regulation gives no references to concrete methods, systems or instructions that would enable to perform a practical analysis of the results of scientific and technology activity, including reports, to recognize rights on these results and to assess results with respect to potential protection rights. Underestimation of IP can lead to an after-effect in form of material losses in case of privatisation of scientific organisations. At present when material complexes are privatised intangible assets account for 2-5 % of the value of organisation's property, while in developed countries this figure is as high as 50-70 %.

In 2002 there was also adopted a Regulation concerning objects in military, special and double usage – «On state registration of results of scientific research, research and development effort and technological works for military, special and double purposes» (#131 of February 26, 2002). According to this Regulation there is planned a single registry of results, the rights on which belong to the Russian Federation. In 2003 there is to be performed an inventory of results of intellectual activity. Subjects of the inventory shall be the results created or acquired on the account of the republican budget of the RSFSR, that part of the state budget of the USSR that was a part of the budget of the whole Union, and means from the federal budget of the Russian Federation. Thus, effort and means are once again aimed at a partially useless action – inventory of IP, which in a considerable degree is outdated and represents no value. This testifies to the effect that approaches to solving the problem concerning IP have not changed.

Some departments have started their own IP policies. For example, according to the Charter of the Academy of Sciences one of its functions is to protect rights on intellectual property that belong to researchers and organisations under the Academy, to participate in execution of government policies in the sphere of achieving scientific and technological progress and making economic use of these achievements and technologies, as well as to ensure fulfilment of the Academy's engagements with respect to protection of state, official and commercial secrets. Prior to 2002 these goals were not attended to, later there was established

a Coordination council for the Academy's innovative activities under its Presidium (Decision of the Academy's Presidium #17 of January 22, 2002). The Council's goal is to give aid to the Academy's institutes in organizing innovative contacts with industry, to contribute to establishing units in the Academy that will directly assist the institutes in commercial use of their results, to render them a whole series of services in the sphere of innovative management, to promote their commercial activities on the whole. In particular the Council will design mechanisms to make economic use of intellectual property created by the Academy's institutes and to work out recommendations on practical use of this IP. Should the ordering party of all works performed by the Academy were the Academy itself this novelty would have been quite defensible. But as far as many of the works are paid from off-budget means, this centralisation of decisions under the Presidium of the Academy of Sciences can be viewed as excessive.

#### Realisation of the most important national innovative projects

Last year one of the key government directives in the sphere of innovations was establishing ties among principal participants in the innovative process, first of all the science, small business and industry. One of the implementation mechanisms became large-scale innovative projects carried out by groups representing science and industry. It was this form of support that the President focused on in his message to the Federal Assembly (on April 18, 2002) having stressed that there was not enough noteworthy and long-term projects in the economy, and the government in this connection should make up their minds about forms of state support of new technologies.

In May the Ministry of industry and science announced a tender for large-scale innovative projects. Each of the winning projects is to get 20 mln US dollars for two years, which is quite a considerable funding for the scientific-innovative sphere. Though the government will stand for a maximum of one third of the needed funding, the rest is to be obtained from interested investors. As of today 11 projects of more than 200 submitted at the tender are chosen. In a separate line of the 2003 budget there is already planned 1.25 bln roubles as funding of scientific support of the most important innovative projects of national importance.

At the basis of this initiative there is the idea that hi-tech branches more than other branches favour the country's economic growth. But conditions for different branches are uneven, as the risks in the innovative sphere are very high. That means that giving large-scale innovative projects its support the government takes technological risks upon itself and thus creates conditions for high-tech business growth. At the same time the government support of innovative projects is a temporary initiative, which is only used to set examples of success.

Innovative projects were chosen – which is also a novelty for such tenders – by a commission consisting not only of officials and researchers, but also of business representatives. All this taken together gives hope that chosen projects are not just promising research projects but someone is willing to implement these on the market. These projects can also be viewed as priorities actually initiated by those who really need them, that is concrete projects that are capable of being really efficient in the framework of the nine lines for science and technology development proclaimed by the state as priorities. It is expected that 200 mln budget dollars will repay 1 bln dollars in 2-3 years, thus demonstrating to Russian and foreign investors the advisability of investing into science intensive part of Russia's economy. On the whole the



success of this project shall witness that establishing innovative industries and realizing projects based on high technologies in Russia is possible and profitable.

«Side effects» of such projects can be both a growth of the number of modern scientific managers and establishing venture business. It is noteworthy that the problem of trained personnel in the innovative sphere was called one of the crucial ones in 2002. What is meant here is not only managers, but also specialist in technologies, engineers, productions specialists. Indeed, a number of professions have become obsolete, the educational pattern in training highly skilled personnel has noticeably changed in recent years. According to statistics provided by The supreme examination board under the Ministry of education (BAK) nearly half of all new Doctor's and Ph. D. degrees about ten years ago were received in technical sciences and only 20 % in the humanities and social sciences. Today the proportion is reverse and high-tech branches are experiencing lack of specialists.

## Measures to restore the personnel balance in the science and technology sphere

Demographic imbalance of scientific manpower aggravated still more in 2002, researchers' average ageing and drain-away of young researches took place. Situation today is like this: an average statistical Russian scientist is ten years older than his American counterpart.

The manpower issue was given much attention also at the historical meeting of the State Council and in the «Guidelines» adopted by the Council. Also there were announced figures of flow-out of manpower from the science that shocked the public both in Russia and abroad. At the Council it was particularly announced that in the past five years 800 thousand dropped their positions in science and 200 thousand young talented scientists left abroad. The figures were frightening, just as they were partially incorrect. In particular, concurrently with the massive flow-out there was also an inflow of scientific manpower, as a result of which the manpower balance in the past five years was only 103 thousand employees less in the sphere of science. Domestic flow-out at that was greater than the foreign one, scientists left for other sectors of the economy; many specialists got employed in other non-scientific spheres, which is not reflected by the statistics. Aftermath of that is not only a lower quality of scientific research and ineffective use of public funds (in cases when scientific organisations are state-owned ones), but also that young researchers get alienated from the scientific sphere.

In 2002 there were made continued efforts to attract young researchers to the scientific sphere and secure them there, but the majority of initiatives were centred on the youth paying no attention to its connection with other generations of researchers and hence with the problems of these generations. This predetermined chose of temporary and point measures incapable of bringing the manpower situation in harmony on the whole. Besides, government offices that were realizing youth-oriented initiatives were still doing that independently of each other, theirs actions were not coordinated and initiatives actually overlapped. In this sphere several new arrangements were started. In March 2002 a new presidential Decree (#267 of March 13, 2002) was issued – «On certain measures to intensify government support to young Russian scientists – candidates of science and their scientific supervisors». According to this document starting from January 1, 2003 in the name of the President of the Russian Federation there were established 300 yearly grants to support scientific research conducted by young (under 35 years) Russian scientists with Ph. D. degree and 300 grants to support scientific advisors of these young Russian scientists. Amounts attached to these quite prestigious grants are not that great: it is planned that in two years young Ph. D. s will be receiving an addition of 24 thousand roubles per year (that is 2 thousand roubles a month) to their salaries; also planned are certain allocations for conducting research. Scientific advisers will get a lump

sum of 24 thousand roubles as a material encouragement. Thus, also in this programme one could not abandon the practice of many other previous programmes of «quasi equal» small donations. Funds for the grants will have to be found in the budget under line 06 of the functional classification «Fundamental research and promotion of science and technology progress» and according to the definition contained in the Russian government Regulation (#554 of July 24, 2002) issued to fulfil the presidential Decree, the tender and its funding shall be performed from the means of the federal budget designated for support of leading scholars and academic schools on a competitive basis.

The present Regulation also approved the Rules for allotment of Presidential grants, according to them competitors shall be chosen on the basis of analysis of defended theses taking into account the list of priorities in science and technology development in the Russian Federation. Each of the science branches will be allotted its share, and them a maximum of 600 projects will be recommended to participate in the tender. Taking into consideration that the experts will have to look through approximately 12 thousand abstracts of dissertations this can hardly be called a tender, this is rather a selection by non-formalizable criteria. The ongoing selection has shown that the experts had not been given any criteria that they could have used to assess the abstracts.

In October 2002 the Government issued Regulation (#725 of October 1, 2002) «On approval of the regulations on Presidential grants Council of the Russian Federation for support of young Russian scientists and leading academic schools in the Russian Federation», according to this Regulation the Presidential grants Council was established. This Council is a permanent deliberative body, which shall scrutinize three types of grants: newly allotted grants for young candidates of science and their scientific supervisors, grants for support of scientific research by young Russian scientists – Doctors of science, and for support of leading academic schools. The council is to arrange yearly competitions under all the three programmes. The responsibility for the organizational and technical support of the Council's activities is placed on the Ministry of industry and science, which hence will be taking care of both funding of the projects and their expert examination as well. In the budget for 2003 the leading academic schools programme expenses are increased threefold. One is actually faced with several initiatives that get interwoven and merged into each other, but the outcome is a complete vagueness in the question of which of the programmes will be realized and how. At present the programme for support of the leading academic schools, which organizationally and technically has been provided for by the RFFI (Russian Foundation for Basic Research), and funding by the Ministry of industry and science has completely fell under the jurisdiction of the Ministry. It means that the expert examination procedure will have to be build up anew and it is supposed that the examinations will be performed by a state institution called The Republican Research and Scientific-Advisory Expert Analytical Centre (GU RINKTzE), introduction of new criteria for choosing projects is also possible. Review of the programme for the leading academic schools is viewed as a defensible one, as far as the programme actually was boiled down to extra payments to research teams for their previous contributions – an initiative that was crucially important in the middle of 1990s, when the major goal was to preserve the scientific potential, but has become outdated now. Besides, among the leaders of academic schools that will be getting the support 51,7 % are members of the Russian Academy of Sciences, while from January 1, 2003 extra payments for academic status to members and corresponding members of the Academy of Sciences will be increased by a factor of 5 (to reach 20 thousand roubles and 10 thousand roubles per month correspondingly). At the same



time the fact that the programmes for support of the leading academic schools are taken away from the RFFI will have rather negative consequences, as far as it is namely the Fund that possesses the best expert analysis system in the country, it will be more difficult for the Ministry to organize full-scale competitions, it also lacks a corresponding infrastructure.

Attempts to solve the housing problem, which is also an important factor to attract young researches to the science, were predominantly made only by separate organizations and state departments. A federal targeted programme, «Housing for the young», appeared in the 2002 budget, but according to the figures for the third quarter of 2002 it did not start to function. It is planned that young people will be granted targeted subsidies to buy housing and to repay them on certain conditions. Loan repayment shares and terms will be coordinated with the demography statistics. Meanwhile, the Siberian branch of the Academy of Sciences has already started to implement its own programme to help young scientists to buy their own housing. Young researches (under 35 years) and Doctors of science under 40 years that have worked for the Siberian division for at least four years (including the term of their postgraduate studies) can be granted with bank loans to buy or build their own housing against a warranty of the Siberian branch<sup>14</sup>. The programme was just started, but the initiative is by all means is a very important one.

Government initiatives to support young people are much more negligible than needed to change the manpower situation in the country. According to the State Statistics Committee there are more than 83 thousand postgraduate students attending full-time day courses and over 45 thousand young (under 29 years) scientists<sup>15</sup>, which means that at least 130 thousand young people can become potential recipients of youth programmes, though not more than 3-4 thousand persons can be getting support under the government programmes. Consequently the basic level of material incentives for young people remains extremely low. One of the methods to restore the manpower structure could be to invite young scientists and postgraduate students from the CIS-countries, but there exists a number of legal barriers in this respect (difficulties connected with their residence registration, paying them grants from the state budget and a number of others).

The structure of expenses planned in line 06 of the budget for 2003, «Fundamental research and promotion of science and technology progress», testifies rather to a diminishing support to young people or in the best case to its status quo, by no means to a beginning of their systematic «securing» in the science. This reasoning can be supported by the following figures from the new budget:

1. A smaller financing share of state scientific funds, the Russian Foundation for Basic Research (RFFI) in particular – instead of 6 % of budget expenditures on science that the Fund was supposed to get according to the current legislation, in the draft budget for 2003 its share got reduced to 4.9 % even after additional 200 mln roubles after the third reading. Leaders of the Fund in connection with that pointed out that reduced financing forces them to cut and even close a number of programmes. In particular there are expected cuts also in the »Young students and graduate students-programme«, the best known among young people and the largest by the number of grants receivers – a programme for support of young researchers, postgraduate students and undergraduates. A scheduled competition un-

<sup>14</sup> Poisk, #34-35, August 30, 2003. p. 3.

<sup>15</sup> «Nauka v Rossii – 2001», State Statistics Committee of the Russian Federation. Moscow, 2001, p. 26, 37.

der this programme was announced in November, but the number of grants and their dimensions were not advertised.

2. Funds planned for purchase of housing for young researchers and their families in 2003 can only solve the housing problems for approximately 200 among them<sup>16</sup>.
3. Still one more prime federal targeted programme, which promotes an optimised organisational structure of the science and a «gentle» reform of its public sector, as well as a higher educational quality and a better inflow of young researchers – «Integration of science and higher education in Russia in 2002-2006»<sup>17</sup>, is being funded at the level of 2002 and hence actually experiences a financial cut. The Absolute funding value of this programme in 2002 was at the level of the previous year, which means yearly cuts for this programme. Centres of Education and Science created under this Programme were not further developed with respect to a more profound integration of academic institutes and institutions of higher education. It is noteworthy that instead of such an integration in 2002 there was a precedent of establishing a completely new organisation – The Academic University of Physics and Technologies under the Academy of Sciences.

The Academic University of Physics and Technologies under the Academy of Science of Russia became possible in the long run also due the personality of its founder, member of the Academy of Sciences, Nobel Prize winner Zh. Alferov. This university is being built on the basis of the Institute of Applied Physics under the Academy of Sciences named after A. Ioffe, the director there is Zh. Alferov. In spite of the long-lasting connections and co-operation between the Institute of Applied Physics and the Technical university of Saint Petersburg, among other things also within the framework of the «Integration», the Academy preferred doing it its own way and establish its own institutions of higher education. According to the current legislation the Academy being a self-governing organisation and not an executive agency is not entitled to establish public education institutions. That is why the new academic university is devoid of any official status. Its establishing was allowed by a Ruling of the Presidium of the Academy of Sciences and it is expected that this decision will be approved by a special government decree. In his turn Zh. Alferov has suggested to introduce an amendment to the Law «On the science and public science and technology policies», which will allow the Academy to build public institutions of higher education within its structure.

This university is not the first one in the system of education under the Academy of Sciences. There is one university located in Puschino, it has a rather narrow profile and educates specialist for academic research institutes located in the vicinity. The idea of an early specialization is a rather dubious one and has as many advocates as it has opponents. An early narrow-purposed specialized education can not only become a drag on researcher's way to his success, but also a hindrance for a whole line of research in case such a specialist occupies an administrative post. There is one more academic institution of higher education – a university for liberal education that works on the basis of several institutes of higher education in Moscow. All the above-named academic institutions possess the public status, as far as they were officially founded by the Ministry of education, though established at the initiative of the Academy of Sciences.

Simultaneously there are vocalized proposals – among others by representatives of the academic community – to establish closer contacts between universities and academic research institutes in connection with the difficult manpower situation particularly in academic institutes and a possibly closer integration to the point of merging academic organisation with institutes of higher education. Representatives of the academic community in Novosibirsk, for example, moved forward a rather grounded idea to reform the cluster of academic research institutes so that the local university becomes the centre of the community<sup>18</sup>, to make a transition to an institu-

<sup>16</sup> Poisk, #40, October 4, 2002. p. 6.

<sup>17</sup> For more detail about Federal targeted programme «Integration of Science and higher learning in Russia in 2002-2006» see in «Rossiyskaya Ekonomika v 2001 godu. Tendentsii i Perspektivy» Issue 23. Vol. 1. Moscow, IET, March 2002. p. 554.

<sup>18</sup> V.Doroshenko, I. Koshever, V. Matizen «A scientific centre in Novosibirsk: is there a strategic alternative?» (in Russian) // Otechestvennye Zapiski, 2002. #7. p.p.:259–272.



ditional model of science after universities in the West, which has proved effective in many different countries. But one can almost surely assert that the Academy and the Siberian branch of the Academy in particular will not view such changes requisite.

On the whole the above instances show that the science and technology policy remains quite personified and preferences given to this or another alternative are not determined by a chosen strategy approved in official documents. They are to a very high degree dependent on current views of persons of high status – in ministries and other organisations — on what they think is important at this very moment.

## Changes in payment system in the sphere of science

The issue of raising salaries in science in 2002 was a subject matter not only for young researchers. The issue was a burning one especially for those employed by the budget science institutions, where payments are rigidly attached to the fixed payment rates and coefficients defined in the Single scale of wages and salaries. Starting from October 1, 2003 it is planned to introduce new payment systems differentiated by branches. The principal criteria that are going to define a basic salary in the sphere of science shall become the academic degree or the academic status, length of service and the subject of the research in progress. Those doing a work within the framework of the national priority research lines are going to get 10-15 % more. In 2002 there started a heated discussion on whether one should attach remuneration of labour to the length of service, as in this case young scientists lose the chance to get decent payment. The alternative suggestion is that instead of the «length of service» criterion there should be a «corridor» for fixed official salaries and researchers' salaries should depend on the results of their certifications. But on the whole this does not mean much: though fixed salaries are planned on average to be raised by 150 %, an average researcher's fixed salary at that will only reach 3600 roubles. The motivating factor of that kind of salary is close to zero, especially in view of the fact that at effectively run institutions bonuses and additional payments can be 10 times higher than the official salaries and even higher.

Academic degree allowances for candidates and doctors of science were tripled starting on January 1, 2003, they are 900 roubles and 1500 roubles per month correspondingly. But the present regulations will only be effective until October, when the new branch system of labour remuneration will enter into force. The preliminary draft budget envisaged tripled allowances only for candidates and doctors working for institutions under the Ministry of education of the Russian Federation. But the budget committee before the third reading agreed to allocate funds for academic allowance increases for candidates and doctors also working in Federal Researchinstitutions in addition to institutions of higher education.

Also planned that alongside with the new system of remuneration of labour there will be a wider use of terminal labour contracts. This is one more step in bringing the system closer to standards in the West: for example in US universities only 20 % of faculty members and researchers have permanent posts.

The attempt to ensure an inflow of young manpower exclusively by raising salaries and by giving different kinds of bonuses and allowances is unproductive, as far as reasons why young people do not want to stay in the scientific sphere are more profound and complex. The situation when the hiring system is rigid, the contract payment systems is hardly used, when institute administrations are afraid of getting social problems in case of pursuing a strict manpower policy – all this led to the flourishing «preservation-of-workplaces» policy, rather than to the policy of preserving the scientific potentials. The problem lies not only in the fact that

scientists in the pensionable age have no desire to leave their workplaces – many of them according to their young colleagues are quite industrious, able-bodied and resourceful – it is rather an issue of a rather thick accumulated layer of «scientific dead weight». This is a rather dangerous phenomenon, as far as the «dead weight» not only impedes providing young researches with workplaces, but also is a serious factor in itself turning them away from science. Quite many young researches and postgraduate students admitted in interview that the scene of research laboratories that produce nothing and degradation of whole research teams call for negative feelings with young scientists, making them take a closer look at new dynamic sectors of the economy (such as consulting and computer programming) and seriously consider their chances of scientific emigration. This problem can only be dealt with by system reforms in the scientific sector through restructuring of the network of research organisations, more considerable funding to renovate research facilities, etc.

### The Problem of Brain Drain

The problem of young manpower is closely connected with another manpower problem – the brain drain. Scientific emigrants are younger than before and keep staying young, they are predominantly graduates of institutions of higher education, postgraduate students and young candidates of sciences. There is also a «back-flow», but the number of those that come back according to the most optimistic estimates is as low as 10 % of those left to work or study abroad. Last year on the government level there were attempts to solve the problem of preventing the brain drain and re-establishing the balance of the manpower structure by looking for mutually acceptable ways of interaction with Russian scientific communities abroad.

In the recent one or two years there appeared more favourable conditions in Russia for establishing contacts with former compatriots. For example the mathematicians community note that many of the mathematicians that had left make effort to work part of their time in Russia, suggest reading series of lectures in Russian universities free of charge. Representatives of Russian scientific communities abroad supported several scientific conferences financially and organizationally. Former compatriots also assist scientists that work in Russian to get access to electronic subscription to foreign periodicals and other scientific literature. Also discussed are such forms for interaction as doing joint scientific research, establishing mobile laboratories in partnership, invitations to former Russian scientists to spend some of their time to collect material and combine it with lecturing for Russian students and postgraduates.

Prevention and slowing down of the brain drain is put as one of major goals by new Russian private charitable funds that have started announcing programs to support of youth. In 2002 organised charity activity in form of corporative funds was growing. In addition to already existing funds — V. Potanin's charity fund and The social charity fund for support of national science, which were established in 2000, there appeared one more – Non-commercial programmes fund «Dynasty», which puts as its priority support of one of fundamental sciences in Russia – theoretical physics. In 2002 the «Dynasty» fund started realization of a programme of grants for Russian students that specialize in theoretical physics (it is planned to give support on the basis of an open-type competition to 60 students, paying them 2000 roubles per month during the academic year), and a programme of support for young scientists. Within the framework of this programme 10 young candidates of sciences will get an opportunity to work for three years in the country's leading scientific organisations, receiving a grant of 15 thousand roubles each month.





Characteristic tendencies in realization of the programmes of the already actively functioning charity funds in 2002 was a broader target group, in other words number of contenders to get the support, first, and larger grants, second.

In V. Potanin's charity fund today there are several programmes, the largest of them is the Federal grants programme. Under this programme support is granted to excellent daytime students, who concurrently do research and have displayed good organisational skills. In addition, support is also given to sub-faculties having largest numbers of students already receiving grants from the Fund. In 2002 the number of grant receivers grew from 1000 to 1260 alongside with monthly grants – from 1200 to 1500 roubles. On all grant programmes taken together in 2002 V. Potanin's fund spent 1.5 mln US dollars.

The fund for support of national science has also announced as one of its goals financial and moral support to outstanding Russian scientists and talented young researchers, as well as its desire to prevent that talented young people leave for the USA and countries of Western Europe. The charity programme of support for outstanding Russian scientists and talented young researchers was initiated in 2001, its first stage was over in March 2002, and then the programme was renewed. Within its framework there were given 100 grants to young doctors of science and 100 grants to young candidates of science, total amount that went to charitable aims accounted for 1 mln US dollars. The grants were 10 thousand roubles per month or about 4 thousand US dollars per year. The results of the first stage of the programme showed that of 210 grant receivers only one left Russian in the current year.

Thus the support granted thanks to private initiatives is bigger than the allowances and bonuses paid within the framework of state programmes, including presidential ones. Actually private programmes provide young scientists with grants that in the majority of sociological polls young people named as a minimal acceptable salary to stay in the science and really do research instead of having several places of work causing inevitable damage to their scientific work.

On the part of private persons, Russian entrepreneurs, establishing such funds is not just charity, it promotes company image. Support of education and science belong to social initiatives, researches made in the West show that in recent years more than 80 % of consumers when making their choice of services have taken social image of the company in consideration<sup>19</sup>. Thus, it's not by chance that V. Potanin's fund uses about 30 % of the educational projects money for advertising support of the arrangement.

## Foreign Science Foundations' Activities

Last year foreign organisations started paying more attention to working out strategies for joint activities in Russia, bearing in mind that the time of uncoordinated effort was coming to an end. An outline for establishing a coalition of donors in education and science is being discussed among other things. There is a lot of unsolved issues here: what is the advisable limit of duplicating initiatives? In which lines shall efforts be united? How can the effort be assessed by the participants in order to increase the effectiveness of project realization? The main line in coordination of effort is connected with the fact that many organisations plan to reduce their initiatives in Russia, that is why integration of resources, exchange of expert analysis experience and even of «blacklists» of those who violate conditions of grant financing can result in a more effective use of the diminishing funding.

One of the most striking events last year was the announcement made by G. Soros that he would curtail his charitable activities in Russia, cut the budget of the «Open Society» institute in 2003 from 20 to 5 mln dollars and transfer some of the programmes to six newly established organisations, including three regional ones.

«New Russia» will become the leading one, its co-finders are the «Open Society» institute and the «Eurasia» fund. It is planned that all the organisations will be Russian juridical persons, their work to a considerable

<sup>19</sup> Dengi, #40, October 15 – 21 2002, p. 108.

degree will be possible due to Russian philanthropists. There are no grounds to expect a flourishing private charity yet, that is why the tendency is viewed on the whole as an alarming one. G. Soros was the first one to give a full-scale support to fundamental sciences in Russia in their hardest time, other funds took his activities as a possible pattern when planning their own work in Russia.

At present the situation is as follows: in a number of research fields (biotechnologies, molecular biology, chemical physics) the share of foreign sources of funding reaches 70-80 %<sup>20</sup>, that is why curtailing of activities of foreign charity organisations can deteriorate the already rather unstable situation in Russian science.

With respect to activities of foreign charitable organisations some other tendencies that made themselves visible last year can also be pointed out. The first one is a closer attention to the regions in contrast to Moscow and Saint Petersburg. One of the reasons is the common opinion that scientists of these two cities are spoiled by lavish funding from abroad and have lost the ability to spend funds effectively. Another tendency is a higher selectiveness with respect to the lines of research and effort spheres (more emphasis is placed on such spheres as protection of the environment and population health, biomedical research, studies on anti-terrorism, solving social problems, building of civil society, initiatives that promote closer contact between education and science and between research and its commercialisation). The tougher selectiveness is connected with the fact that funds and international organisations, having analysed the effectiveness of their activities in Russia, arrived at the conclusion that considerable amounts of funding was used to no purpose. This was especially evident in cases when they funded lines and programmes that Russian authorities were not interested in. It is now expected, that priority activities of sponsoring organisations will be coordinated with Russia's interior interests. In particular, the US government is thinking of using this pattern when choosing the lines of rendering support to Russia for its science and technology development. There are other tendencies connected with the previous one: financing organisations are more and more focused on parity funding for their projects alongside with means from government and regional sources, more funds are hiring Russian experts to help them work out development strategies.

#### Russian state science foundations: current situation and new projects

Russian scientific funds – the RFFI (Russian Foundation for Basic Research) and the RGNF (Russian Fund for Humanitarian Research) – also in 2002 played an important role in support of both scientific research and upgrading the material resources of the science, they also rendered emergency assistance to a number of institutes when as a result of natural catastrophes their unique equipment was destroyed. This in spite of the fact that conditions for functioning of the funds were far from being the best. The budgets of the funds are not great: for example an average grant given by RFFI for a group of 5-7 persons in 2002 was 150 thousand roubles per year. Inpayments from the budget to the funds reached their peak at the end of the year, that is in the period when it's most difficult to spend the money provided that it is not solely spent to pay salaries and taxes. Pattern of inpayments to RFFI in 2002 looked as follows: 1<sup>st</sup> quarter – 17 %, 2<sup>nd</sup> quarter – 25 %, 3<sup>rd</sup> quarter – 19 %, 4<sup>th</sup> quarter – 39 %<sup>21</sup>. That means that the fund in the first three quarters actually received only a third of the due financial resources. In the 2003 budget the funds' share is reduced and accounts for not more than 6.9 % of the budget expenditures under line 06 instead of 8.5 %. The fund's leaders view it as a setback with respect to the idea of support in form of grants and govern-

<sup>20</sup> Izvestiya-nauka, #16, May 17, 2002, p.4.

<sup>21</sup> Poisk, #10-11, March 15, 2002. p. 3.



ment funds as a form and source of its financing. Definition of the word «grant» is now given only in the Tax Code, in the Budget Code this notion is not explained and the word is used only in one article (article 78 «Subsidies and Subventions»). Besides, in the Budget Code state scientific funds are deprived of their functions as one of administrators of budget means. In case the funds stop receiving funding stated in a separate budget line, their activities priorities can be considerably changed under the influence of interests of the administrator of budget means (most likely this will be the Ministry of industry and science). That is why a new law on Federal Science Foundations has become a necessity. It would identify the meaning of primary notions (including the form of financing called «grant») and mechanisms for Federal Science Foundations' functioning.

In 2002 two state funds – RFFI and the Fund for assistance to small innovative enterprises– started a new perspective programme of joint financing of innovative projects. Besides the possibilities that the programme gives to a number of research teams that work together with small innovative enterprises to commercialise the results of their joint effort, it also gives a try to check a commercial potential of intellectual property created at the expense of the federal budget and thus belonging to the state. Following the competition conditions applications for funding shall be presented by teams that unite research groups that received RFFI grants before and small companies that are ready to invest their own funds to place a ready product at the market. Funding under this programme consists of three equal shares – RFFI funds and money from The Fund for assistance to small innovative enterprises, and financing from small companies. RFFI will finance the necessary research, The Fund for assistance will support research and development, and small enterprises shall make their investments at the stage when the prototype elaborated in the course of the project will be replicated and sold. Each project depending on its dimension will get a non-refundable financing from the funds between 1.5 and 3 mln roubles. The financing procedure will include an advance for one year and later after the report is submitted there will be taken a decision to continue or stop financing. The expert Council that will choose among applications is comprised of both specialists that RFFI cooperates with permanently and scientists that have experience in development and realization of applied works.

As for the IP, the rights for its application are laid down in the contract signed by the four participants: the two funds, the researchers and the manufacturing company. Attached to the contract is the patent or a know-how description. The right to use the IP shall be transferred by the researcher to the small company in question. The IP developed in the course of the project pursuant to programme conditions shall in equal shares belong to the funds and the researchers, its use is regulated in accordance with the government regulation «On basic lines of realisation of the government policies to attract results of scientific and technological activities to the economy» (#1607-r of November 30, 2001). Also according to the programme the funds shall defend interests of the state with respect to the property created using public funds, while the government is interested in turning the results of the research work into commercial products. Due to this the funds will encourage all kinds of transfer of the state share in IP to the researchers including its purchase so that the IP can be commercialised and will transfer all the rights to the research organisations under the condition that the results will be used in the economy. This is the subject of the special agreement between the researchers and the funds.

The organisers of the competition received 503 applications, finally there were chosen 86 projects, though only 60 were planned initially. Good projects turned out to be plentiful. The final outcome will be clear in 2003, as far as the selection process was over only in autumn, meanwhile specialists prognosticate that at least half of the supported projects will be successful.

### Organisational reform in the science sphere

Organisational reform in the scientific sphere has many times been proclaimed as a priority, but in 2002 it was somehow kept in the «background». During the meeting in the State Council the President said that the country needed «a new economy for the science itself», and first of all «targeted financing, not of organisations, but of productive lines of research». It was pointed out that to achieve this in the first place one needed most of all an inventory of the organisational structure of the science, which experienced a very slow progress. At the highest state level it was also stated that one should think over measures to bridge over the lack of unity between the academic, university and applied science that has built itself up in Russia in the course of the historic development.

During the past year these strategic ideas have converted into several directions for practical activity, namely: reform of the system of Federal Research Centres (GNTz), restructuring of the Russian Academy of Sciences (RAS), and establishing new consolidated forms for organisation of science and technology activities.

After the «Guidelines...» were adopted the actual reform of the network of science and technology organisations started with working out a concept for reform of the system of Federal Research Centres of the Russian Federation, which was approved in August 2002 by the collegium of the Ministry of industry and science. The reform of GNTz was planned to make each of the centres responsible for realisation of one of the newly approved priority lines and to bring their organisational and legal forms into conformity with the special features of tasks performed by them. At present there are 58 such Centres, twice a year they go through a procedure that reconfirms their status. By their legal-organisational form the majority of these Centres are state-owned enterprises: of the 58 GNTz 49 are federal state-owned enterprises, 7 – federal state departments and 2 exist in the form of closed-type joint-stock companies. GNTzs are large organisations: being only 1.2 % of the total number of organisations in the science and technology sphere, they employ 9.2 % of the whole of the scientific manpower.

Bringing the GNTzs into conformity with the selected priority lines presupposes elimination of works doubling (which is highly questionable if one's aim is good scientific results, as far as elimination of doubling leads to monopolisation and lower quality of works), finding out which of the priority lines are not covered by a GNTz and should it be the case – giving the corresponding status to organisations on a competitive basis. At present the Ministry of industry and science has more that 200 applications from organisations that wish to get the status of GNTz. Ineffective GNTzs are planned to be abolished or consolidated.

There are two ways to reform GNTzs organisationally that are considered as key ones. The first one is for GNTzs that wish to get or keep this status – their legal-organisational form shall be changed by turning them from federal state-owned enterprises to state-owned non-commercial organisations. State-owned non-commercial organisations the Civil Code provides today with only one form – institutions. It is expedient to give this form only to GNTzs that have proved capable as fundamental institutes. The second way provided by the concept is to privatise GNTzs that have the form of state-owned enterprises and do not wish to keep this status and possibly include a number of these into financial and industrial groups or scientific-industrial or scientific-educational complexes.

According to the draft concept GNTzs will start working on a contractual basis, they will conclude framework contracts that will be adjusted every year with an authorized federal



executive body. GNTzs will get their financing from the federal budget in form of binding government contractual work, and subsidies and subventions.

It is expected that the reform of GNTzs will be more effective if these organisations will have the right to choose from a greater variety of legal-organisational forms for their activity. In particular, the GNTzs could not only become institutions, but also non-commercial organisations controlled by the public, in case the current legislation will be supplemented with this kind of form of state-owned non-commercial organisations.

During one year in the system of the Academy of Sciences there were taken a number of practical steps, which can be viewed as an intention to make organisational changes in the Academy. It's interesting that it was reorganisation of the Academy that was on the agenda initially, later the idea of reorganisation developed into the idea of restructuring. All the plans for organisational changes were worked out by the Presidium of the Academy, without calling in «rank and file» members and corresponding members of the Academy<sup>22</sup> – in spite of the fact that the Academy is a self-governing non-commercial scientific organisation with the General Meeting of the Academy as the highest governing body.

The restructuring of the Academy followed three main directions: 1) changing the number of branches in the Academy; 2) introduction of the system of competitive financing of scientific research done by scientific organisations of the Academy; 3) changing the number of employees at the scientific institutions of the Academy.

The first of the directions as it developed in its essence reminded to a certain degree of the organisational reform of the Academy's institutes made in previous years. At that time the Academy had a plan to cut the number of academic institutes. The result was amalgamation and consolidation of a number of institutes, as far as it was expected that amalgamation of the strong and the weak would lead to a reinforcement of institutes. This didn't happen. Besides, in modern conditions, when only flexible research teams and institutes under 100 persons can become the most effective ones, consolidation of research institutes can hardly be a promising idea. Life showed that it really is so. Some time after the reorganisation was over, the institutes started getting divided and split up, at present their number has grown by 4 % as compared to their quantity three years ago.

The aim of the present restructuring was a more efficient coordination of research within the frameworks of chosen fields of the science and a better management of research programmes<sup>23</sup>. To achieve this goal the number of profile branches was halved from 18 to 8, while new branches in their turn were divided into sectors, so that the result was 21 new structural units instead of 18. The number of administrative posts after the restructuring also grew. In May the General meeting of the Academy approved the new structure for the Academy practically unanimously. It is expected that the changes in the Academy's structure will lead to more democracy in the Academy's activities with respect to the mechanism of administering budget means. The branches can now handle a considerable part of the Academy's budget, while before the bulk of the funds was distributed at the level of the Presidium of the Academy of Sciences.

Also being discussed at present is establishing of one more regional branch of the Academy, the fourth one, this time in Saint Petersburg. The initiative to create it belongs to Zhores Alferov, a member of the Academy. A new regional branch is a new separate line in

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<sup>22</sup> *Ginzburg V.* "Restructurizatsiya ili Profanatziya?" // Poisk , #13, March 2002, p. 3.

<sup>23</sup> *Mesyatz G.* Maximum Samostoyatelnosti // Poisk, #16, April 19, 2002, p. 5.

the budget, and, hence a possibility to lobby interests of Saint Petersburg science when the budget is being tailored.

The second trend of changes in the Academy was connected with introduction of new principles for planning of scientific-research work of scientific organisations under the Academy. The presidium issued a new ruling on establishing new Basic principles of planning scientific research by the scientific structure of the Academy. According to the Principles the organisation of planned work and its reporting system are changed. The central idea is that the competitive basis for developing plans of research financed by the state budget needs to be reinforced.

According to the new ruling by the Academy bureaus of the Academy's branches got the right to decide against unpromising research themes and to send the money to priority fundamental research. It is expected that this procedure will allow to cut off low-quality works and to stop unjustified doubling. The criterion for «unjustified doubling» at that is rather vague, and it's not clear how one can distinguish between justified and unjustified doubling. In many fundamental researches parallel works is an incentive for higher results and to a certain extent protection against possible mistakes and erroneous interpretations of research results. Moreover, this kind of detailed breakdown of the institutes' works to the level of themes, which will be subjects for scrutiny by Branch bureaus will lead to a manifold increase of paperwork, as far as each of the institutes will be researching in several themes, while each of them will be split into dozens of assignments. According to the new procedure each of the assignments will actually become a theme and shall undergo the process of state registration.

The working plan for the scientific organisation approved by the Academy's Presidium will get the functions of a government contract and be used as a basis for assigning financing for concrete scientific organisation from the state budget.

As for the reporting, structural units will be giving their intermediate and final reports on their theme works, and by analysis of the results ineffective units can even be closed.

One cannot give an advance assessment of this recent innovation, but it is quite obvious that administrations of the institutes and those employed by the Branches will experience a manifold increase of work. The «competitiveness» notion strictly speaking is hardly present here, as far as tenders are not planned and it does not stand who is actually going to compete with whom.

This initiative is to a certain extent connected with still another ruling by the Academy's Presidium on recommencement of competitive check-ups of scientific organisations of the Academy aimed at a systematic analysis of research, organisational and economic activities of the institutes. The check-ups planned to be done at least once in five years can result in suggestions to adjust or close down certain research lines in some of the organisations and even in proposals on reorganisation or a complete liquidation of organisations. This ruling was issued by the Presidium after an audit of the Academy's activities by the State Auditing Chamber.

And at last the third of restructuring lines was initiated at the very end of 2002 after the Academy's Presidium approved the ruling on a 4 % cut of normative employment rates for the scientific organisations of the Central part of the Academy. The ruling was fulfilled in one month, which means that this initiative is likely to become a short-term campaign bearing no clear argumentation, because it's hardly possible to work out criteria for reduction of the staff in such a short term. It is typical, though, that concurrently within the framework of the Academy new scientific centres are being established – the Southern scientific centre of the Acad-



emy, and the scientific educational complex «Scientific and educational centre of applied physics under the Academy in Saint Petersburg». Hence, the total staff of the Academy will most likely grow.

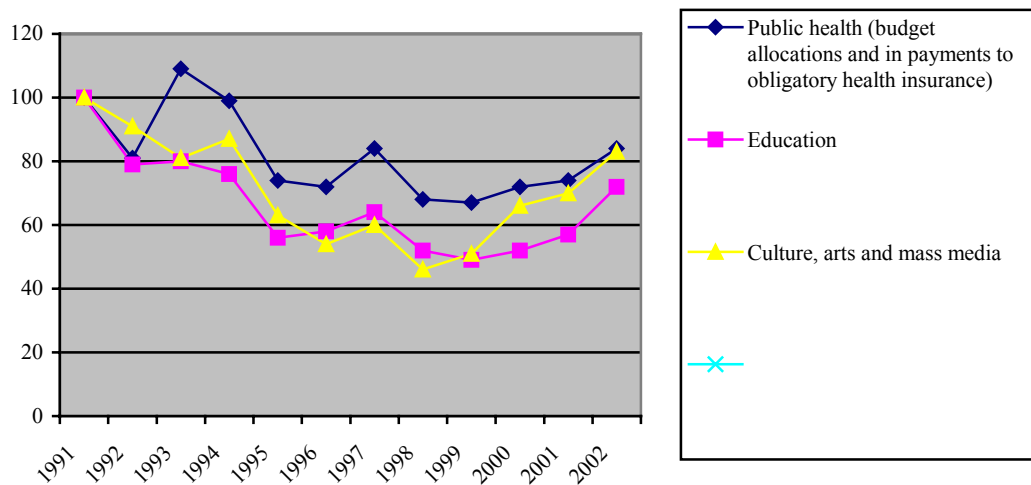
In 2002 also the Ministry of industry and science did some work to form new organisational structures in the scientific sphere, namely: it gave its support to establishing holding companies. For example, there was started the Federal innovative chemical and pharmaceutical company that is supposed to get its final organisational form in 2003. The company will unite nine leading scientific centres, among them several GNTzs, and two or three largest chemical and pharmaceutical enterprises. Organisations that will become parts of the amalgamation will lose their structural independence, but some the institutes' directors will get leading posts in the concern. It is expected that such an amalgamation will possess a higher transparency of the financial system, which will attract investors. As distinct from the classical scientific-manufacturing amalgamations the concern will not only conduct scientific research, work out projects, designs and specifications, it will also manufacture final goods (medicines in this case) and sell them, that is finalise the process by giving the product to the final consumer.

Establishing cooperative groups in the science and technology sphere on the whole is impeded by the current legislation: neither the Civil Code nor the Law on Science provide any feasible mechanism to establish any kinds of cooperative groups usable in the science and technology sphere (for example inter-branch educational and research centres). In other countries legislations on cooperative associations in the science and technology sphere are rather elaborated.

In conclusion it should be noted that the previous year was distinguished by appearance of several clear directions for the government's activities in the science and technology sphere, the financial policies were shaped according to these major directions and a consistent development of the institutional sphere was started. Attention was focused on and maximum progress was achieved in bringing the science and industry closer together through realisation of large-scale innovative projects and establishing holding structures, as well as through developing infrastructure for the innovative activities (a start-up for establishing venture industry).

### **3.6. The Social and Cultural Sphere**

In 2002 the social and cultural sphere branches were really given a priority when budget means were distributed. Financing of public health and physical culture, education, culture, arts and mass media was increased by the government by 20% in real terms as compared to the previous year. The share of these spending in the GDP reached 7.5% (6.5% in 2001). The largest increment of allocations was in education, culture and arts – they were increased by 25% in real terms.



Source: calculated on the basis of the data provided by the State Statistics Committee using GDP deflator indices published after the end of the corresponding years (17.2 in 1992; 10.2 in 1993; 4.1 in 1994; 2.8 in 1995; 1.4 in 1996; 1.2 in 1997; 1.1 in 1998; 1.6 in 1999; 1.4 in 2000; 1.2 in 2001).

Fig. 79. Government expenditures on social and cultural sphere branches (1991 = 100%)

Table 33

**Government expenditures on social and cultural sphere branches (1991 = 100%)**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Public health Including	100	80	108	98	72	71	81	67	67	72	73	
State budget	100	80	91	81	59	57	65	51	51	54	55	
Obligatory insurance in payments by juridical persons	-	-	17	17	13	14	16	16	16	18	18	
Education*	100	79	79	76	56	58	64	52	49	52	57	
Culture, arts and mass media*	100	91	81	87	63	54	60	46	51	66	70	

\* State budget expenditures.

Source: calculated on the basis of the data provided by the State Statistics Committee using GDP deflator indices published after the end of the corresponding years (17.2 in 1992; 10.2 in 1993; 4.1 in 1994; 2.8 in 1995; 1.4 in 1996; 1.2 in 1997; 1.1 in 1998; 1.6 in 1999; 1.4 in 2000; 1.2 in 2001).

Table 34

**Government expenditures on social and cultural sphere branches (in % of the GDP)**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Public health Including	2.9	2.5	3.7	3.9	2.9	3.1	3.4	3.1	2.9	2.6	2.8	
State budget	2.9	2.5	3.1	3.2	2.4	2.5	2.8	2.4	2.2	1.9	2.1	
Obligatory insurance in payments by juridical persons	-	-	0.6	0.7	0.5	0.6	0.6	0.7	0.7	0.7	0.7	
Education*	3.6	3.6	4.1	4.5	3.7	3.9	4.4	3.6	3.2	3.1	3.2	
Culture, arts and mass media*	0.5	0.6	0.6	0.8	0.6	0.5	0.6	0.5	0.5	0.6	0.6	

\* State budget expenditures.

Source: calculated on the basis of the data provided by the State Statistics Committee of the Russian Federation.





At the same time the situation with remuneration of labour of those employed in the social and cultural branches remained rather complicated. By the results of the 3<sup>rd</sup> quarter average monthly wages in education were only 63.1% of average wages in the country, 52% compared to the industry. Analogous figures in public health were 68.9% and 56.8%, in culture and arts they were 64.4% and 53.1% correspondingly.

By the results of 2002 aggregated arrears of wages outstanding in favour of those employed in social and cultural branches increased compared to the beginning of the year by 26.3%. The basic reason for this was under-financing of establishments in the social and cultural sphere on the part of the budgets of subjects of the Russian Federation, which grew by 26.5% in one year. The outstanding debts' branch breakdown in the budgetary sphere was as follows: close to 30% in education, 11% in public health and 3% in culture and arts.

The largest debts in arrears of wages due to the under-financing from the budgets of regions and municipalities in the social sphere have the Republic of Sakha (Yakutia), Krasnodar krai, Kirov, Irkutsk and Kamchatka oblasts. At the same time there were no arrears of wages in such regions as Moscow, Saint Petersburg, the Republics of Kalmykia, Ingushetia, Buryatia and Chuvashia, Ryazan and Penza oblasts, Nenets, Khanty-Mansi, Taymyr autonomous okrugs.

*Table 35*

**Budget arrears of wares caused by under-financing from budgets of all levels in 2002  
(for the begging of the month) (in mln roubles)**

<b>Showings</b>	<b>01.02</b>	<b>02.02</b>	<b>03.02</b>	<b>04.02</b>	<b>05.02</b>	<b>06.02</b>	<b>07.02</b>	<b>08.02</b>	<b>09.02</b>	<b>10.02</b>	<b>11.02</b>	<b>12.02</b>
Total	3633	4025	4673	4648	4049	4328	5142	5487	4336	4728	4655	4493
From the federal budget	562	610	727	716	612	598	600	614	623	699	722	655
From budgets of the subjects	3071	3415	3946	3932	3437	3730	4542	4873	3713	4029	3933	3838
Including Social sphere branches – total	2308	2562	3027	3069	2691	2596	3630	3940	2806	2977	2995	2915
From the federal budget	17	19	21	25	26	25	25	25	25	23	20	17
From budgets of the subjects	2291	2543	3006	3044	2665	2931	3605	3915	2781	2954	2975	2898
<i>Education</i>	531	671	816	872	712	806	1098	1175	337	467	642	612
From the federal budget	16	17	15	15	13	13	13	13	13	15	12	12
From budgets of the subjects	515	654	801	857	699	793	1085	1162	324	452	630	600
<i>Public health</i>	146	180	335	297	207	293	465	617	466	438	372	323
From the federal budget	0.3	2	5	10	12	11	11	11	11	8	8	5
From budgets of the subjects	146	178	330	287	195	282	454	606	455	430	364	318
<i>Culture and arts</i>	59	62	102	103	85	98	161	183	92	101	100	98
From the federal budget	0.3	03	1	0.4	0.5	1	0.3	0.4	0.1	0.1	0.0	0.0
From budgets of the subjects	59	62	101	103	84	97	161	183	92	101	100	98

Source: based on the data by the State Statistics Committee of the Russian Federation.

In November 2002 the Government of the Russian Federation approved the provisions of the Concept of reform in the system of payment to those employed by organisations in the budget sphere (education, public health, culture and arts, science). The basic idea in the Concept worked out by the Ministry of Labour of Russia is boiled down to a transition from the Single tariff scale to branch systems of remuneration of labour and to a transfer of the respon-

sibility to fix wages, of their indexation and payment to subjects of the Federation and local governments. Federal guarantees with respect to branch system of remuneration of labour will be limited to establishing the minimal amounts of remuneration of labour.

The desire of the government to get quit the responsibility of fixing salaries for those employed in the budget sphere is quite understandable, as far as the government is not capable of exerting a complete control of the payment process. This transfer of the main responsibility in fixing wages for budget sphere workers and their payment from the federal to the regional level when budget revenues have been accumulated in the federal centre in the past years and the majority of Russian regions are subsidised, can lead to consequences opposite to those expected by those, who worked out that Concept. In case this new system will be accepted this will aggravate regional differences in levels of wages and can lead in a number of regions to a considerable lag in wages to those employed in budget branches compared to the inflation and a greater social tension right before parliamentary and presidential elections. The regional governments at that will in all probability be telling the physicians and teachers that the basic reason for their low wages are the policies of the federal centre that takes away too much of the revenues and gives away too little subsidies.

### **3.6.1. Public health**

From the economic viewpoint the status in the public health sphere in 2002 did not undergo any essential changes compared to 2001. Having analysed the situation in this branch by the results of 2001 we have ascertained that the budget and insurance system of government financing of public health got reasonably balanced, though the balance was institutionally ineffective.<sup>24</sup> The past period confirmed this conclusion. All system constituents capable of joint efforts (branch administrations, funds of compulsory medical insurance, medical insurance organisations, physicians' associations) are rather interested in keeping the present institutions than in changing them considerably. Public health was no priority sphere in the eyes of the leaders of the stat, they did not exert any serious pressure on major social interests groups urging them to take effort to change the present situation. As a result no progress in solving acute problems in public health organisation in our country was achieved.

Public health financing from budgets of all levels and the system of compulsory medical insurance in its real terms was increased inconsiderably. Changes in government financing of public health in real terms are given in *Table 33*. The acute imbalance between the guarantees of free of charge medical assistance by the state to its citizens and the scope of financing of these guarantees did not diminish. Inadequate means to ensure this free of charge assistance is compensated by the citizens' outlays. Changes of expenditures of the population and the government on public health in the past years are given in *table 4*. The share of paid medical services in the total paid services to the public in the period from 1993 until 2001 increased from 1.7% to 4.6%. These impressive changes can hardly be explained only by a growing demand for medical services on the part of wealthy citizens.

<p>The above figure of the population's expenses on medical services refer to the services that are legally paid for by the population to cash desks of medical institutions. The official figures do not take into account the informal payments, the money that the patients give directly into the hands of medical personnel.</p>
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<sup>24</sup> Rossiyskaya Ekonomika v 2001 godu. Tendentsii i Perspektivy. Vol. 2. Moscow, IET, 2002. p. 16.



Table 36

**Government and private spending on public health, in bln roubles\***

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Public health expenditures of the government	6.38	23.9	51.3	72.1	98.5	88.0	137.7	199.3	241.0
Inpayments to voluntary medical insurance	0.06	0.4	1.2	2.2	3.4	3.8	7.2	12.8	23.8
Paid medical services provided to citizens	0.11	0.6	2.9	5.6	9.3	11.4	19.7	27.5	37.9
The population's spending on medicines	**Н.д.	2.1	8.1	12.2	19.8	26.3	51.7	70.1	94.2

\*Before 1998 – in roubles reduced according to the denomination scale.

Source: Rossiyskiy Statisticheskiy Yezhegodnik (Russian Statistics Yearbook), 2000. Moscow, The State Statistics Committee of Russia, 2001; Rossiyskiy Statisticheskiy Yezhegodnik, 2002. Moscow, The State Statistics Committee of Russia, 2002.

According to a research done by the Independent institute of social policies in two subjects of the Russian Federation in 2002 by means of interviewing public health employees<sup>25</sup> and polls of a representative sample the share of citizens that are forced to buy medicines at their own expense and to pay for medical services both to the cash desk and to the personnel directly is higher in places where government financing is lower. At the same time the informal payments for medical services turned out to be higher in place with higher popular incomes. The research revealed a low interest of medical workers in giving paid services in present legal forms. Because of this legal payment for medical assistance in itself is no guarantee against ensuing informal payments. There are being built up different views in physicians' communities as to informal payments, sometimes these views are directly opposite. Among medical workers there are lots of advocates of payments from the patients in form of "expression of gratitude" and opponents of wringing money out of patients. Though at the same time there already exists a layer of those who have made informal payments a stable source of a better life for themselves. Quite definite rules of informal payment for medical services have arisen. If the existing formal institutes that regulate the conditions for the population to get medical assistance and for medical workers to get paid for their work will continue, the practice of informal payments for medical services will persist and scopes of these payments will grow in pace with the increase of the citizens' financial resources. No realistic growth in government financing of public health will be enough to prevent greater informal payments. The conclusion is that one needs a review of the basic terms of giving medical assistance to the citizens in state-owned and municipal public health institutions.

The economic conditions of medical assistance to the population in the past year were discussed at special meeting in the Security Council of the Russian Federation. The inter-ministry commission of the Security Council of the Russian Federation on population health took on April 22, 2002 a decision "On measures to prevent negative tendencies in developing paid medical services". This document acknowledges that the lower expenditures on public health is the major reason for an increase of paid medical services, and that an inadequate control of organisation of these services leads to a veiled commercialisation of medical institutions' activities, getting of remuneration from the patients directly by the personnel and an increased "shadow" turnover in the

<sup>25</sup> *Besplatnoye Zdravookhraneniye: Realnost I Perspektivy*. Pre-print WP1/2002/07 / by *Bogatova T., Potapchik Y., Chernetz V., Churikova A., Shilova L., Shishkin S.* (the project leader). The Independent Institute of Social Policies. Moscow, 2002.

public health system. The recommendations by the commission contain a whole series of measures, which may make these problems less acute. But the discussion and the decision did not entail any tangible reinforcement of government activities to implement such measures.

A major problem in this branch is that the compulsory medical insurance system has not been completely introduced and public health financing is now an eclectic combination of the budget and insurance systems elements. In the past two years there was a broad discussion about a possible way of developing medical insurance in form of establishing a single system of compulsory medical and social insurance. This goal was formulated in “The basic lines for socio-economic policies of the Government of the Russian Federation in long-term outlook”, approved by the government of the Russian Federation on June 28, 2000 and in the Plan for activities of the Government of the Russian Federation in the sphere of social policies and modernisation of the economy in 2000-2001 (The Government of the Russian Federation. Decree # 1072-r of July 26, 2000). A single system of compulsory medical and social insurance was planned to be established on the basis of integration of the existing system of compulsory medical insurance and social insurance system.

Proposals about integration of the compulsory and social insurance into a single system of compulsory medical and social insurance were being worked out starting from the autumn of 2000. The key barrier for establishing such a system was the issue of sources of insurance payments for nonworkers. The problem of transfers of inpayments from budgets of subjects of the federation for insurance of nonworkers in the existing compulsory medical insurance system is not solved yet. An effective way to solve this problem would be an unambiguous establishing of financial sources of these inpayments as fixed labelled tax revenues, for example, certain parts of revenues from income taxes of natural persons or excise taxes on tobacco or spirits. Similar suggestions were discussed by the government, but in April 2002 it was decided to refrain from that kind of integration, as far as possible ways to fix certain tax revenues as sources of financing payments for nonworkers were not found. Without fixing sources of means to pay for nonworkers an integration of the existing system of compulsory medical insurance and the social insurance systems is truly inexpedient. Building up a more complicated system without having solved the problem of financially uncovered obligations within the framework of one of the primary systems would have a destructive influence on implementation both of the medical and social insurance.

At the same time it is still needed to reform the compulsory medical insurance system. In the year of 2002 the Ministry of economic development actively participated in discussions about this problem. Due to the Ministry’s initiative there was worked out a draft law on this, which suggests the following:

- to establish a firm basis for giving the citizens guaranteed free of charge medical assistance.
- to establish per capita normative inpayments to the compulsory medical insurance system for nonworkers from budgets of subjects of the Russian Federation;
- to exclude local budgets as a source of financing payments to the compulsory medical insurance system for nonworkers; payments to the system for nonworkers shall be made only from the means of the budgets of the subjects of the Russian Federation;
- to use means of the federal budget to subsidise payments for nonworkers;
- to complete an agreement between the Federal Fund of the compulsory medical insurance system and subjects of the Federation on insurance of nonworkers that



would specify obligations of its parties with respect to financing payments for nonworkers that would be transferred to territorial funds of the system; the subjects of the Federation that would not conclude such a contract would independently define the procedure of nonworkers' insurance, giving the medical assistance under the territorial compulsory medical insurance programmes and paying for it;

- to concentrate a bigger part of the compulsory medical insurance system's means in the Federal Fund of the system by changing the distribution proportion of the social tax revenues between the Federal and territorial funds of the system thus extending the capability of the Federal Fund to even out financial conditions for realisation of the basic compulsory medical insurance in different regions;
- to keep medical insurance organisations as insurers in the compulsory medical insurance system and to increase the government's requirements to their activities simultaneously;
- to give the insured the right to choose their insurers;
- to unify the mechanisms of price formation and payment for medical assistance in the compulsory medical insurance system.

Since August 2002 the Pension Fund of the Russian Federation has been actively participating in discussions about the reform of the compulsory medical insurance system. The Fund moved that it should be included among the subjects of compulsory medical insurance as an insurer of nonworking pensioners and suggested to participate in payment of corresponding inpayments to the compulsory medical insurance system, provided that there will be signed agreements between the system's funds, the Pension fund and the administrations of the subjects of the Federation on financing inpayments to the compulsory medical insurance for nonworkers. The Pension fund worked out its suggestions on corresponding amendments to the current law on medical insurance.

But as late as in the end of 2002 these suggestions had not even been accepted for discussion at a government meeting. Only in the beginning of 2003 there appeared indications that the Ministry of economic development, the Ministry of finance, the Ministry of Health, the Pension Fund of the Russian Federation and the Federal fund for compulsory medical insurance found a compromise and worked out a joint position about the core of the planned reform.

In addition to the above principal of the draft law worked out under the guidance of the Ministry of economic development, it is also suggested that the Pension Fund will become one of the subjects of the compulsory medical insurance system, will participate in multilateral agreements between the administrations of the subjects of the Federation, the Ministry of finance, the Ministry of Health, the Pension Fund of the Russian Federation and Federal and territorial funds of the compulsory medical insurance on insurance of nonworkers that live on territories of corresponding subjects of the Russian Federation. These agreements will determine the parties' obligations on volumes of financial means that are transferred to make payments to the compulsory medical insurance for nonworkers or certain categories of these for one financial year. It is suggested that payments for nonworking pensioners from the federal budget will be financed from the single social tax revenues that are transferred to the federal budget for financing the basic part of the labour pension.

The Pension Fund will keep the register of all those insured by the compulsory medical insurance system, take part in working out the basic and territorial compulsory medical insurance programmes, perform spot checks of the insurers' and medical organisations' activities

in the system. The Pension fund also proposed to start already in the current year in a dozen regions of the country an experiment on financing the compulsory medical insurance from its own means. It can be supposed that the sudden active movements by the leaders of the Pension Fund in reforming the compulsory medical insurance and the achieved compromise are instruments to reach other political and economic goals. In case the above pattern gets realised, one can expect that the Pension Fund's leaders will take measure to visibly demonstrate the ineffectiveness of the existing system of compulsory medical insurance organisation and the potency of its own efforts to make it more efficient.

If we look away from the measures under discussion, and turn to changes that took place in regulation of activities in the sphere of public health, we can state that no significant changes in the mechanisms to administrate and finance public health happened in 2002.

In the past three years the Ministry of Health of the Russian federation has been very active in issues of reform of the branch's administration and financing mechanisms only with respect to the federal medical institutions within its own jurisdiction. In 2000 there was an attempt to change the budget financing mechanism of federal clinics by means of tariffs for payment for treated patients by the final treatment results thus linking budget allocations to a medical institution with the resulting showings of the institution's activities. A pilot approbation of this mechanism was started in 2001 in the Scientific obstetric, gynaecological and perinatal centre under the Academy of Medical Sciences (Moscow), but this long-awaited innovation is being spread in a very low tempo. At the beginning of 2003 financing of only 8 of federal medical institutions was transferred to the new mechanism of budget financing. In February 2002 the Ministry of Health jointly with the Russian Academy of medical sciences issued an order "On organisation of giving high-technology (expensive) types of medical assistance in federal public health institutions". It is planned to work out for these institutions yearly targets for high-technology (expensive) types of medical assistance. But the document leaves the budget mechanism for financing of these clinical activities on the basis of tariffs for treated patients unattended. The essence of establishing targets for institutions is a more stringent control so that the budget means allotted under article 1701/430/315 "Targeted expenditures on high-technology types of medical assistance" are used to provide exactly these types of assistance and not used as a simple addition to the budget allocations to support these clinics (article 1701/430/300)

In the past year the Government of the Russian Federation took decisions "On licensing of some types of activities" of February 11, 2002 # 135; "On licensing of activities connected with circulation of narcotics and psychotropics" of June 21, 2002 # 454; "On approval of the Regulation on licensing of pharmaceutical activities" of July 1, 2002 # 489; "On approval of the Regulations on licensing of medical activities" of July 4, 2002 # 499. The Ministry of Health now got the possibility not just of regulation of the licensing procedure of medical activities performed by executive authorities of subjects of the Federation, which was the case before, but also of independent licensing of medical activities of juridical persons under federal executive authorities, the Russian Academy of Sciences and branch academies.

In May the State Standardisation Committee of the Russian Federation in co-ordination with the Ministry of Health approved the Rules for certification of medicines (Decision # 36 of May 24, 2002). The rules prescribe a compulsory certification of each lot (series) of manufactured or imported medicines. Previously such a certification was only performed when a new medicine appeared at the market.



Giving an assessment to the changes that happened in the normative regulation on the whole, one should state that they continued the line pursued by the Ministry of Health in recent years to broaden its “licensing rights”.

### 3.6.2. Education

In contrast to the public health sphere there were taken real measures to reform the educational system. This year can be characterised as a period of detailed elaboration and concrete definition of previously adopted strategic decisions on basic lines for the reform in education. The Ministry of education of Russia in its order # 2866 of June 23, 2002 approved the Plan of actions for 2002-2004 to put into practice the Concept of modernisation of education in Russian until 2010. This document includes arrangements grouped into two sections: I. Ensuring government guarantees of accessibility of good quality education; II. Building up conditions to increase the quality of general and vocational education.

The basic lines to ensure government guarantees of accessibility of good quality education are:

- working out suggestions to distribute powers between social security authorities and education management institutions on issues of targeted social support to schoolchildren and students from poor families, handicapped, orphans and children that lost their parents’ support, in the part of paying for their lodgings, food, medical care, summer vacations, covering their expenses to buy schoolbooks, etc; in this line there is planned to work out a draft Government decree in the 1<sup>st</sup> quarter of 2003;
- working out suggestions on military draft adjournment for students graduated from institutions of higher learning and secondary vocational training that were given pedagogical education while they work full time as pedagogues, mentors, teachers in general education institutions, orphanages and boarding schools, in primary vocational training institutions that have state accreditation; in this line there is planned to work out a draft presidential decree in the 4<sup>th</sup> quarter of 2002;
- increasing overall accessibility of preschool education; establishing a system of guarantees on payment of educational services in preschool institutions by the state; support and development of their material resources on the account of their founders, financing of their expenses on the account of the parents with a simultaneous targeted social support to poor families; in this respect it is planned to work out a draft government decision (in the 3<sup>rd</sup> quarter of 2004) that would include experiments in 2003-2004;
- establishing cultural, educational, vocational, medical centres on the basis of educational institutions (especially in rural arrears); working out of legal basis for functioning of such centres is planned to be finalised in the 2<sup>nd</sup> quarter of 2004;
- ensuring social conditions for education of children with limited health capabilities; with this aim it is planned to work out and approve a state standard for special (correction) education in the 4<sup>th</sup> quarter of 2003;
- an analysis of the experiment on organisation of the single state examination (SSE) and a summary of its results; working out administrative decisions on developing the experiment on the basis of the analysis of its results for each stage of it; monitoring of public opinion; bringing the number of subjects of the Federation

participating in the experiment to 75 by 2004; by the results of the experiments it is planned to work out a draft government decision in the 3<sup>rd</sup> quarter of 2004.

Within the framework of the second section of the Plan of actions it is planned to work along the following basic lines of modernisation of education:

- introduction of a state and public controlled system to assess the quality of education that will be independent of educational administrative authorities; within the framework of this line there are planned arrangements that will be finalised in the 1<sup>st</sup> quarter of 2005 by establishing a single service of examination boards that will be controlled by the state and the public;
- adoption of a state general education standard; ensuring the guarantees of general education quality and unification of the educational space in Russia that would take into consideration ethnic and cultural peculiarities of the population, etc; adoption of a government decree to approve the state standard for general education was planned for the 4<sup>th</sup> quarter of 2002;
- introduction of profile education in the secondary school; decreasing the load on schoolchildren and students in general education institutions and providing better quality to schoolchildren's readiness to start their education in the system of vocational training; arrangements – from working out a Concept for the profile school to writing schoolbooks for it – are planned for the period the starts in the 2<sup>nd</sup> quarter of 2002 and ends in the 4<sup>th</sup> quarter of 2004;
- ensuring the conditions that will promote health of schoolchildren and inmates of the educational system; here it is planned to work out and realise an under-programme “physical training and health support of children, teenagers and youths in the Russian Federation” in the period from the 1<sup>st</sup> to the 4<sup>th</sup> quarter of 2004;
- ensuring government support to educational institutions that perform innovative activities as starting pads for the process of modernisation in educations; in the period from the 2<sup>nd</sup> quarter of 2002 until the 4<sup>th</sup> quarter 2004 it is planned to work out a corresponding system of starting pads;
- working out criteria for choosing and approving the list of the leading institutions of higher learning, scientific and artistic schools with the aim of their higher effectiveness in using the scientific and pedagogical potential of the higher school, building up a modern scientific experimental basis and ensuring priority government support to these institutions; arrangements in this sphere cover the period from the 2<sup>nd</sup> quarter of 2003 until the 4<sup>th</sup> quarter of 2004;
- making a new attestation of educational programmes for training in economy, law and management, a new attestation and in case of necessity a new licensing of branches of institutions of higher learning; arrangements in this sphere are planned for the 2<sup>nd</sup> quarter of 2002 – the 4<sup>th</sup> quarter of 2004;
- ensuring priority development of elementary and secondary vocational training with its simultaneous restructuring taking the regional markets' needs into consideration, reform of the primary and secondary vocational schooling administration; here in the 4<sup>th</sup> quarter of 2004 it is planned to work out a draft federal law “On amendments and additions to the Law of the Russian Federation “On Education”;
- restructuring and institutional reform of vocational training system, enhancing effectiveness of its institutions, perfection of different models of integration of ele-





mentary and secondary education, secondary and higher vocational education, establishing university complexes; arrangements in this line will be finalised in the 4<sup>th</sup> quarter of 2004 by working out draft government decisions.

In 2002 there was started a full-scale work on one of the key issues of this plan – elaboration of educational standards. It should be noted that state standards were mentioned for the first time in the first version of the Law “On Education”. The federal law “On changes and amendments in the federal law “On education” and the federal law “On higher and post graduate vocational education” of June 25, 2002 (#71-FZ) states that the basic regulations about state educational standards in primary general, basic general and secondary (complete) general education, the procedure for their elaboration and approval are established by a federal law at least once in ten years.

The state standards at that shall define the basic parameters of educational process integrating the existing uncoordinated requirements to the school education. For example at present the number of school hours is defined by the basic curriculum, the maximal load for pupils is prescribed in sanitary-planning norms, etc. To set down a new standard that would integrate these requirements the Ministry of education of Russia established in April 2002 a temporary scientific team called “Educational standard”. The first result of this work was the document “Volumetric figures for working out the federal component of state educational standard for general education”. A collegium of the Ministry of education of Russia by its decision #13/2 of June 11, 2002 took these figures into consideration and ordered the temporary scientific team “Educational standard” to be guided by the attained volume figures when it would be working out the federal component of the state educational standard for general education.

The suggested figures prescribe that the federal component for general education shall cover at least 75% of the total normative time for mastering the educational programme in general education, the regional (national-regional) component – at least 10% and the school component – also at least 10%. According to the document that is being worked out to get a complete (general) education a Russian pupil shall study for 4 years in the elementary school, 5 years in the basic secondary school and 2 years more in the complete secondary school. The possibility of a transfer to a 12-year schooling is kept in the document by allowing other normative terms (different from the 11-year schooling) for mastering the curriculum for some categories of pupils in the way of an experiment. The school year in the elementary school shall at least be 33 school weeks in the first form and at least 34 school weeks in the second-fourth forms, the length of the school year in the basic and high school shall be at least 35 school weeks.

The “Volumetric figures...” actually prescribe the minimal list of compulsory subjects: the Russian language and literature, foreign languages, mathematics (including algebra and geometry), information, history, social science (including basic cultural and political studies, basics of the law, psychology, sociology, philosophy, economy), geography, natural studies (including physics, chemistry and biology), arts (including the fine arts, music and world arts culture), technology (including productive work and informational technologies), physical culture and basics of personal security.

As far as according to the current regulations the teachers’ salaries depend on their hours of teaching, it is evident that the number of hours designated by the standard to each of the subjects will surely become an object of tough lobbying on the part of groups of teachers of different subjects. This kind of direct interest in a maximum number of school house led to

a situation, when the “Volumetric figures...” actually fail to reach the goal of easing the school load on schoolchildren that had been proclaimed several times. A formal cut in the number of compulsory hours is actually reached by means of putting the physical training classes outside the framework of compulsory hours, in other words, when the maximum allowed load of lecture hours for schoolchildren is being calculated the hours for subject “Physical training” are not taken into account.

The situation when subject standards will keep the tendency to overload the schooling programme becomes even more probable in connection with the fact that approval of educational standards is planned to be transferred from the level of the Federal legislative assembly to that of the Government of the Russian Federation.

In 2002 considerable effort was taken to work out a Concept for profile education for the highest level of general education. The Concept was approved by the order of the Minister of education # 2783 on July 18, 2002; the schedule for introduction of profile education for the highest level of general education was adopted by the decision of the Ministry of education of the Russian Federation # 970-13 of September 30, 2002. The composition of the Concept’s provisions can be broke down into the following:

- a possibility of simultaneous functioning in the system of general education institutions in the Russian Federation of profile and non-profile schools and classes, as well as a possibility to build up individual educational trajectories with more profound studies of chosen subjects;
- a three-component structure of school subjects (courses) for the highest level – basic level subjects (courses), profile and selective subjects (courses);
- multivariant forms of profile education organisation, including the “distributed network” type that includes usage of vocational training institutions and additional education institutions for children and teenagers, as well as network coordination among schools;
- the necessity to organise a pre-profile training for schoolchildren in the 9<sup>th</sup> grades.

The time-schedule for profile education introduction envisages performance of basic preparatory arrangements until the end of the 2<sup>nd</sup> quarter of 2004 with the aim to start a full-scale transition to profile education in general education institutions starting in September 2005 after the necessary experiments will be over.

Within the framework of the Concept alongside with the general characteristics of the profile education system in the senior school there are also suggested approximate educational profiles. Among the latter the authors of the Concept name the following ones:

- natural and mathematics profile;
- social and economic profile;
- the humanities profile;
- technological profile;
- universal (non-profile) education.

After the Concept was ready it became a subject for a wide discussion in the professional community and in regions. Regional educational authorities in 49 subjects of the Federation held discussions on the Concept. The majority (81%) spoke for taking the Concept as a basis and a subsequent perfection of it, 10.9% viewed it as ready for approval, and only 2.7% believed the Concept to be not worth to be accepted as a basis. 43.3% suggested that the time for a full-scale transition to the profile education should be after 2005, 18.9% wanted it in 2005, and 13.5% in 2004.



The parliamentary hearings made by the Committee on education and science of the State Duma on October 17, 2002 revealed that though the general assessment of the Concept was positive it should be further developed and an additional study of a whole number of issues related to the transition to profile education should be done. Among these issues are:

- the list of the profiles and their content and universal (non-profile) education;
- breakdown of school seats by profiles;
- the procedure of access to profile education on a competitive basis by applying results of examinations of graduates of the basic stage;
- possibility to change the profile during the education process and possibility to keep the profile in case of changing schools;
- organisation of pre-higher school training for graduates of elementary vocational education institutions or non-profile (universal) senior schools, etc.

In 2002 the experiment on introduction of the Single State Examination (SSE) was given a broader application, it covered 23% of school graduates in 16 regions of Russia already (*see Table 37*).

*Table 37*

**Advance of the experiment on introduction of the single state examination (SSE)**

	<b>2001</b>	<b>2002</b>	<b>2003 (planned)</b>
Number of subjects of the Federation participating in the SSE	5	16	49
Number of graduates participating in the SSE, thousand persons	30	300	715
The share of graduates participating in the SSE, in % to the total number of graduates	2	23	58
Number of higher learning institutions participating in the SSE experiment	16	117	245

*Source:* data provided by the Ministry of higher learning of the Russian Federation.

In order to improve the legal regulation of the experiment's process and in accordance with the Federal Government Decree "On participation of educational institutions of secondary vocational education in the experiment on introduction of the single state examination" # 222 of April 5, 2002 the Ministry of education adopted the Regulation "On the single state examination procedure" (order # 1306 of April 9, 2002). The Regulation establishes the procedure of final examination of graduates of general education institutions, entrance examinations and enlistment of students by secondary and higher vocational education institutions in the subjects of the Federation, where the experiment took place. The SSE envisages that the final examination of graduates of general education institutions and entrance examinations to secondary specialised education institutions and institutions of higher learning shall be the same thing. The results of the SSE shall be acknowledged by general education institutions as results of final examination, and by secondary specialised education institutions and institutions of higher learning as results of entrance examination. Examination works according to the SSE system are graded by using scores (according to 100-score scale) and marks (according to the 5-score scale). Graduates that have passed the SSE receive: (1) certificate of secondary (complete) general education; (2) certificate of the results of the SSE, its validity shall be until the 31<sup>st</sup> of December next year. Should a graduate postpone his/hers entering an institution of higher learning, he/she shall pass the SSE again in the year when the graduate decides

to enter the institution. To arrange the SSE in each of the subjects of the Federation there were formed state examination commissions, their compositions were approved by the Ministry of education of the Russian Federation.

Last year there were changes in economic mechanisms of higher learning institutions' activities. First of all according to the abovementioned Federal law # 71-FZ (of July 25) article 41 of the Federal Law "On education" was changed. The 25% restriction on intake of students by state and municipal professional secondary and higher learning institutions for paid education of specialist in justice, economy, management, state and municipal administration was changed for 50% of the total intake for each profession.

Secondly, approbation of the new financing mechanism for institutions of higher learning was started. The Government of the Russian Federation by its Decree #6 of January 14, 2002 "On the experiment of transition to financing of certain institutions of higher professional learning by using state registered obligations (SRO) in 2002-2003" approved the regulations about conditions and procedure for this experiment in 2002-2003. The regulations prescribe that the experiment of transition to financing of institutions of higher learning by using SRO shall be performed in interplay with the experiment of introduction of the SSE. They describe the SRO as "a proof of the results of the single state examination passed by a citizen bearing a corresponding inscription that testifies to the category of the financial obligation, which shall be the basis for granting budget means to this institution for education of this citizen in this institution during the whole term in accordance with the state educational standard". For those that fail at the SSE (graduates of previous years, graduates of education institutions in the subjects of the Federation that do not participate in the experiment, etc) or have passed a SSE in subjects, that are non-profile subjects for this institution, the state examination commissions that arranges the SSE shall organise an examination in the form of SSE and using its materials.

The group of institutions of higher learning that participate in the experiment of transition to SRO approved by orders of the Minister of education # 1012 of March 25, 2002 and # 1166 of April 3, 2002 is comprised of 6 institutions of higher learning in 3 subjects of the Russian Federation:

1. The State Technology University of the Republic of Mary-El;
2. The State Pedagogical Institute of the Republic of Mary-El named after N. Krupskaya;
3. The State University of the Republic of Mary-El;
4. The State University of the Republic of Chuvashiya named after I. Ulyanov;
5. The State Pedagogical University of the Republic of Chuvashiya named after I. Yakovlev;
6. The State University of the Republic of Yakutiya.

It should be noted that the institutions in the Republics of Mary-El and Chuvashiya previously participated in the experiment with SSE.

One should also make a note that institutions of higher learning not run by the state and branches of state-owned institutions of higher learning located at the territories of the Republics of Mary-El and Chuvashiya were not chosen to participate. Besides, institutions of higher learning run by different ministries did not give their consent to take part in the SRO experiment, which decreased the representativeness of its participants on chosen territories.

The institutions of higher learning participating in the experiment were supposed at least three months before the date they started accepting entrance documents to define and



announce the price of education for each profession, each line of training and form of education. Those institutions were obliged to take in as first year students in all professions that they educated in only applicants on the basis of SRO.

The number of students whose education was paid for from the means distributed on the basis of SRO with no additional payments on the part of the students was to be at least 50% of the total number of students taken in that year and at least 25% of the total number of students in each profession. Should an applicant fail to be included into the number of those whose education is exclusively paid for from budget means and the price of his education exceeds the financing covered by the SRO issued in his name, he shall conclude a contract with the institution for the time of his studies and pay the difference between the price for his education and the financing covered by his SRO in the order stated in the above contract.

It is stressed in the Regulations that granting of budget means to the higher learning institutions that participate in the experiment shall be done in accordance with the legislation within the framework of federal budget performance. Budget financing of institutions that participate in the contract and are run by executive authorities of the subjects of the Federation and local governments shall be done from the budgets of the subjects of the Federation and local budgets correspondingly. The Ministry of education and the Ministry of finance of the Russian Federation on April 29, 2002 issued a joint order #1597/39n "On approval of methods of planning and financing of federal budget expenditures on higher professional education on the basis of state registered obligations with respect to institutions of higher learning that participate in the experiment". Pursuant to these methods for the period this experiment is run there are introduced 5 categories of SROs; there is established a certain correlation between the SRO categories and the sum of scores received by the applicant on the subjects that he took the SSE in (*see table 38*). Each year the SRO value will be recalculated depending on the budget possibilities, but the correlation between the SRO category and the scores got in the SSE will remain the same.

It should be noted that the institutions of higher learning using the SRO means can cover such expenses as wages, the single social taxes and other current expenses. Other expenditures shall be financed from the budget according to calculations as before.

*Table 38*

**Correlations between the scores received at the SSE, the SRO category and its value**

SRO category	Scores got at the SSE	Budget financing of the SRO*, roubles
Category 1	Over 80- 100	14500
Category 2	Over 68-80	7500
Category 3	Over 52-68	3900
Category 4	Over 43-52	2800
Category 5	Over 35-43	1200

\*Approved by Order of the Minister of education of the Russian Federation # 1013 of March 25, 2002.

By the results of intake of students by the 6 institutions of higher learning participating in the experiment in the academic year 2002/2003 there were admitted 14.3 thousand applicants as first-year students of the total number of 35 thousand applicants; the number of admitted students whose education is financed by SRO was 8.4 thousand or 59% of all admitted applicants. The distribution of first-year students participating in the experiments by SRO categories is given in *Table 39*.

*Table 39*

**Distribution of first-year students participating in the experiment by SRO categories**

SRO category	First-year students, in %	Schoolchildren that took the SSE, in %
Category 1	2	8
Category 2	38	9
Category 3	37	34
Category 4	11	25
Category 5	5	17
No category	1	13

*Source:* data provided by the Ministry of Education of the Russian Federation

Thus the SROs provide applicants with the right to get a higher professional education using budget means, though the scope of financing will depend on the results that the applicant got at the SSE and the budget financing that the government will allot for higher education in the budget of each year.

The parliamentary hearings in December on the results of the experiment of introduction of the SSE in 2002, as well the Congress of the Russian Association of heads of institutions of higher learning showed a general support for the education modernisation programme, though opinions on methods to realise some of its lines differ greatly. Heads of universities subjected to strict criticism the suggestion about transition to an intake based exclusively on the results of SSE, when the institutions of higher learning actually do not participate in the process of choosing their applicants. Though the SSE was acknowledged as an unbiased mechanism of independent control of schooling quality, many expressed their concern about the fact that in the situation of the present formalised SSE procedure many of the first-year students will prove incapable of studying at an institution of higher learning. Thus there still remains the risk that the applicants' expenses connected with the traditional private tutoring prior to the entrance examinations will take a new form of the first-year students' expenses to "drag them up" to the level of requirements to freshmen in a particular higher school or university.



It is evident that knowledge quality of the students that enter institutions of higher learning by the results of their SSE can only be assessed after they have studied for a certain time in the institutions, that is by monitoring the SSE experiment. But already now to increase the number of institutions that would participate in the SSE experiment and accept its results one needs some kind of a compromise between higher school leaders and advocates of intake of students by institutions of higher learning by the results of SSE. There is a possibility that flexible quotas can serve as a compromise, they will define the share of those entering institutions of higher learning by the results of SSE and by using the traditional system of competitive examinations.

Transition to budget financing of institutions of higher learning through the system of different SRO categories can entail a negative influence on the pattern of professions that are studied in the higher school. Heads of universities in their strive to survive the structural restrictions that will be introduced on financing of studies will in all probability be reducing the intake of students in “costly” professions and extend studies in professions that require minimal cost per student. There can emerge a situation when the higher school system loses its bearings with respect to development trends in economy, science and technologies.

The analysis of the government policies in 2002 on realisation of its proclaimed reform of education testifies to state executive bodies' wish to go over to giving a practical work-out to some of the concrete and organisational-economic components of this reform in pilot regions. This kind of approach allows a more active progress in adaptation of the education system's functioning in market conditions, though it requires of government authorities a much quicker reaction with respect to amendments and adjustment of their tactics in implementing the reform at the local level. There is a possibility that the commission on education that is established pursuant to a government decree and consists of the most reform-oriented leaders of regional education administrations as well the suggestions worked out by the Russian President's Administration on distribution and regulation of powers and of corresponding financing between all levels of federal and local authorities will allow solving this task in a more effective way.

### **3.7. Foreign economic activities**

The WTO in its annual report states a striking contrast between the data on world production and trade volumes in 2001 and 2000. In 2001 the world GDP growth slowed down to 2.2% and the world trade for the first time since 1982 decreased by 1.5%, as apposed to 2000 when record breaking growth rates in trade and production were registered in the past 10 years.

For the world economy as a whole the beginning of the year 2002 was rather a success, though in the last month the outlooks worsened. The state of the US economy will in all probability be getting better in a slower tempo than it was expected; showing of the Japanese economy in the latest period testify to the effect that the economic recession it getting to its end, though the level of domestic demand remains low; in the Euro zone there is registered a slack rise. The steady growth in Asian economies with their developing markets give hope, but the weak economies in Latin America worsen outlooks for the developing markets. A factor that adds to the uncertainty is a possibility of an armed conflict in the Middle East.

Though the world economic activities got more active in the first half of the year 2002, the volume of export and import operations remained 4% lower than that of the previous pe-

riod. In January-June of the current year volumes of imports in Europe and the USA fell by 6% as compared to 2001, the decrease in Japan and Latin America exceeded 10%.

*Table 40*

**Goods and commodities trade growth in value terms in 1990-2001**

	Exports				Imports			
	Value in bln dol-lars		Change in 1 year (%)		Value in bln dol-lars		Change in 1 year (%)	
	2001	1990-2000	2000	2001	2001	1990-2001	2000	2001
World	6162	6	13	-4	6439	7	13	-4
North America	994	7	13	-6	1410	9	18	-6
Latin America	349	9	20	-3	381	12	16	-2
Mexico	159	15	22	-5	176	15	23	-4
Other countries in Latin America	190	6	18	-1	205	9	10	0
Western Europe	2484	4	4	-1	2527	4	6	-3
EU (15)	2290	4	3	-1	2335	4	6	-2
Without internal EU trade	873	5	7	0	140	5	15	-4
Countries with economies in transition	285	7	26	5	268	5	14	11
Central/Eastern Europe	129	8	14	11	159	10	12	9
Russian Federation	103	-	39	-2	54	-	13	19
Africa	141	4	28	-5	134	3	5	1
The Middle East	239	7	42	-9	174	5	10	4
Asia	1671	8	18	-9	1544	8	23	-7
Japan	405	5	14	-16	350	5	22	-8
China	266	15	28	7	244	16	36	8

Source: WTO data.

Russia and China on the contrary have increased their imports by 7% and 10% correspondingly. The WTO points out specially stronger positions of China, which both in goods and commodities trade turnover and its sells of services occupies now the fourth place in the list of the biggest importers and exporters of the world before Canada. China today is only out-conquered by the USA, the European Union and Japan.

On the whole the growths in economies of the USA and South-East Asia and a small upsurge in Europe and Japan led in 2002 to a 1.5-2.0% growth in world trade.

Russia's foreign economic relations during year 2002 developed in rather complicated conditions and were characterised by contradictory tendencies. Against the background of negative foreign factors – a slowdown in the world economy's growth and worsened state of goods and commodities markets in the first half of 2002 there was registered a decrease in Russian exports in value terms. The major reason for exports value decrease were lower world prices on oil, natural gas and metals. According to the assessments of the IMF in the first half of 2002 world prices on Russian exported goods were 20% lower that in the same period of 2001. For example, in January-June 2002 the world Brent oil prices were 12.9% lower than in the same period of 2001, prices on petrol were 21.9% lower. World copper prices lowered by 6.8%, aluminium prices by 11.2%. Natural gas got 43.7% cheaper.

But in the second half of the year as a result of a better situation at the oil market the development of Russia's exports changed and by the results of the year Russian exports exceeded that of 2001 by 5.2% and equalled to 106.9 bln dollars (according to the Central Bank of Russia). Bigger revenues were achieved basically due to a quantitative increase of deliver-





ies. Though the world prices on basic Russian export goods grew in the second part of 2002, their average was still lower than the year before.

*Table 41***Average world prices**

	1996	1997	1998	1999	2000	2001	2002
Oil (Brent), USD/tonne	21.33	17.4	14.1	15.9	28.19	24.843	25.022
Natural gas, USD/1 mln BTU		1.9642	2.5469	2.1876	4.3442	3.9764	3.3857
Petrol, USD/gallon	0.71	0.6146	0.5113	0.5289	0.8869	0.7922	0.7545
Copper, USD/tonne	2574.9	2369.7	1775.3	1539.9	1863.9	1613.6	1592.9
Aluminium, USD/tonne	1590.2	1554.0	1413.5	1318.0	1550.0	1444.7	1350.7
Nickel, USD/tonne	8053.9	7312.4	5352.5	5239.5	8624.0	5966.0	6175.1

*Source:* calculated on the basis of the data of London Metal Exchange (Great Britain, London), the World Oil Exchange (London).

The oil and gas markets experienced considerable price fluctuations. The average world oil price for Urals in January 2002 was 18.3 dollars per barrel, in June it was 23.0 dollars per barrel, in September – 27.1% dollars per barrel. In October, thought, the price went down by 4.1% and by additional 11.6% in November (down to 21.4 US dollars per barrel). As a result the monthly average oil price in 2002 remained at the level of 2001, prices on oil products decreased by 1.1%.

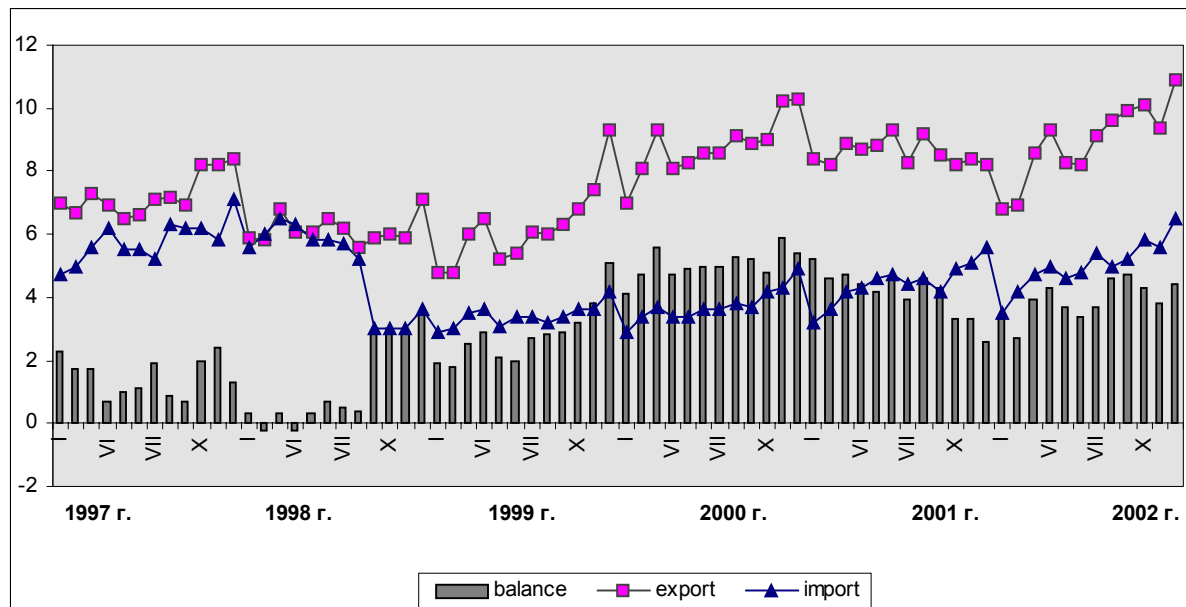
Since the 2<sup>nd</sup> quarter of 2002 there were signs of a better situation at the market of ferrous metals. Steel works in Western Europe went on cutting their production and exports aiming at restricting the supply of steel at the market to support the prices. The average world market price on hot-rolled steel strips in 2002 were 260.8 dollar per tonne, having exceeded the price level in 2001 by 27%, the price for cold-strip steel was 315.4 dollars per tonne (a 4.1% growth), the prices on iron-and-steel scrap and waste were 66.2% (an increase by 20.9%), and the price for profiled steel was 245.8 dollars per tonne (a growth of 5.4%).

The non-ferrous metal market witnessed a poor price situation in the 3<sup>rd</sup> quarter of the year. Prices on all principal metals fell to the level of the 2<sup>nd</sup> quarter: aluminium by 3.4%, copper by 5.9%, nickel by 1.6%. There was no traditional seasonal price increase and a greater demand in September. As a result the price on aluminium in 2002 was 1350.7 dollars per tonne, which is 6.5% lower than the corresponding level in 2001, nickel was 6175.1 dollars per tonne (a 3.5% growth), copper – 1592.9 dollars per tonne (a 1.3% reduction).

The steady growth of domestic demand in Russia alongside with cheaper food and agricultural import prices promoted a highly positive development in goods imports in value terms and especially in quantitative volumes. By the results of 2002 imports value increased by 12.5% compared to the level of 2001 and amounted to 60.5 bln dollars.

A considerably lower development of exports against the background of continuing imports led to a decrease in the positive trade balance, which in 2002 accounted for 46.4 bln dollars, which is 2.9% less than the same in the previous year. Nevertheless the trade balance was highly positive and equalled to 13% of the GDP.

On the whole Russia's foreign trade turnover in 2002 reached in the past 10 years its highest level – 167.4% bln US dollars, which is 7.8% more than in the previous year.



Source: The State Statistics Committee of the Russian Federation.

Fig. 80. Principal showings of Russia's foreign trade turnover

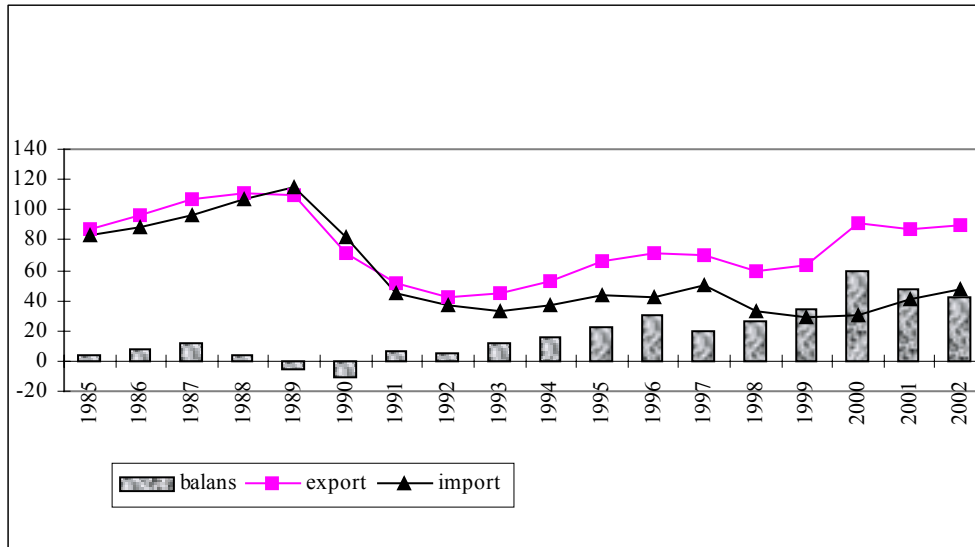
### 3.7.1. Russia's foreign trade with countries outside the CIS

Russia's major trade partners are still Countries outside the Commonwealth of Independent States. The share of these countries in Russia's foreign trade turnover increased in 2002 to 83.0% against 81.8% in 2001. The foreign trade turnover with countries outside the CIS accounted for 138.9% bln dollars, having exceeded the analogous figure of the previous year by 9.3%. A greater turnover in foreign trade was achieved basically due to a quick growth of imports.

The macroeconomic situation of recent years, for the most part the growth of domestic prices and the real exchange rate of the rouble, promoted a quick re-establishing of foreign producers' positions at the Russian market and a tougher competition with domestic manufacturers. This process was to a considerable degree supported by "cheaper" imports, both due to lower average contract prices and imports restructuring that resulted in imports of cheaper goods.

Against the background of a real strengthening of the rouble and a quantitative growth of the GDP the value of goods imported from countries outside the CIS increased in 2002 compared to 2001 by 18.4% and amounted to 48.2 bln dollars. At the same time lower world prices on Russian exported goods, first of all oil and gas prices called for a lower growth tempo of Russia's exports to countries outside the CIS, which in value terms accounted for 90.7% bln dollars (a growth by mere 5%).

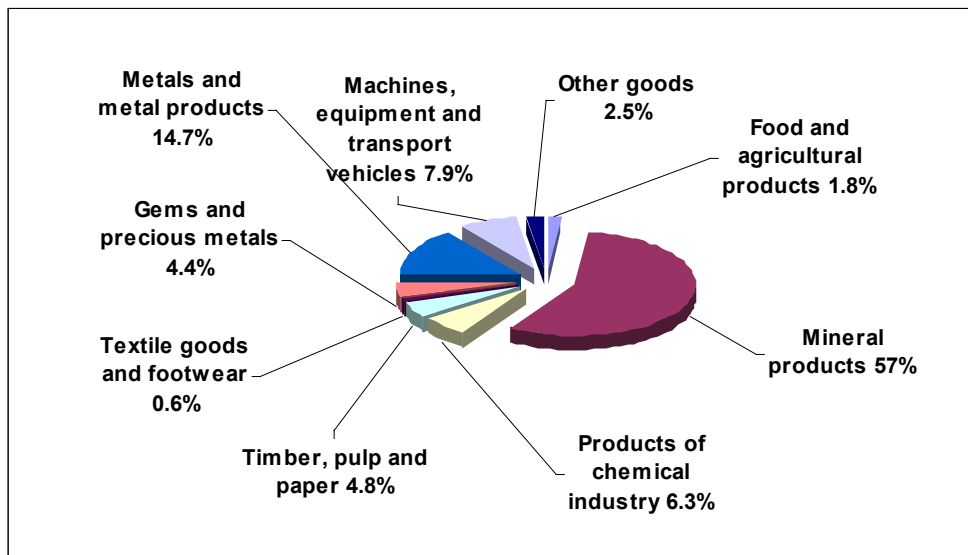
As a result the positive trade balance decreased compared to the level of 2001 by 7%, though it still had a considerable value of 42.5 bln dollars.



Source: The State Statistics Committee of the Russian Federation.

Fig. 81. Major showing for Russia's foreign trade with countries outside the CIS

The core of Russia's exports is still comprised of goods with a low added value; for the most part it is raw materials. The share of raw materials in Russia's exports amounts to 45-50% of exports totals. In the period since 1992 and until 2002 Russia lost about a half of its exports of advanced technology products. In 1992 the share of these products in Russia's total export deliveries was 25%, in 2002 their share was as low as 12%.



Source: The State Customs Committee of the Russian Federation.

Fig. 81. Russian exports' pattern in 2002.

The share of fuel and energy products in 2002 was 57% in Russia's total exports to countries outside the CIS. There was exported 154.7% mln tonnes oil, which is 9.9% more

than in 2001. Though contract prices in 2002 were 2.8% lower than in the previous year, export revenues increased by 14.1% and accounted for 25133.2 mln dollars.

The second basic group of goods and commodities in Russian exports are metals and metal products. But after 1998, when the share of this group peaked at 24.5%, it has been constantly decreasing. In 2002 it accounted for 14.7% of Russian deliveries to countries outside the CIS (15.4% in 2001).

This is basically connected with a more complicated situation at the world metals market. At the beginning of 2002 the USA imposed prohibitive import duties from 8% to 30% on the majority of imported steel products. Freed from these duties are deliveries from Canada and Mexico (they have a free trade agreement with the USA), and from a number of developing countries – the Argentine, Turkey, Thailand. A 30% duty was imposed on all types of rolled iron, a 15% duty – on stainless steel products except for wire (8%). A 13% duty is effective for imports of carbon steel and ferroalloys. Slab imports are regulated by a quota (5.4 mln tons per year), if it's exceeded this import will be subject for a 30% duty. In three years the duties will be gradually lowered to 24% in the second year and 18% in the third year.

To protect its market against a possible inflow of metals that previously were sold at the US market the European Union has also adopted a decision to introduce on April 3 prohibitive duties on 15 types of metal products imported to the EU countries. This basically concerns of high-technology products – alloyed steel. More simple types of ferrous metals, for example cast iron or metal scrap are subject for usual dues. The prohibitive duties vary from 14 to 26.5%.

The situation was further worsened by the fact that after the USA introduced prohibitive duties a number of markets became automatically less accessible as the competition among the biggest steel exporting countries that were ousted from the American and later from a number of European markets toughened. Though Russia managed to come to an agreement with the European Union, the situation at the markets in South-East Asia turned out to be much more complicated.

Higher duties on the majority of steel products imported by the USA that were imposed in March, gave the desirable effect to the American steel lobby. In 2002 the huge American corporation U.S. Steel for the first time since 1999 had profit.

As a result a reverse situation revealed itself in the second half of the year. A number of big American companies that consume Russian steel started lobbying to abolish the prohibitive duties. One has managed this in 100 of 470 cases of traded goods. In addition in the second half of the year one has managed to lift some of the restrictions on export of Russian ferrous metals. This concerns in particular export of Russian rolled metal to the USA. In July the United States have softened some of the restrictions with respect to Russian steel import.

Also in July The Ministry of Economic Development of the Russian Federation and The European Commission signed a new agreement on conditions for deliveries of Russian steel to the EU, previously in the lack of this agreement Russia's steel exports to Europe were impeded. Among other things new limits on rolled steel export from Russia were made effective, the limits were extended by 30%.

To support Russian metal products exporters the 5% duty on export of ferrous metals was abolished on July 1.

In November Russia and the United States signed an amendment to the comprehensive agreement on steel of 1999. According to the amendment Russian manufactures in 2003 can export 1.2 mln steel slabs to the USA (previously the deliveries were restricted to 1 mln tons).



According to the agreement Russia also gets preferences on heavy plates: the fact that also this country has gained the status of a market economy was taken into consideration and previous quotas and price limitations were abolished. According to the new agreement conditions our manufacturer shall report to US authorities quarterly on cost prices of products delivered to the United States. Based upon this information our partners will fix the minimal price level.

The problem of restrictions on exports of Russian steel is thus made less acute. As a result in the last months of 2002 there was registered a considerable growth in exports of Russian ferrous metals in value terms.

By the results of 2002 the exports of metals and metal products in value terms increased by 1.1%. Prices on ferroalloys grew by 4%, on half-finished products of iron and non-alloy steel by 6.8%, on rolled metals by 13.9%.

On the contrary the nonferrous metals exports has a clear downtrend. Copper export decreased by 14%, aluminium export by 11.3%. Copper and aluminium prices were reduced by 6.4% and 11.8% correspondingly.

Exports of timber, paper and pulp grew in value terms by 10.1%, their share in Russia's exports to countries outside the CIS was 4.8% (4.7% in 2001). Quantitative export of round timber grew by 15.7%, of converted timber by 18.9%, of plywood by 11.2%, of cellulose by 2.0%. Export deliveries of newsprint stayed practically the same. Average export prices grew: on round timber by 1.9%, on converted timber by 5.4%, on plywood by 2.7%. Average export prices on newsprint decreased by 21.1%.

*Table 42***Average export prices on basic goods (dollar per tonne)**

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Crude oil	100.6	108.2	133.5	118.6	74.2	100.8	175.0	159.8	155.3
Natural gas, for 1 thousand m <sup>3</sup>	72.8	80.1	84.2	88.6	66.3	53.5	87.5	100.2	90.4
Coal	33	36.2	38.8	35.7	27.3	16.6	26.4	29.5	26.8
Iron ore	19.6	23.1	26.7	23.9	21.5	15.1	15.8	13.8	15.1
Nitrogen fertilizers	80.9	119.8	128	90.3	60.5	38.3	58.3	63.8	60.7
Potash fertilizers	69.7	71.9	77.2	79.8	87.4	86.4	87.0	77.9	74.7
Round timber, for 1 m <sup>3</sup>	53	58	59.4	57.5	50.5	43.4	43.5	45.1	45.9
Newsprint	291.5	591.8	473.7	383.4	398.9	358.3	397.4	445.1	350.7
Cast iron	112.8	130.4	136.8	124.3	108.5	68.3	85.4	90.0	90.8
Ferroalloys	832.7	1090	1114	818.9	733.8	560.3	631.0	619.0	643.8
Copper	2042	2550	2143	2102	1655.0	1429.7	1658.3	1519.0	1421.8
Nickel	5973	8057	7272	6733	5148.4	5236	8949.4	6091.2	6099.9
Aluminium	1029	1519	1500	1402	1349.4	1145	1343.2	1200.3	1058.7

Source: The State Statistics Committee of the Russian Federation.

Exports of machines and equipment in value terms decreased by 3.7% and their share in Russia's total exports to countries outside the CIS was 7.9% against 8.7% in 2001.

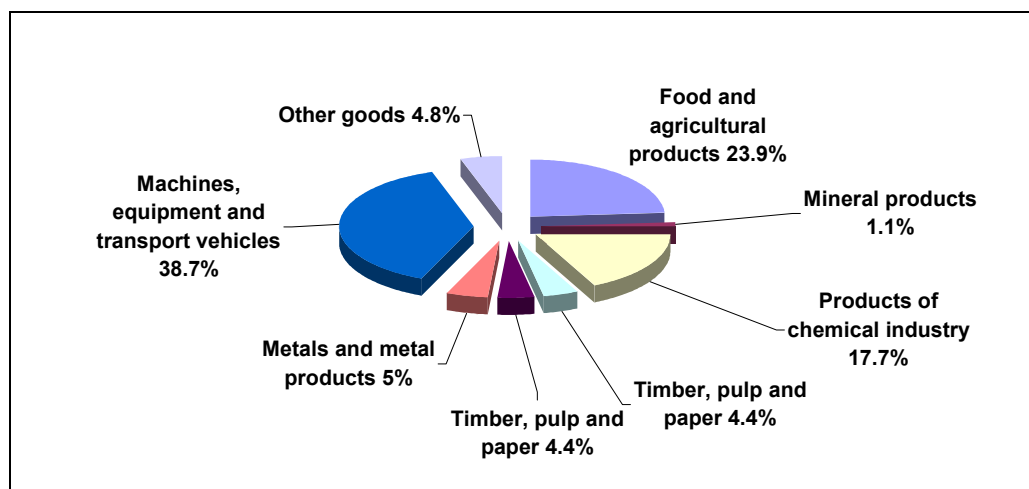
Starting from the second half of 2001 Russia's economy reveals the tendency of substitution of domestic manufacturing by imports that becomes more and more clear. This process is a reverse reaction to the active substitution of imports that happened in 1999-2000 because of devaluation of the rouble and the drop in real incomes of the population. Ousting of domes-

tic manufacturers in those two years was aggravated by the lack of investments for upgrade of production. The quality of the majority of goods remained practically unchanged, while price ratios clearly changed for the better in favour of foreign goods.

A distinctive feature of Russian imports in 2002 was a stable growth of imports from countries outside the CIS and a decrease I imports from CIS-countries.

The real exchange rate growth in 2002 added to the competitiveness of foreign manufacturers. Moreover, the level of the GDP increased by 4.3% as compared to the level of 2001. A growth of economic activity promoted a greater aggregated domestic demand both on the part of households (for consumer goods) and from enterprises (for investments and intermediary goods). A stronger national currency and a growth of incomes in the economy secured a considerable growth of imports.

The most often imported goods from countries outside the CIS in 2002 were machines and equipment. Their share in the total imports accounted for 38.7% (37.2% in 2001). As compared to the previous year purchases of machines and equipment in value terms increased by 21.4%.



Source: The State Customs Committee of the Russian Federation.

Fig. 83. Russia's goods imports pattern in 2002.

Imports of foodstuffs and agricultural products last year increased compared to 2001 by 18.2%. Quantitative imports of fresh-frozen meat grew by 32.1%, of fresh-frozen fish by 8.0%, of butter by 62.1%, of oranges, lemons, etc by 26.6%, of coffee by 17.7%, of tea by 5.5%, of sugar by 11.1%, of sunflower-seed oil by 5.3%, of canned meat by 8.6%, of chocolate by 6.8%, of cocoa beans by 10.8%. Imports of dried and condensed milk decreased 3.2-fold and of raw sugar by 18.0%. The share of foodstuffs and raw materials for their production in the total imports from countries outside the CIS was 23.9% and remained practically unchanged compared to 2001.

In September 2002 Russia introduced a new import certificate for chicken from the USA. Pursuant to this document there were imposed higher requirements to chicken quality imported from the United States.

As a result the import of chicken legs from the USA in 2002 got considerably diminished. In nine months of 2002 Russian imported from the USA 509.2 thousand tonnes of chicken against 682.2 thousand tonnes in the corresponding period of the previous year (a



25% decrease). The value of chicken delivered to Russia was 268 mln dollars against 378.7 mln dollars in eight months of the previous year (a decrease by 29%).

But due to deliveries from other markets the import of chicken on the whole exceeded that of 2001 in value terms by 10.5% and quantitatively by 1.4%.

Purchases of chemical products increased in 2002 by 4.8%, at the same time their share in the total imports from countries outside the CIS decreased to 17.7% from 19.8% in 2001.

In geographic breakdown of Russia's foreign trade countries of the European Union had a share of 36.6% in Russia's turnover (36.7% in 2001), CIS-countries' share was 17% (18.2%), countries of Asia Pacific Economic Cooperation had a share of 16.4% (16.1%), and the share of countries of Central and Eastern Europe had a share of 12.9% (13.8%). Russia's principal trade partners in 2002 among countries outside the CIS were Germany, whose turnover equalled to 14.6 bln dollars (97.1% compared to 2001), Italy with 9.6 bln dollars (105.7%), the USA – 6.9 bln dollars (92.8%), China – 9.2 bln dollars (126.8%), the Netherlands – 8.3 bln dollars (149.2%), Great Britain – 4.9 bln dollars (93.1%), Poland – 5 bln dollars (97%), Finland – 4.4 bln dollars (100.5%), Turkey – 4.1 bln dollars (108.1%), France – 4.5 bln dollars (119.6%), Japan – 2.8 bln dollars (84.1%).

In 2002 the EU and the USA acknowledged Russia's economy as a market one. Previously, when the Russian economy did not possess the market status, our exporters could easily be blamed for using government subsidies at home and delivering their products to other countries' markets at prices below the cost price, thus getting advantages in the competition at world markets. That is why in the USA and in Europe there were started anti-dumping investigations on a great number of Russian exported goods. In the course of these investigations prices on Russian products were compared to the so-called normal prices on analogous products produced in any other country close to Russia in its development. The disclosed differences expressed in per cent were called the dumping margin. Depending on its dimension the "defending" state in addition to the usual customs duties imposed extra anti-dumping duties on Russian products. For example, as a result of an anti-dumping investigation about Russian cold-rolled metal started by the US Department of Commerce in October last year, it was suggested to impose a 137% duty.

Having acquired the status of a country with a market economy Russia will be saved from unjustified losses in cases of anti-dumping procedures. In the course of anti-dumping investigations about Russian manufacturers prices on their products will be calculated on the basis of the manufacturers' real costs and not by using prices of the so-called "ersatz-countries", arbitrarily chosen countries with market economies as the case was before.

From the practical viewpoint the market status will allow domestic manufacturers to appeal about reconsideration of the current anti-dumping measures at the EU territory. There are 14 of those, losses due to them account for 230-240 mln dollars per year. At present countries of Europe impede imports of Russian metal products, mineral fertilizers, fibreboards and some other types of products. Moreover, in the past year the EU started anti-dumping investigations about four more types of imported goods (technical carbon, metallic silicon, hollow sections and transformer steel), which can cost Russia at least 50 mln dollars per year.

Last September Russia and the USA signed a special agreement, according to which Russian metal manufacturers have taken upon themselves the responsibility of informing the American part about the constituents of the cost price of Russian rolled metals. On the basis of this the US Department of Commerce shall fix minimal prices for Russian products. In the beginning of November the US Foreign Trade Commission stopped the anti-dumping investi-

gations aimed against deliveries of cold-rolled metals from Russia, and the US Department of Commerce lost its right to dictate minimal prices to Russian manufacturers. Thus, the American rolled metals market with its prices that are one and a half times higher than in other countries became more accessible for Russian metal manufacturers.

A further improvement of the situation for Russian exporters can be expected after Russia joins the WTO. The negotiations process is rather complicated, though members of the working group say that the joining procedure has entered into its final stage. That is why active work on this issue went on also in 2002.

The draft worked out by the WTO Secretariat accumulates the results of the negotiations that started in 1995 and studies Russia's trade regime and its compatibility with the norms in WTO. In these years the Russian delegation has submitted to the WTO Secretariat about 200 analytical documents and more than 1000 legislative and normative documents.

The report was discussed by its sections at the 15<sup>th</sup> sitting of the working group on June 19-20 last year. To this meeting members of the working group and Russia have prepared their draft versions of certain provisions. Concurrently with the meeting of the working work there were held multilateral consultations on issues of the stock market, technical barriers in trade, sanitary and phytosanitary measures and agriculture. There was also held a series of bilateral negotiations on accessibility of the goods and services markets and on system issues.

By the results of the 15<sup>th</sup> meeting of the working group there was taken a decision that the WTO Secretariat will work out a second version of the draft report and a series of multilateral consultations will be arranged.

At present the Russian delegation negotiates in four basic lines:

1. *Negotiations on accessibility of the goods market.* Their issue is to determine the maximal level of import duties, which Russia will be entitled to use after it joins the WTO. The negotiations basis is the third version of Russia's suggestions on accessibility of the goods market adopted by the government of the Russian Federation in January 2001. In the period June 12-22, 2002 there were conducted negotiations with 21 countries. Until now the Russian delegation has coordinated about 75% of tariffs.
2. *Negotiations about agricultural issues.* In addition to tariffs they include also discussions about dimensions of government support to the agricultural sector and dimensions of export subsidies.

On September 26 there were held multilateral consultations on agriculture participated by the USA, the EU, countries in the Cairns group (the leading agricultural exporters), a number of countries of Central and Eastern Europe, Asia and Latin America (in all about 30 countries). Negotiations in this line are quite complicated in their essence, as far as the parties' positions about the level of government support to agriculture and dimensions of export subsidies allowed to Russia as a member of the WTO are extremely different.

The government of the Russian Federation at its meeting on March 14, 2002 approved a new approach to negotiations on agricultural issues. At the same time to continue with the negotiations members of the WTO expect of Russia that it will submit renewed versions of documents on measures that deal with support and subsidies that can be used as a basis to assess whether the Russian position is justifiable.

*Negotiations on accessibility of the market of services.* Their aim is to agree upon conditions of foreign service providers' access to the Russian market. In march 2002 the government of the Russian Federation approved as a basis for negotiations a third version of suggestions on access to the market of services (in the variant approved at the meeting of the





tions on access to the market of services (in the variant approved at the meeting of the Government Commission of the Russian Federation on WTO-related issues on March 12, 2002).

The bilateral negotiations revealed differences in the countries' interpretations of WTO rules about horizontal regulation of service trading. In connection with this on March 19, 2002 there were held multilateral consultations on special aspects of this regulation in Russia (natural monopolies, subsidies, closed administrative-territorial entities, border territories, cultural heritage, anti-monopoly regulations, public services, etc). All key partners have submitted their official requirements, which allowed focussing the negotiation process upon the sensitive sectors, which are of the greatest commercial interest to WTO member states. The latest round of the negotiations that took place in June 2002 showed that to continue a constructive dialogue with WTO members (the USA, the EU, Japan, Canada, Norway, Switzerland, Australia) one needs to adjust Russian suggestions on the key sectors (financial, telecommunications, transport services).

In September there were held negotiations with the Norwegian delegation, and in October – with US experts in Washington.

1. *Negotiations on system issues.* Their aim is to identify the measures that Russia will have to take in the sphere of legislation and its application to fulfil its obligations as a member of the WTO. On the whole the requirements of WTO member states in this sphere can be divided into three parts:

1.1. Non-compatibility of Russian legislation and application practice with WTO norms.

The major concern of WTO members is a number of provisions in the current legislation in the sphere of the customs, excessive requirements to imported goods in the sphere of sanitary and phytosanitary measures, etc. Participants in the negotiations demand that WTO's provisions in this sphere shall be fulfilled unconditionally. This is a standard requirement to all joining countries.

1.2. Using by Russia of certain regulation elements, which are in principle allowed by the WTO can be caused by requirements and obligations, which will be specified in the report of the working group. These are "negotiations requirements".

1.3. Requirements that are clearly outside the framework of WTO obligations ("WTO+" requirements), such as joining the non-obligatory agreements on government purchases and civil aviation equipment, unification of domestic and foreign prices on oil and gas, cancellation of export duties.

In the beginning of October the system issues and the lawmaking process were discussed with the US delegation in Washington. In the middle of October there were held full-scale negotiations in all lines with the European Commission and US delegations in Moscow.

The result of all the negotiations was that one failed to reach a compromise in a number of issues so far, including telecommunications, financial services (insurance, banking, services at the stock market), oil and gas prices, measures to support agriculture.

The Russian part refuses to raise tariffs of RFO "EES Rosii" to the European level and open Russian markets of banking, insurance and telecommunication services. Russia intends to introduce a transition period, that is it will be ready to open its market of financial services and telecommunications 10 years after it joins the WTO. It is quite evident, that dramatically raised tariffs on electricity shall have and utterly negative outcome for the Russian economy. Besides, clearly less dangerous suggestions to open the Russian financial market raise strong objections on the part of Russian bankers and insurers.

EU representatives consider Russia's suggestions unacceptable, especially Russia's intention to restrict the proprietary rights of foreign companies to 49% in telecommunications and to approximately 25% in the brokerage services and insurance sector. Introduction of restrictions is also inspected in the sector of banking services.

Russia's legislative doctrine envisages the precedence of provisions of international contracts in front of home laws, because of this Russia's joining the WTO is connected with considerable lawmaking and rules adjustment activities. Russian will have to pass (adjust) about 100 laws and about 1 thousand departmental regulations. In this way Russia will get at its disposal a full-scale and systematised bulk of modern business legislations, comparable with the international law system, which in modern conditions is one of the crucial advantages of Russia's joining the WTO.

Due to this in 2002 high emphasis was placed on the legislative basis in the sphere of domestic market protection to make it up-to-date, in the focus were tariff regulation measures to ensure the best conditions for the access of Russian goods to world markets, to international resources that are of strategic importance for the country's economic development (goods that are not produced or their production is limited in the Russian Federation), there were made investigations on a considerable damage to Russian manufacturers done by imports of certain goods and introduction of special duties, the issue of planning imports of products that are felt to be in shortage at the domestic market was attended to.

In 2002 The Government commission on protective measures in foreign policies announced about the commencement of a whole series of anti-dumping investigations about foreign foodstuffs. In focus were chicken, starch syrup, butter, confectionery produced of sugar containing cocoa,

The initiator of anti-dumping investigation about imports of chicken legs was the Russian poultry union. According to its data imports of chicken grew 6-fold in the past 3 years. The share of imported goods at the market increased from 24% in 1999 to 61% in 2001. Chicken import growth rates in per cent to previous years were 291.3% in 2000 and 202.4% in 2001. In January – April 2002 the import grew by 21.3% as compared to the same period of 2001. At present the government of the Russian Federation is working out a draft on rates of the special duty on imported chicken and the date for its enactment. It is planned to make it 8.3% of the customs value, though not less than 0.07 Euro per 1 kilogram. This special duty is planned in addition to the existing one (25%) to make competition conditions at the market even.

The investigation about butter was started upon a request from the administration of Krasnodar krai. It is planned to increase customs import duties on butter and margarine from 15% to 20%.

The investigation about starch syrup was renewed. It was supposed to be over by September 1, 2002. By its results customs import duty on starch syrup can be raised, it is 16% of value now, though not less than 0.07 Euro per 1 kilogram.

As for confectionary of sugar containing cocoa is concerned, this investigation is also a renewed one. In focus here are caramels from the Ukraine. There was done an investigation on caramels in 2000 and a special duty was enacted then. But the Ukrainian part managed to find a way to overcome this barrier. Classical caramel practically does not contain cocoa and is included by the Foreign Trade Nomenclature of Goods into group 17. Ukrainian manufacturers increased cocoa content in their caramels, thus making it fall under group 18, which is



not subject for any special duty. Thus the anti-dumping investigation is started concerning another type of goods.

There was started an anti-dumping investigation about imports of wallpaper. Domestic manufacturers of wallpaper have gained a much stronger position at the home market after devaluation of the rouble in 1998, when increased prices on foreign products made them non-competitive. Nevertheless, foreign manufacturers, especially German ones, are gradually increasing their share at the Russian market. It is connected with the fact that in other countries people prefer other finishing materials to wallpaper. Because of this the Russian market becomes still more important for foreign wallpaper manufacturers. Besides, the Russian market is also attractive for manufacturers in CIS-countries, in particular the Ukraine and Byelorussia, their products are quite competitive in price compared to domestic ones.

In 2001 as compared to 2000 wallpaper imports to the customs territory of the Russian Federation increased 2.8-fold, and compared to 1999 more than 4-fold. The share of imported goods in the total of wallpaper sold at the Russian market grew from 32.7% in 1999 to 64.3% in 2001, while the wallpaper imports growth rate in the above period was 435.6%.

The annual wallpaper imports growth rates were accompanied by a greater consumption of this product in the Russian Federation. In the period from 1999 until 2001 wallpaper sales at the domestic market grew by 121.5%, at the same time in spite of a greater wallpaper production in Russia the share of Russian manufacturers in the total sales of this product decreased from 67.3% in 1999 to 35.7% in 2001, which testifies to the effect that Russian manufacturers are being ousted from their home market.

To protect Russian manufacturers the government of the Russian Federation imposed a special customs duty on butter imported to the customs territory of the Russian Federation, the 5% duty is calculated from the basic import customs duty, but shall be not less than 0.07 Euro per 1 kilogram. The duty was effective until December 31, 2002. This duty was not applicable to butter of manufacturers in Byelorussia. At the same time the special duty is applied to the butter when it is imported to the territory of Russia from the territory of Byelorussia in cases when it is produced for free sale in Byelorussia with no special duty paid or when the sums of this special duty paid are not transferred to the federal budget in the prescribed order. The principal suppliers of butter to Russia are the Ukraine (37% of the imports), Byelorussia (20%), New Zealand (14.6%) and Finland (11.1%).

The special import duty on starch syrup was extended for 2.5 years (the duty effective previously was 16%, but not less than 0.07 Euro per kilogram). From now on the duty will be 15.57%, but not less than 0.069 Euro per kilogram. It was simultaneously decided that the duty will be decreased by 0.25% each half year, and will be 14.5% starting on January 1, 2005.

The seasonal import duty on raw sugar in Russia was raised on October 1, 2002. The decision to increase the duty from 0.15 Euro to 0.2 Euro per 1 kilogram was taken by the Russian government in August last year. That duty was effective until December 31, 2002.

The government of the Russian Federation decided to abolish since June 20, 2002 the 15% import special duties on frozen Hungarian vegetables, juices, soups and bouillons, as well as on rapeseed, cabbage and mustard oils. The government took that decision "in connection with the fact that the Hungarian Republic abolished the measures that impaired economic interests of the Russian Federation and Russian enterprises". The special duties on Hungarian goods were made effective in July 2001 in response to the measures taken by Hungary to restrict imports of Russian goods to that country. In particular the Hungarian gov-

ernment made effective additional duties on Russian nitrogen fertilizers and initiated the procedure of making effective quotas on deliveries of concrete, rolled iron and fibreboards from Russia.

On October 4, 2002 there were made effective new dramatically increased import duties on foreign vehicles manufactured more than 7 years ago. According to Government decision #643 of August 30, when natural persons import such vehicles that have engine volumes that do not exceed 2500 cm<sup>3</sup>, the single rate of customs duties and taxes shall be equal to 2 Euro per 1 cm<sup>3</sup> of the engine. The previous duty was 1.4 Euro 1 cm<sup>3</sup>. For vehicles that have engine volumes exceeding 2500 cm<sup>3</sup> the new duty rate shall be 3 Euro per 1 cm<sup>3</sup> (1.4 Euro previously).

For vehicles manufactured more than 3 years ago, but less than 7 years ago, the duties will remain the same – 0.85 Euro per 1 cm<sup>3</sup> for vehicles having engine volume not exceeding 2.5 litres and 1.4 Euro for vehicles with engine volume exceeding 2.5 litres.

The new customs duties determine approximately same prices both for vehicles manufactured between 3 and 7 years ago and for very old cars. This is expected to change the popular preferences in favour of more recent vehicles.

There are also enacted higher customs duties for passenger cars older than 7 years imported by juridical persons (Russian Federation Government decision # 642 of August 30). But juridical persons import old foreign cars in much smaller quantities than natural persons.

In 2001 juridical persons imported to Russia 29 thousand second-hand cars (that were manufactured 3 years before the moment of customs clearance or older) against 23.5 thousand cars in 2000. Natural persons in 2001 imported to Russian 352.5 thousand second-hand cars against 131.9 thousand 2000.

Pursuant to the oil prices monitoring performed in 2002 export customs duties on crude oil and oil products, made of bituminous rock were changed several times. On February 1 the duty was reduced from 21.1 dollars per tonne to 8 dollars, on April 1 it was increased to 9.2 dollars, on June 1 – to 20.7 dollars, on August 1 – to 21.9 dollars, on October 26.2 – to 26.2, and on December 1 – to 29.8 dollars per tonne.

But as far as import duties on other goods and commodities is concerned the government sticks to the proclaimed principle of decreasing customs duties and simplifying the customs regime.

Export duties on ferrous metals were abolished since July 1 in connection with worsened situation in the world and anti-dumping investigations in a number of countries. The customs duty of 5% on ferrous metals exported from the Russian Federation was made effective in May 1999. Since April 2002 export customs duties on certain types of ferrous metals were decreased from 5 to 3%. Annual budget losses caused by the abolishing of the duty are assessed as 120 mln dollars. But this measure will help Russian metal manufacturers to maintain the level of export sales keeping the price advantages in competition. Foreign currency revenues coming from sales of metal by the results of 2001 amounted to 15% of the total Russian exports.

The government commission on protective measures in foreign trade and customs and tariffs policies recommended also to abolish export duties on writing paper, cellulose, germanium and goods produced of it and import duties on glycerine and television tubes.

In September 2002 The government commission on protective measures in foreign trade and customs and tariffs policies took the decision to abolish export customs duties on 432 types of goods that have minimal exports from the Russian Federation. Customs revenues col-



lected on these goods slightly exceed 5 mln dollars. At the same time these goods are about 50% of the total list of goods liable to customs duties.

Still another important decision by the government in 2002 was the cancellation of export customs duty on silver. This measure will in all probability lead to a greater export and a growth of the number of participants at the market. This very result was achieved when the duty on export of gold was cancelled. According to the Gold-mines Union in 2001 there were extracted 646 tonnes of silver in Russia. Of this exported were 462 tonnes, but duties were paid only on 61 tonnes. The rest of the silver was exported through countries of the Customs Union – Byelorussia and Kazakhstan. Thus about 90% of silver from Russia is exported with no duties paid. The volume of explored reserves in Russia is now greater than in all other countries taken together. The share of explored reserves of the biggest producers of this metal – the USA, Canada, Mexico and Australia – at the world market is 40%. Russia possesses the biggest share.

On October 1 the Government resolution “On introduction of changes into the regulations on transfer of goods through the customs border by natural persons” entered into force. This is another try by the government to minimize the “grey” exports. According to the assessment of the Ministry of economic development of the Russian Federation the “grey” imports of footwear and other products of light industry accounted for 10.8 bln dollars in 2000 and 12.4 bln dollars in 2001.

The petty traders called “shuttles” are allowed to bring in goods that weigh less than 50 kg. and cost less than 1000 dollars. This is only permitted when the owner of the goods is present in person at the customs station. Everything exceeding the above norms will be liable to customs duties and the VAT according to usual rates. Temporal preferences will be effective until January 2003 for lots of goods that weigh between 50 and 100 kgs. and cost between 100 and 5000 dollars. Lots that fall under this category will be freed from the VAT.

The regulations effective before were established for petty traders, but in practice they were used by juridical persons, so-called cargo-companies that built up their trade as a tax-free import of goods acting as if they were private persons. The pattern of these cargo-companies’ transactions for tax-free imports was simple. Carriers of cargos divided them into small lots and issued powers of attorney for each lot from private persons and imported the goods using legal preferences. Cargoes between 50 and 200 kgs that cost less than 10 thousand dollars were liable to a 30% tax with no VAT paid. Those that split the cargo into tiny lots (weighing less than 50 kgs.) imported their goods with no duties paid.

The work on the Customs Code of the Russian Federation is going on. The new Customs Code shall be integrated into the world legal and economic systems, because customs procedures will be unified. Consequently one of the major tasks is to bring the Customs Code in conformity with the “Kyoto Convention” (Brussels protocol of 1999), this would bring all of the customs procedures to harmony and conformity.

The first draft of the new Customs Code was ready in 1998. But as far as the then version of the law gave rise to criticism on the part of businessmen, there was made an agreement to form a joint working group that would polish up the document. As a result more than 400 amendments were made to a new draft of the Code.

The major task of the proposed amendments was to deprive the government and federal departments of a large number of powers. A great number of customs rules and procedures, which previously were established by executive authorities, will be written down in the law. The list of documents needed to perform customs clearance was previously prescribed by the

Customs Committee; it is now the Code that will contain the full list of all the required documents.

The new version of the law abolished licensing of certain types of foreign economic activities. In particular, no licenses will be needed for customs brokers, customs carriers, warehouses and tax-free shops, as far as according to the opinion of the lawmakers shops and warehouses are anyway always under customs control.

Temporal customs warehousing regime will also be liberalised. At present the place to put cargos waiting for customs clearance is defined by the State Customs Committee. In future – if the new version of the Code gets passed – entrepreneurs can choose warehouses at their own discretion. The integrity of the goods will be ensured due to a system of financial amenability of entrepreneurs – for example with the help of money deposits.

The government is yet undecided which of the provisions of the Federal law “On customs tariffs” will be adopted by the Tax Code, which by the Customs Code, and which of them will be left in the law proper. It is not yet decided, whether the Law “On customs tariffs” will be kept, and if not, whether the part on tariffs will be absorbed by the Customs Code. It is expedient to unite these two laws, which will be in a complete conformity with the Customs Code of the European Union. One can leave the Law “On customs tariffs” completely unchanged. But dispersing the provisions of the Law “On customs tariffs” in several other laws is in all probability unadvisable.

In our opinion basic shortcomings of the Customs Code draft version submitted by the government are as follows.

The government version keeps the number of references to the normative documents of the State Customs Committee practically unchanged. It would be expedient to cut their number, though in certain cases attempts to introduce direct norms (complete documents lists, lists of information required for customs clearance, etc.) shall be given a more detailed analysis.

Requirements to the law on the customs shall be formulated from the viewpoint of participants of foreign trade, rather than from that of customs officers, in particular in cases of restrictions or creation of impediments to personal activities not prohibited by the law provisions of the customs law shall be proclaimed null and void.

The Customs Code shall agree with the principle declared by the government of a weaker “incoming” control and a quicker clearance of goods and of a tougher control after the clearance. In the government version the preliminary procedure demands practically the same documents as during the clearance itself. A testimony of this are wordings like “the concrete list of information is defined by the State Customs Committee”, “should the information required by the customs authorities lack in the documents there arises a need of providing additional documents”, etc.

The government version envisages a development of “customs related” business, licensed by a customs authority. This refers to such types of activities as “customs cargo carrier”, “customs broker”, “temporary warehousing”, and «customs warehouse”. At the same time it is expected that a new Customs Code will eliminate the institutions of customs cargo carriers and brokers. Instead of them there should be built an institution of empowered representatives of goods owners, which will function in compliance with the civil law without any licensing or any other interference of customs authorities. As for “temporary warehousing” is concerned, ideally these warehouses shall be established by the customs and placed on premises that belong to the customs or let by them. Should this provision get passed it would entail budget financing of the customs to establish such warehouses.



The Customs Code shall put the customs authorities into strict conditions requiring them to clear goods within 24 hours from the moment they accept customs declaration for clearance. The after-clearance control shall be placed on customs authorities. To perform the control the customs house in question shall send a copy of the customs declaration to the tax authority that has jurisdiction over the place of goods owners' registration.

Adoption of the new Customs Code is one of the basic priorities in the sphere of foreign trade legislation for 2003.

New Customs Code is only the first stage of the customs reform according to the plan worked out by the budget committee of the State Duma. There is planned a reform of customs tariffs in 2004. Import duties shall become more differentiated; export duties shall be completely abolished. Later the Customs Service shall undergo a reform together with customs administration.

### 3.7.2. Russia's foreign trade with CIS-countries.

Russia's turnover with CIS-countries in 2002 accounted for 28.57 bln dollars, including exports – 16.25 bln dollars (a 6.9% growth); imports – 12.32 bln dollars (a decrease by 5.5%). Compared to 2001 the turnover decreased by 4.3%.

The balance of trade with these countries was positive and amounted to 3.93 bln dollars (2.16 bln dollars in 2001). The share of CIS-countries in the country's total trade turnover was 17.1% (18.3% in 2001); the share of these countries in the total exports was 15.20% and 20.36% in the total imports.

*Table 43*

**Changes in Russia's trade with the CIS in 2001.**

	2000	2001	2002
Turnover (bln dollars)	27.68	28.24	28.57
Exports (bln dollars)	14.25	15.20	16.25
Imports (bln dollars)	13.43	13.04	12.32
Balance	0.82	2.16	3.93
Growth rates (%)	23.68	2.02	1.16
Share of CIS in the total turnover (%)	18.47	18.17	17.1

*Source:* The Central Bank of the Russian Federation.

Russia's major trade partners in 2002 among bordering countries were as before Byelorussia and the Ukraine, their share exceeds 11% of Russia's total foreign trade turnover.

Among CIS-countries trade with Byelorussia accounts for about 40%. In 2002 only these two countries' mutual exports and imports, in contrast with tendencies of Russia's bilateral trade with the majority of countries in the CIS, exceeded the level of 2001 by 6%.

In 2002 Russia's foreign trade turnover with CIS-countries was distributed by its major partners as follows: Byelorussia's share was 38.4%, the Ukraine had a share of 35.1% and Kazakhstan of 16.8%.

*Table 44*

**Shares of CIS-countries in Russia's trade turnover**

Country	Share (%)
Byelorussia	38.4
The Ukraine	35.11
Kazakhstan	16.8

Uzbekistan	3.1
Azerbaijan	1.4
Moldova	2.1
Kyrgyzstan	0.7
Turkmenia	0.7
Armenia	0.6
Georgia	0.6
Tajikistan	0.5

The Ukraine's share in Russia's total trade with CIS-countries decreased compared to 2001 by 1% because of restrictive measures in the Ukraine's exports. The share of Kazakhstan got also slightly diminished in the past year.

Most decisively increased (nearly two-fold) trade turnovers with Azerbaijan, Kirgizia, Georgia and Armenia, the increments were from 10 to 20%. As for other countries, there was a decrease in turnovers; most sizeable ones are in the trades with Tajikistan (by 30%) and Turkmenistan (by more than 20%).

*Table 45*

**Volumes of trade with CIS-countries in January – September 2002 (bln dollars)**

Country	Turnover	Exports	Imports	In % to January – September 2001		
				Turnover	Exports	Imports
Byelorussia	7.04	4.12	2.91	103.2	106.2	99.2
Kazakhstan	3.12	1.71	1.41	85.5	81.6	90.6
The Ukraine	6.33	4.07	2.26	92.1	104.4	76.1
Azerbaijan	0.24	0.18	0.05	162.8	211.4	92.0
Uzbekistan	0.58	0.32	0.26	74.3	109.5	52.9
Tajikistan	0.09	0.05	0.04	53.9	95.4	35.4
Turkmenia	0.12	0.10	0.02	86.1	95.5	55.8

### Exports

Fuel and energy commodities occupied the decisive place in the exports to CIS-countries in 2002. Their exports in quantities compared to 2001 grew by more than 12% (not counting mutual trade with Byelorussia).

Though the goods pattern of the exports to CIS-countries did not change considerably in 2002, it got somewhat degraded – the share of fuel and energy commodities in the total exports to CIS-countries increased by 4% compared to 2001 and exceeded 42%.

Exports of the basic energy commodities grew in 2002 (data for January – November 2002): deliveries of crude oil grew in quantity by 38.7%, of natural gas by 6.5%, oil products by 0.7%. Thus the tendency of 2001, when oil deliveries grew and natural gas deliveries decreased, changed in 2002.

When quantities of exports of oil products and natural gas to neighbouring countries grew, average export prices on these types of products decreased: export prices on oil diminished by approximately 30%.

The share of Commonwealth countries in the total exports of fuel and energy products (in quantities) continued to decrease, resulting from a low effective demand in the region and still remaining considerable debts for delivered gas.

The present negative tendencies in the pattern of Russia's exports are confirmed by the data on exports of machines and equipment. Their deliveries to CIS-countries decreased by





5.1%, their share in the total exports to these countries got reduced to 20% against 25% in the same period of 2001.

Exports of paper and pulp industry products grew considerably in 2002 – by 42.6%; of wheat – by 62.5%.

One of the factors that promoted exports of paper and pulp industry products to neighbouring countries was a low domestic demand at the Russian market for these goods, moreover Russian manufacturers win in the competition with supplies from the West due to low costs of raw materials, manpower and transport.

Export deliveries of coal decreased by nearly a third, of diesel oil by a fourth, of ores and iron products by more than 16%.

*Table 46*

**Exports of some types of goods to CIS member-states**

	<b>January – November 2002</b>	<b>In % to January – November 2001</b>
Crude oil, mln tonnes	29.7	138.7
Oil products, thousand tonnes	2339.6	100.7
of these:		
car petrol	437.5	104.7
diesel oil	714.2	74.1
fuel oil	288.0	146.7
Natural gas, bln m <sup>3</sup>	46.5	106.5
Coal, thousand tonnes	3660.9	70.3
Machines and equipment, mln dollars	2541.6	94.9
Iron ore and concentrates, thousand tonnes	4614.7	83.9
Ferrous metals, mln tonnes	534.6	102.7
Synthetic rubber, thousand tonnes	65.4	111.2
Wood cellulose, thousand tonnes	94.9	142.6
Cotton fabrics, mln m <sup>2</sup>	199.9	119.3
Wheat and meslin, thousand tonnes	972.9	2.5-fold

*Source:* The State Statistics Committee of the Russian Federation.

### Imports

The prevailing part of imports from CIS-countries were deliveries of engineering products and foodstuffs, their share was approximately 20% of the total imports from CIS-countries (mutual trade with Byelorussia is not taken into account). The shares of chemical products, metals, metal products and fuel and energy commodities were 10% each of total imports; the share of textile fabrics was 5%.

There was an increase of imports quantities of such goods as fresh-frozen meat by 15.7% and sugar (2.6-fold) as compared to January – November 2001.

Besides, purchases of spirits and non-alcoholic beverages grew by 5.8% and of textile and knitted clothes by 59.2%.

At the same time from these countries there was purchased 4 times less dried and condensed milk, 15.9% less sunflower-seed oil, 47% less butter and 70% less wheat.

The imports pattern besides less imports of many types foodstuffs also showed cuts in deliveries of ferrous metallurgy products: of ferrous metals by 31.3% and of steel pipes by 45.3%.

The drastic cuts in Russia's imports are connected in particular with reduced imports of foodstuffs and a new orientation at Russian products in this sphere. Goods from CIS-countries more often than not were less competitive. For example prices on products delivered from CIS-countries were much higher than that of countries outside the CIS: on fresh-frozen meat – 1.5 times, poultry – 2.2 times, dairy products – 1.6 times, butter – 1.2 times, sunflower-seed oil – 1.5 times, coffee – 1.5 times, tinned meat – 1.2 times, white sugar - by 13.7%, leather footwear – 1.6 times.

The upsurge of poultry deliveries from CIS-countries was basically connected with the sanitary control problems with deliveries of these products from the USA, but they were reduced considerably because of the unsatisfactory quality according to the Russian part. But in absolute terms deliveries of poultry from Western countries remain incomparably bigger than the imports from CIS-countries: imports of this type of products from CIS-countries account for less than 1%.

*Table 47*

**Imports of some products from CIS member-countries.**

	January – November 2002	in % to January – November 2001
Machines, equipment and transport vehicles mln dollars	2492.2	96.91
Personal cars, pcs.	10589	115.1
Ferrous metals (without cast iron, ferroalloys and scrap) mln dollars	355.0	62.8
Steel pipes, thousand tonnes	329.6	53.7
Coal, mln tonnes	18.7	71.8
Spirits and non-alcoholic beverages mln dollars	297.2	105.8
Meat, fresh and frozen (without poultry) thousand tonnes	154.6	115.7
White sugar, thousand tonnes	281.2	2.6-fold
Condensed milk and cream, thousand tonnes	51.6	74.3
Fish, fresh and frozen, thousand tonnes	28.2	92.2
Wheat and meslin	242.4	30.3
Sunflower-seed oil, thousand tonnes	89.4	84.1
Butter and butterfat, thousand tonnes	40.5	53.0
Balsam wool, non-spread, thousand tonnes	273.9	92.0
Cotton fabrics, thousand m <sup>2</sup>	32613.3	57.6

*Source:* The State Statistics Committee of the Russian Federation.

Russia's imports in 2002 compared to 2001 increased from such countries as Azerbaijan, Armenia, Byelorussia, Kirgizia.

On the contrary deliveries from the countries of Central Asia – Tajikistan, Turkmenia and Uzbekistan – decreased. Deliveries of goods from Tajikistan more than halved, deliveries from Uzbekistan decreased by more than 40% and from Turkmenistan by 20%.

Russia cut its imports of unprocessed aluminium from Tajikistan, and because of an unprofitable economic situation, a landslide of cotton price in the world and development of its own processing industry reduced its purchases of cotton from Uzbekistan.

#### Trade relations with some of the member-countries in the CIS

##### Trade with the Ukraine

In the sphere of foreign trade both countries continued to pursue rather tough protective policies: in 2001 – the beginning of 2002 the Ukraine and Russia took different measures



against each other to restrict the accessibility of their home markets for industrial goods. In particular, Russia restricted its imports of pipes, caramels, galvanized rolled metals and rods from the Ukraine. The Ukraine on its side restricted imports of raw materials for iron ore industry, concrete, electric lamps, syringes.

For example the current regulation on import of Ukrainian pipes was prolonged for the whole of the year 2002. Pursuant to the bilateral agreement on regulation of imports of ferrous metal pipes of April 10, 2001 the Ukrainian Ministry fixed quotas for export of pipes of ferrous metals to Russia, which are subject to licensing. Because of this total pipes exports in 2001 was considerably reduced and amounted only to 413 tonnes of pipes, while in 2000 the exports to Russia were 789 thousand tonnes, or 17% of the total Russian market of this type of products.

In July the government of the Russian Federation signed the decision “On measures to protect Russian manufactures of bars for reinforced concrete constructions”, which was adopted by the results of an investigation by the Commission on protective measures about damages to Russian manufactures. By this Decision the government imposed a countervailing duty on the goods in question imported from the Ukraine, which amounts to 21% of the customs value and will last for 3 years.

The Ukraine in its turn took its countermeasures to protect its domestic market and on August 1, 2002 imposed a 32% duty on personal cars imported from Russia. The new duty was initiated by the leaders of the automobile plant in Lutsk and the Ukrainian – South Korean enterprise “AutoZAZ-Daewoo”. The duration of the duty was restricted to 4 months and was aimed at restricting imports of Russian cars with engine volumes not exceeding 1.5 thousand cm<sup>3</sup>.

The Ministry of economy and of European integration of the Ukraine and the Ministry of trade and economic development of Russia as early as in April-May 2002 reached an agreement to set a moratorium on mutual trade sanctions and anti-dumping investigations. In two months Russian and Ukrainian specialists were making an analysis of already imposed trade sanctions to optimise and possibly reduce them.

At last in September in the course of negotiations between the governments of Russia and the Ukraine there were achieved agreements to lift the excessive fiscal barriers in mutual trade between the two countries. The Ukraine lifted its special duties on imports of a number of Russian goods; the duties in question are the special 20% duties as countermeasures with respect to Russian goods after the special duty on import of pipes of ferrous metals from the Ukraine was imposed.

In October the government of the Russian Federation in its turn declared void the decision “On the regulation to impose the special duty on import of pipes of ferrous metals from the Ukraine”, which was effective since May 2001 and imposed for 3 years special customs duties on import of pipes of ferrous metals from the Ukraine. Concurrently the duration of the previous Agreement (of April 10, 2001) on regulation of deliveries of pipes of ferrous metals from the Ukraine to Russia was prolonged. That kind of decisions can have negative effects on the interests of domestic manufacturers of pipes in Russia, as far as now that the duties are lifted the Ukrainian part has no reasons either to conclude or prolong any agreements to restrict itself. Previously it were basically the special duties that induced the Ukrainian part to keep the system of quotas on its imports.

Besides, the Ukraine introduced a quota on Russian concrete for four years. The quota from October 10, 2002 until September 30, 2003 was 150,000 tonnes, from October 1, 2003

until September 30, 2004 – 157,500 tonnes; from October 1, 2004 until September 30, 2005 – 165,000; from October 1, 2005 until October 10, 2006 – 172,500 tonnes. Each period is split into half a year periods, when not more than 60% of the annual quota can be imported.

In all probability the practice of mutual temporal restrictions on import deliveries of certain types of goods will persist in the near future in order to protect national manufacturers and to regulate the Russian and the Ukrainian market of goods, in spite of the progress that was achieved during the numerous negotiations between representatives of the two countries.

In the sphere of customs regulations in the current year another stage of joint work between the Russian State Customs Committee and its Ukrainian partner was finalised. There were achieved important agreements in the sphere of export control of Russian fuel and energy commodities and on cooperation in the sphere of customs statistics. Deviations in the data of national statistics services on mutual trade today are 5% on the average, especially significant are the deviations in data on deliveries of ferrous metals, which account for more than a fourth of the Ukrainian exports to Russia.

#### Trade with Kazakhstan

In the current year the states of the Customs Union, Kazakhstan in particular, went over to collection of indirect taxes on “the country of destination” principle. In connection with that there was a natural decline in the mutual trade between Russia and Kazakhstan, which presumably will have a temporal character. As early as in the second half of 2002 positive tendencies in this sphere were visible.

Nevertheless turnover between these two countries shortened compared to the previous year by 10%, it was Russian deliveries to Kazakhstan that decreased to a greater extent – by close to 20%.

The major part of Russia’s exports to Kazakhstan are fuel and energy commodities, machines and equipment and products of chemical industry. In its turn Russia imports machines and equipment, which accounts for a fourth of total imports. Shares of other groups of goods, such as products of chemical industry, metals and metal goods are approximately 15% each.

There exist certain differences in customs legislations of the two countries. For example, there is a flat VAT rate of 16% in Kazakhstan, practically no export customs duties, there are only duties on 10 types of goods, on non-ferrous and ferrous metals scrap, fells and wool, in particular.

When comparing the level of customs tariffs one should point out that the rates are equal only for a half of the goods that comprise the foreign trade lists of goods. On 60% of goods customs duties are higher in Kazakhstan, than in Russia.

New Customs Codes that are planned to be adopted both in Russian and Kazakhstan in the nearest future can make the process of unification of customs tariffs rates and excise taxes somewhat more complicated.

In the sphere of customs and tariffs regulation one should point out the decision of Kazakhstan to ban exports of diesel oil from the country and a higher excise tax on petrol imported from Russia. The protective measures by the government of the neighbouring country are connected with the fact that prices on Russian petrol and diesel oil are lower than the ones in Kazakhstan. As a result the three largest petroleum refineries in Kazakhstan experience serious difficulties with sales of the their products. The restrictive measures against Russian imports were effective until June 1, 2002, that is until the end of the sowing period.



## Regulation of foreign economic activities in CIS-countries.

In 2002 new lines of integration processes among CIS-countries took shape. For example, in May there was held a meeting of the leaders of member-countries in the Eurasian economic association. Special attention was given to the issue of coordinating activities when members of the Association will be joining the World Trade Organisation and to establishing common customs tariffs.

The international Eurasian Economic Association was founded in 2000 by the presidents of Russia, Byelorussia, Kazakhstan, Kirgizia and Tajikistan on the basis of the Customs Union, which was founded 4 years before that. The priority goal of this Association is a more profound coordination among its member-states in trade, economy, social, humanitarian and legislative spheres. This in particular presupposes unified customs legislations and reporting systems, rules for documentation and transit of goods, joint construction of customs points at outer borders and ensuring economic security of the member countries.

At the summit of this Association in May there was reached an agreement on non-use of anti-dumping measures against each other. Moreover, the Ukraine gained the observer status in the Association, next step can be granting the Ukraine the status of associated member of the Association. An economic integration within the Association besides giving real benefits to the Ukrainian economy due to a growth of tax revenues from imports of Russian oil and gas can lead to stronger economic ties within the CIS, a cooperation, which the Ukraine has for a long time been trying not to get involved into.

In Brest in June there was held a meeting in the Council of the leaders of customs authorities of countries in the Eurasian Economic Association, who discussed the issue of unification of ensuring payment of customs duties and taxes. Russia's State Customs Committee worked out and submitted for discussion a special draft Agreement on ensuring customs payments by means of depositing on a special account with a custom authority sums due to paid or by using bank guarantees when goods travel under the customs' control between customs authorities of member states of the Association.

In September representatives of the Association's member states held an official meeting, during which they discussed such foreign trade issues as unification of trade withdrawals from the free trade regime between member states of the Association and CIS-countries; establishing new common customs tariffs and indirect taxes; mechanism for protection of domestic markets in conditions of non-use of special protective, anti-dumping and countervailing measures; issue of realisation of the Decision of the interstate council of the Association on negotiations about joining the WTO.

One of the most important tasks of this interstate Association are the problems of import customs duties. At the meeting of these countries' representatives in October it was pointed out that the level of tariffs at present is coordinated for 60% of lists of goods between Russia, Byelorussia and Kazakhstan. One can start speaking about a common customs tariffs system after 80% of customs duties are unified.

In September there was a meeting in the Council of leaders of customs authorities of CIS-countries, who discussed issues of broader cooperation among customs authorities, in particular, they scrutinized a set of measures to make customs control and clearance of goods that are transferred by citizen through borders within the CIS more simple.

A special attention was paid to the problem of unification of customs legislations in Russia and Byelorussia. Drafts of new Customs Codes of these two states are practically com-

completely coordinated, though there still remain considerable differences in rates of customs duties on some goods.

Already in July this year Byelorussia shall start using the new import customs tariffs. The country will go over to unified import tariffs. This actually means that same tariffs on imported goods will be effective in Byelorussia as in Russia. Thus, according to the customs in Byelorussia and Russia, establishing of a single customs area will be finalised.

At present in spite of the fact that as early as in January 2001 a special Agreement between two countries was signed, there are still differences in customs duties on about four thousand types of imported goods, the number of differences in tariffs for exported goods is over one thousand.

Besides, active work in lawmaking in the sphere of customs regulations in mutual trade among CIS-countries was going on in the current year. A number of normative documents that regulate some of the markets in these countries were adopted.

For example, the State Customs Committee of the Russian Federation signed on April 29, 2002 a Directive "On control of customs value of goods that according to the list of goods for foreign trade activities fall under groups 07 and 08 and are imported from CIS-countries".

It is pointed out in the Directive that in connection with a more active trade in agricultural products imported in high seasons from member countries in the CIS leaders of customs authorities shall take prompt decisions about customs values of the goods in shortest possible time without raising difficulties for goods clearance. In order to perform an efficient control of seasonal fruit and vegetables imports from CIS-countries customs authorities shall at regular intervals monitor the wholesale and retail prices on perishable commodities (fruit, vegetables) in regions and use the acquired information to control the customs values within the framework of methods prescribed by the law.

### 3.8. Situation in the Russian Military Complex and Military Reform Trends

At the beginning of 2002, everything proceeded according to the adopted concept (dating back to 1998) of development of the armed forces and no radical change thereof was anticipated. However, speaking of international military security it is appropriate to mention the following: the developments after September 11, 2001 and the US military operation in Afghanistan were viewed by military experts as something new and of considerable military and strategic importance. Yet, many military experts (judging by publications in the mass media) believed that those developments had nothing to do with Russia, and the country's domestic problems dominated the political agenda. Russia carried out restructuring of its military-industrial complex and developed beneficial military and technical cooperation, particularly, with China and India, while Russian generals reported that Chechen fighters would soon be defeated. It was planned to start a military reform in accordance with the principles of the existing Concept of National Security of the Russian Federation and the Military Doctrine and in conditions of a favorable economic development as soon as the victory was won. Approval of the State Arms Program contributed not only to adoption of the government order, but also to beginning of work for fulfillment thereof. In addition to that, Russia entered the year 2002 with the news that the President of the Russian Federation had taken on restructuring of the system of manning of the armed forces of the Russian Federation, while the Government of the Russian Federation had not only held a special meeting on that issue late in 2001, but also took a number of concrete measures to that effect, on which basis a Concept and later a Program of such a reform would shortly be developed.

#### Reflection of the Military and Economic Concepts in the 2002 Federal Budget

The estimate of the volume of military expenditure and distribution thereof for the Year 2002 was largely determined by the success achieved in administration of the 2001 budget. Military expenditure planned for 2001 was financed practically in full. A great portion of the state's old debts to the armed forces was repaid. However, at the beginning of the year certain promises made by the Government of the Russian Federation (in particular, the promise to raise the sum of money allowances to servicemen) remained unfulfilled.

In analyzing military expenditure provided for in the 2002 budget, the following expenses are distinguished in this study:

- a) direct military expenses which are related to the country's military preparations and mostly correspond to the Standard Form of Reporting adopted by the United Nations;
- b) expenses (sometimes referred to as indirect expenses) which are related to the country's military activities in past periods (payment of pensions, conversion of defense industries, utilization and liquidation of arms and such military reform-related expenses as payment of allowances to retired servicemen and the like).

Table 44 shows data on expenditures planned for 2002 with breakdown by the recipient of budget funds, including, firstly, components of the armed forces of the Russian Federation (the Ministry of Defense and the armed forces under control thereof, as well as the Ministry of Internal Affairs and the Federal Security Service with troops, military formations and authorities under their jurisdiction), secondly, some non-military entities and organizations which are direct recipients of a portion of military allocations of the Russian Federation.

Table 44

**Military expenditures of the armed forces of the Russian Federation in 2002 (planned)**

№ of item	Type of the expenditure	Amount, mil rubles	Share in the federal budget's expenditures, %	% GDP
	The National Defense Section	284158	14.59	2.6
1	<i>Military expenditure on the armed forces under the 'national defense' section, including:</i>	270697	13.9	2.47
1.1	Development and upkeep of the armed forces of the	263864	13.55	2.41

	Russian Federation			
1.2	Mobilization and non-military training, including the following expenses:	3270	0.17	0.03
	Federal Military Railway Service	2395	0.12	0.02
1.3	Preparation of participation in collective security and peace-keeping operations	2728	0.14	0.02
	Law Enforcement and State Security Section	173863	8.93	1.59
2	<i>Military expenditure on the armed forces under the ' law enforcement operations and state security' section, including:</i>	62972	3.23	0.58
2.1	Internal troops of the Ministry of Internal Affairs of the Russian Federation	13571	0.7	0.12
2.2	State security authorities	31813	1.63	0.29
2.3	Border service authorities	17588	0.9	0.16
3	<i>Other sections of the federal budget, including:</i>	4392	0.23	0.04
3.1	Financing of specialized building authorities	654 <b>662</b>	0.03	0.01
3.2	Financing and equipment of troops of the Ministry of Rescue in Emergencies, Including the following expenditures:	3716	0.19	0.03
3.2.1	Allowances of the personnel of the armed forces	1982	0.1	0.02
3.2.2	Combat training and material and technical maintenance of troops	898	0.05	0.01
3.2.3	Procurement of military equipment, industrial goods and property	740	0.04	0.01
3.2.4	Repair of military equipment, industrial goods and property at industries	71	0	0
3.2.5	Insurance guarantees to servicemen	25	0	0
3.3	Civil defense	22	0	0
4	TOTAL: the aggregate military expenses of the armed forces of the Russian Federation	338061 <b>338069</b>	17.36	3.09

Note: It is believed that the sum specified in Item 2.2. includes expenses on financing of authorities of the Federal Security Service (FSS), Intelligence Service (IS) and certain national security authorities of the Russian Federation..

In calculation of the values of the relative amounts of expenses shown in Tables 44, 45 and 46, the following reference values were used: the volume of the Gross Domestic Product, 10.9 trillion rubles and the total expenditure of the federal budget, 1947 billion rubles. Shown in **bold type** in Tables 44 - 45 are total allocations, including both direct and additional expenditure provided for in Federal Law № 99-FZ of July 24, 2002 on Amendment of the Federal Law on the 2002 Federal Budget.

Table 45

**Military Expenditure Not-Related to Financing of the Armed Forces (plan)**

№.№ of item	Type of the expenditure	Amount mil rubles	Share in the federal budget's expenditure, %	% , GDP
<i>The National Defense Section of the Federal Budget (pls. refer to Table 1)</i>				
1	Military program of the Ministry of the Atomic Energy	13994	0,72	0,13
2	Russian Defense Sports and Technical Organization (RDSTO)	40	0	0
3	Financing of operation of branches of the economy which work for the needs of national defense (the Ministry of Industry, Science and Technology)	303	0,02	0
<i>Other sections and sub-sections of the federal budget</i>				
4	Preparation of the economy for mobilization	500	0,03	0
5	Subsidies and subventions to budgets of ZATO , including:	12 219	0,58	0,1
5.1	Subsidies and subventions to ZATO	10544	0,54	0,1
5.2	Subsidies and subventions for upkeep of infrastructure of the city of Baikonur	675	0,03	0,01
5.3	Subsidies and subventions to ZATO budgets	1000	0,05	0,01
6	TOTAL: aggregate military expenditure not related to financing of the armed forces of the Russian Federation	27056	1,39	0,24

Note: Some of the expenditure specified in the Table can be regarded as military expenses only formally, in particular, expenses on upkeep of the infrastructure of the city of Baikonur, since the primary occupation of the above city's residents consists in servicing of commercial launches of space devices and those for the needs of the national economy.



Table 46

<b>Expenditure Related to Military Activities in Past Periods (plan)</b>				
<b>№,№ of item</b>	<b>Type of the expenditure</b>	<b>Amount mil rubles</b>	<b>Share in the federal budget's expenditure, %</b>	<b>%, GDP</b>
1	Pensions to servicemen, including those granted via:	40274	2.07	0.37
		<b>47502</b>	<b>2.44</b>	<b>0.43</b>
	- the Ministry of Defense	37291	1.91	0.34
	- the Ministry of Finance	2983	0.15	0.03
2	Pensions to servicemen of law-enforcement institutions, including those granted via:	18562	0.95	0.17
		<b>23493</b>	<b>1.01</b>	<b>0.21</b>
2.1	- the Ministry of Internal Affairs	12791	0.66	0.12
		<b>16209</b>	<b>0.83</b>	<b>0.15</b>
2.2	- the Federal Security Service	4514	0.23	0.04
		<b>5475</b>	<b>0.28</b>	<b>0.05</b>
2.3	- the Federal Service of Tax Police	472	0.02	0
		<b>547</b>	<b>0.03</b>	<b>0</b>
2.4	- the Ministry of Justice	785	0.04	0.01
		<b>1056</b>	<b>0.05</b>	<b>0.01</b>
3	Utilization and liquidation of arms	10315	0.53	0.09
4	Conversion of the defense industry: the Ministry of Industry, Science and Technology	250	0.01	0
5	Military reform, including in the spheres within the jurisdiction of:	16545	0.85	0.15
	- the Ministry of Rescue in Emergencies	103	0.01	0
	- the Ministry of Defense	14997	0.77	0.14
	- the Ministry of Internal Affairs	916	0.05	0.01
	- the Federal Border Service	529	0.03	0
6	The State Housing Certificates Program (1998-2002) within the framework of the federal Housing specialized program for the 2002-2010 period	5400	0.28	0.05
7	TOTAL: Expenditure related to military activities of the Russian Federation in past periods	91346	4.69	0.83
		<b>102505</b>	<b>5.32</b>	<b>0.99</b>

It is to be noted that repayment of the public debt in respect of the government defense order (fulfilled before 2000) is also related to military activities of the Russian Federation in past periods. In accordance with Resolution № 1020 of December 29, 2000 by the Government of the Russian Federation on Repayment of Debt in Respect of the Government Defense Order, that debt (which, according to estimates, exceeds 16 billion rubles) was restructured and to be repaid before January 1, 2003. However, in the 2002 federal budget it was not explicitly shown and, for that reason, it was not taken into account.

So, the total amount which was officially allocated and due to financial authorities of the armed forces at execution of the 2002 federal budget (Item 4 in Table 44) accounted for over 17 percent of the federal budget's expenditure. The total sum of military expenditure not related to financing of the armed forces of the Russian Federation (Item 6 in Table 45) was far less significant.

However, it is to be noted that in 2002 the share of the military expenditure actually available to the armed forces of the Russian Federation was reduced by 5 percentage points on the 2001 figure (in 2001, it accounted for 22 percent of the federal budget's expenditure). The same situation can be observed with the total military expenses provided for in the 2002 federal budget (Item 1 in Table 47). The share of such expenditure in the budget's total expenditure went down to 18 percent, as against 24 percent in 2001. With the expenditure related to military activities in past periods taken into account (Item 2 in Table 47), military expenditure went down from 28 percent in 2001 to 23.4 percent in 2002.

Table 47

<b>Aggregate indices of military and related expenditure</b>				
<b>№ № of ite m</b>	<b>Type of the Expenditure</b>	<b>Amount mil rubles</b>	<b>Share in the federal budget's expenditure, %</b>	<b>%, GDP</b>
1	Total military expenditures (both those related to financing of the armed forces and those not related to it) (total of values of Line 4 in Table 1 and Line 6 in Table 2)	353128 <b>353136</b>	18.13 <b>18.13</b>	3.22 <b>3.22</b>

2	The sum of the total military expenditures and those related to military activities of the Russian Federation in past periods	444474	22.82	4.06
	(total of values of Line 1 in the present Table and Line 7 in Table 3)	<b>455633</b>	<b>23.40</b>	<b>4.16</b>
3	Total expenditure on the national defense, law enforcement and national security (see Table 1)	458021	23.52	4.19

The figures of the total expenditure on the national defense, law enforcement and national security (Item 3 of Table 47) are illustrative in that they permit comparison of the level of the 2002 expenditure (4.19 percent of the GDP) with the notional quota which was approved by the President of the Russian Federation in 1998. Under the above quota, total expenditure should have accounted for 5.1 percent of the GDP. However, the planned level of expenditure was not only below the quota, but even went down on the 2001 figure (4.47 percent of the GDP).

If expenditure on national defense is examined separately, the situation is about the same. Under the quota, 3.5 percent of the GDP should have been spent for that purpose, which is much more than the proportion observed in 2002 (2.6 percent).

It is also be noted that with passing on August 7, 2002 of a new conceptual document (the Guidelines of the State Policy of the Russian Federation in Development of the Armed Forces in the Period ending in 2010) all mention of such quotas has become improper (the quotas are simply not provided for in that document).

Also, such an issue as an increase in the above analyzed expenditure at revision of the 2002 federal budget needs to be explained in particular. It is to be noted that that increase concerned only armed forces pensioners' pensions, which were raised in line with an increase in the amount of money allowances of servicemen and had nothing to do with direct military expenditure. A certain portion of additional subsidies was allocated to the Department of Specialized Building of the Russian Federation.

Speaking of the absolute amount of the military expenditure, its inadequacy, to say nothing of its reduction in the face of very real military threats, has been in contrast with the disproportionately high spending on military preparations of a number of other countries, the US first and foremost. In such a situation, it becomes ever more important not only to establish control over budget spendings, but also find new ways to increase budget revenues; as a result, considerable funds can become available to the country for solution of many of its present problems, including speeding up of the military reform.

Priority needs to be given to such expenses as 'pay off' efficiently, both in the civilian sphere (stimulation of highly technological innovative activities) and the military sphere.

### **Adjustment of the Strategy of Development of the Armed Forces as a Reaction to Exogenous and Endogenous Factors**

As we know, the issue of efficient adjustment of the strategy of development of the armed forces is not a new one. The year 2002 was not an exception. Discussed below are some of the factors, which in 2002 either brought about conceptual changes or caused high-ranking officials make statements on need for such changes.

The first of those factors is related to the following global processes: a) continuous growth in the scale of human activity; b) emergence of transnational corporations which are more powerful than many individual states and c) globalization of international economy with the civilized world entering a new stage in its history, known as 'postindustrial'. Knowledge has become an important asset sought after by both governments and companies and at the same time a source of power which can be used for creative and destructive purposes alike. However, the top military are slow in taking in those processes. Typically, there was no mention of importance of knowledge in the article on methodology of development of the armed forces by A. Kvashnin, Head of the General Staff of the Russian Federation, published in the Military Thought Magazine late in 2001. Notably, the article was written on the eve of discussion by the Security Council of the Russian Federation of issues related to development of Russian science. If applicable recommendations by the Security Council have been heeded in the effort to reform the armed forces, the results of that are not yet to be seen.

Another important factor is change in distribution of power centers in the world. As is known, there is only one superpower left after the collapse of the Soviet Union and the end of the cold war, which superpower is seeking to be the sole power center in the geopolitical environment. It is to be noted that, keeping a low profile on that matter, the United States has guided the NATO's strengthening through expansion eastwards towards Russia's borders and that expansion was declared to be allegedly in the interests of Russia. In that situation, Russia can only rely upon its nuclear weapons. That situation cannot be ignored in analysis of the balance of forces and military threats in the world. At the same time, the potentials of the countries, such as China and India, which are not content with the above world order have been growing. As the geopolitical situation is getting more complicated, Russia has to make its choice, define its interests and find ways of securing thereof. The President of the Russian Federation naturally reacted to those developments by stating the need to revise the National Security Concept. That belief is shared by the Security Committee of the Russian Parliament which intends to revise the law on national security. (The need to revise the National Security Concept was underlined in the IET's review on the 2001 results.)<sup>1</sup>

The third factor (which is often rated first by politicians) is threat of international terrorism, which threat has become a reality not only for Russia, but also for many other countries, including the USA. However, it is to be noted that present-day terrorists take into account the above two factors and ever more rely on the power of knowledge and humanity's achievements seeking to use these to their own ends. From the geopolitical point of view, present-day terrorism is of a global nature, but unlike 'established power centers' power centers of terrorism are dispersed and more difficult to identify.

The system of views of the future of the armed forces of the Russian Federation, which proceeds from the factors listed above and is discussed below is based on the following:

1. Analysis and generalization of views of experts adhering to the official views exemplified by the ideas expressed in the anniversary collected papers of the Security Council of the Russian Federation; similar views are professed by the President of the Academy of Military Sciences;

2. The authors' perception of potential goals of Russia's foreign and domestic policy, Russia's National Security Concept, the Military Doctrine, the ways of attaining those goals and the means required for implementation of the proposed strategies.

It is quite natural that the above approaches do not always produce similar outputs. Problems related to development of the armed forces are so complicated and have so many aspects to them that it is almost impossible to find the correct solution thereof in principle, especially in a situation where some experts rely on theory, while others on experience, traditions and practice. It is obvious, however, that should recommendations by theorists be taken into account in decision-making by practitioners, that could be a positive factor contributing to solution of those problems.

For the purpose of ensuring more effective military security it is also important to analyze a large number of non-military factors of national security (political, economic, information, social and other); in the present-day conditions, these need to be given more attention, since the best way to resolve conflict situations consists in nipping potential threats in the bud.

In this study, the authors could not analyze all the documents related to development of the armed forces or determine the extent to which those documents are justified due to the fact that an excessive number documents are classified. It is to be noted that such a political document as the Guidelines is also a classified material. However, proceeding from the general laws of development of military science, military theory and facts available for analysis it is possible to formulate the principal provisions of an effective strategy of development of the armed forces of the Russian Federation. Those principles are formulated below in the following five points:

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<sup>1</sup> See: Russian Economy in 2001: Trends and Prospects. Issue 23. IET. Moscow, 2002.

1. Peaceful work of the people of Russia and completion of rational economic reforms are possible only if military security of the country is ensured. For that purpose, Russia needs efficient armed forces.

2. Major objectives of the Russian armed forces and the ways of attaining thereof (see Table 48) are clearly formulated even without any reference to a likely enemy.

3. Technically, for the purpose of attainment of those objectives it is important to preserve and develop nuclear weapons, highly intellectual (high-precision) weapons, dataware facilities of these and means of information warfare.

4. According to outputs of research, in formulation of military and strategic objectives emphasis on deterrence of aggression is more efficient from the economic point of view. Today, expenditure on prevention of war is much less than that on war, to say nothing of the damage any modern war can cause.

5. Manning of the armed forces in the time of peace should be such as to ensure recruitment on a voluntary basis of knowledgeable, healthy and moral defenders of the country who are ready to learn and professionally use the advanced methods of warfare and accomplish any military tasks. At the same time, the country needs reserves (trained in warfare techniques) that could be mobilized in addition to contract servicemen for the purpose of repulsion of an aggression (act of terrorism) if the strength of the peace-time regular forces and navy is insufficient to repulse such an aggression.

At present, the armed forces of the Russian Federation are unable to implement efficient strategic concepts and attain objectives set by such concepts, the principal reasons behind that being the failure to complete the military reform, imperfection of the system of manning of the armed forces, unacceptably low social status of servicemen, Russia's lagging behind developed countries in terms of availability of the more advanced weapons to its armed forces, misbalance between the strength of the armed forces and the level of their financing by the state and poor civilian control over the military.

For the purpose of solving the above problems, it is important from the economic point of view to upgrade the system of management by the state of development of the armed forces, which means upgrading of planning, drawing and administration of the military budget in accordance with the Budget Code of the Russian Federation and ensuring of effective transparency of the country's military expenditure and civilian control over such expenditure.

Described in the IET's previous reviews (issue 22 and 23) were certain measures, which seemed to be appropriate for today's Russia and its armed forces.

*Table 48*

**Objectives of the Armed Forces and the Means for Their Attainment**

Conditions	Principal objectives	Ways and means for attainment of objectives
Peace	Prevention of aggression and attempts at force-based pressurizing from abroad, ensuring of high combat preparedness and fighting efficiency of troops, prevention of civil war and of terrorism, both on domestic and on global scale.	Strategy of deterrence (both nuclear and non-nuclear) as a part of a set of political, economic and other measures. Effective combat training of the regular armed forces and mobilization training of the reserves. Strategic forces and means of deterrence, front-line forces and means of deterrence, forces and means of ensuring of national security.
Hostilities (military conflicts or acts of terror)	Repelling of aggression, minimizing of civilian loss and economic damage, infliction on the aggressor (both organizers and perpetrators of illegitimate military actions and acts of terror) of such damage as would clearly reduce to nil any such advantages as may be achieved by them through the hostilities, make attainment of the objectives of the act of aggression/terror impossible and make the aggressor/organizers of acts of terror stop such acts.	Conventional and unconventional forms and methods of military action in combination with political, economic and other methods of pressure on the aggressor. Regular armed forces and means of the military machine of the Russian Federation, mobilization reserve (in case of need), armed forces of the allied states and of international organizations (primarily the UN).

Let us discuss these in greater detail.

1) Adjustment of the National Security Concept and of the Military Doctrine is needed;

- 2) It is advisable that priority is given to development of highly accurate long-range weapons (as a means of targeted measured retaliation permitting strikes on both vital facilities of the aggressor and on terrorist camps);
- 3) Information on most types of military expenditure needs to be declassified and civilian control over such expenses needs to be introduced;
- 4) A concept of and program for switchover to a new system of recruitment of the armed forces of the Russian Federation need to be developed; some of the provisions of the Concept have been included in the new Guidelines, while others are to be developed in accordance with the Instructions issued by the Government of the Russian Federation following its Meeting of November 21, 2002.

It is also advisable that a considerable proportion of specific plans for reformation of the armed forces be unclassified. That would permit comprehensive checks of such plans' reasonableness by the academic community, civilian control over these and greater support of these by society at large, which would make such plans more feasible (in particular, allocation of funds from the federal budget would thus become uninterrupted).

Many of the above measures have already been taken or are provided for in officially adopted plans.

### **Administration of the 2002 Federal Budget**

Figures concerning total federal on-budget expenditures in 2002 and expenditures related to the armed forces of the Russian Federation are shown in *tables 49, 50 and 51*. In those tables, progressive total of such expenditures in the period beginning on January 1, 2002 is shown as of the end of each month. In ordinary type, cash federal budget performance is shown, while in italic, federal budget administration by the item, sub-item and type of federal in-budget expenditure, as presented in reports (submitted by the Government of the Russian Federation to State Duma and based on data prepared by the Ministry of Finance of the Russian Federation) on federal budget execution in the first six months and the first nine months of the Year 2002 and also the expected federal budget performance in 2002 (as of August 1, 2002).

As can be seen from the tables, all the planned expenditures on the armed forces were executed in full. Moreover, in 2002, the total executed expenditures on national defense were 4 percent higher than planned (they amounted to 295.3 billion rubles accounting to 2.7 percent of the GDP).

The expenditure amounts marked with “\*” in the tables are those causing certain doubt. These are shown in Federal Treasury reports without explanation of the causes of alteration of the planned amounts.

As can be seen from *tables 49, 50 and 51*, with certain sections and subsections of the federal budget the amount of financing considerably exceeded cashier execution. That means that recipients failed to produce any documentary proof of reasonableness of expenditures under certain items and types of federal budget expenditures and for that reason could not receive from the Federal Treasury funds allocated them in the Federal Budget.

The share of allocated but unassigned funds in the total amount of financing under military and related items of the 2002 budget is shown in *Table 52*.

According to *Independent Military Review* No. 45 (December 25, 2002 – January 16, 2003) in conditions of full financing the Ministry of Defense of the Russian Federation received less than its due in 2002 (by 25 billion rubles). The Ministry of Defense of the Russian Federation lacked funds to pay expenses under such items as money allowances of servicemen, subsistence and sanatorium-and-spa treatment. As a result, in December 2002 servicemen were not paid bonuses for the 4<sup>th</sup> quarter of 2002, reimbursement for undistributed food rations or compensation for sanatorium-and-spa treatment of servicemen who were in Chechnya.

Under-utilization of allocations from the federal budget in 2002 points to a low level of justification of expenses at drawing of the budget.

For the purpose of better justification of allocations from a federal budget, it is expedient that the following measures should be taken:

1. The Ministry of Finance of the Russian Federation should identify the specific items and types of expenditure of the federal budget under which allocated funds were not distributed in full.

2. Recipients of budget allocations should justify in detail to the Ministry of Finance of the Russian Federation their requests for budget allocations. Methods of justification of such requests are to be agreed upon with the Ministry of Finance of the Russian Federation.

3. Research and educational institutions of the Ministry of Defense of the Russian Federation, the Military Financial and Economic University of the Ministry of Defense of the Russian Federation, leading research and educational institutions of the Ministry of Internal Affairs and the Federal Security Service, as well as public associations of researchers should be engaged in development of methods of justification of such requests and execution of justifications.

4. Justification of expenditure by the section, sub-section, item and type of expenditure related to financing of the armed forces should be submitted by the Government of the Russian Federation to the State Duma together with the draft federal budget for the next year.

5. The State Duma should ensure expert evaluation of the above justifications in the course of consideration and approval of the federal budget for the next financial year.

Table 49

**Military and related expenditure of the Russian Federation in 2002 (mil rubles)**

No item	Type of expenditure	Approved by 2002 federal budget	January	February	March	April	May	June	July	August	September	October	November	December
0	Total expenditure	1947386	78327	217271	364399	534606	674283	828267 909471	990163	1164636	133259 5 143427 4	158948 2	178007	204597 5 210603 1
1	National defense, including	284158	7513	21883	43863	69819	94836	119774 130778	1458772	1689881	189881 207864	218186	249720	295261 297902
1.1	Development and financing of the armed forces of the Russian Federation	263864	-	19134	39787	63813	87120	109938 120671	134893	156410	175913 193312	202413	232008	275767 277455
1.2	Ensuring of mobilization and non-military training of													
	The federal service of railway troops	2395	-					874 983	1261	1697	1998 2262	2380	2606	3340 3251
1.3	Preparation of and participation in ensuring of collective security and peace-keeping operations	2728	-	354 *	240	385	493	798 798	715	812	849 1169	937	1024	1077 2899



2.1	Mobilization preparations of the economy	500	0,3	22	63	108	143	196 211	244	293	352 369	422	568	635 535
2.2	Civil defense	22	0	0	0,1	81*	2	6 9	7	9	9 16	15	17	22 22
2.3	Subsidies and subventions to budgets of ZATO, code TSSR 485, code VR 350	10544	-	-	-	-	-	5893	-	-	-	-	-	-

Due to the above faults of reports on administration of the budget, data shown in Tables 49, 50 and 51 is less itemized than that provided for by the budget. The least informative are monthly reports of the Federal Treasury. For the above reasons, not all the relevant data is shown in Tables 49, 50 and 51.

Table 51

**Expenditure related to military activities in past periods**

№ item	Type of expenditure	Approved by the 2002 federal budget	Share of unassigned funds, %											
			January	February	March	April	May	June	July	August	September	October	November	December
1.1	Pensions to servicemen (Ministry of Defense of the Russian Federation)	40274 47502	-	5059	7437	12509	12812	15506 15808	19558	23652	27867 28179	32223	37215	42197 47525
1.2	Utilization and liquidation of arms	10315	258	667	6142	2437	3221	4392	3414	5545	7048 7378	7895	8928	10338 10760
1.3	Conversion of defense industry	250	0	0	63	63	84	105 105	127	153	178 178	178	236	250 250
1.4	Military reform	16545	38	773	2182	3657	4817	7866	7529	9340	10816 11789	12058	13054	14383 16549
1.5	Financing of the Housing program as part of expenditure on public investments	-	-	-	-	-	-	13	-	-	-	-	-	-

Table 52

**Share of unassigned funds in the total volume of allocations for military and related purposes (the 2002 federal budget)**

Section (sub-section) of the expenditure	Share of unassigned funds, %		
	For six months	For nine months	For twelve months
<b>Total expenditure</b>	8.9	7.1	
National defense, including:	8.4	8.7	8.4
Development and upkeep of the armed forces of the Russian Federation	8.9	8.7	
Military program of the Ministry of Atomic Energy	0	0	
Mobilization and non-military training	11.1	11.7	
Collective security and peace-keeping operations	0	27.4	
Financing of operation of branches of the economy which work for the needs of national defense	0	0	
Law enforcement and state security, including:	17.2	15.6	
Internal troops of the Ministry of Internal Affairs	23.8	17.7	
State security authorities	21.6	17.3	
Border service authorities and border troops	25.3	17.1	
Military reform		8.3	
Servicemen' pensions	1.9	1,1	

**Requirements and the Existing Economic and Political Potential for Speeding Up the Military Reform**

Dynamics of defense and security expenditure in the 1999- 2002 period and in the 2003 federal budget are shown in Table 53.



It is to be noted that for a long period of time starting from 1999 military expenditure of the Russian Federation has been growing. In that period, not only the authorities, but also the public at large became aware of the need to strengthen the country's military potential and create confidence not only for the sake of their security, but also for a normal course of development of civil economy. The international aspect has become as important of late; Russia is one of those countries, which responded to threats of international terrorism not only with public censure, but also with use of military force.

However, the level of military expenditure should be justified. It is well known from the Soviet Union's experience (and that of other countries) that disproportionately high military expenditure can have a devastating effect on the national economy. Consequently, in justification of the budget it is important to analyze and take into account all the existing interests and all the existing threats and possible countermeasures. It is inadmissible that planning of public expenditure in the civilian and the military spheres should be done separately. Also inadmissible are justifications prepared by interested parties without participation of independent experts.

Table 53

**Dynamics of expenditure on defense and security**

Sections of the federal budget \ years	1999	2000	2001	2002	2003
Expenditure under the National Defense Section (in current prices / in comparable prices of 1999*), mil rubles	93702	140852	214688	281970	345726
	93702	117181	150598	173504	191653
Growth (%) on the previous year figure	-	25.1	28.6	15.2	10.5
<b>Growth (%) on the 1999 figure</b>	<b>0</b>	<b>25.1</b>	<b>60.7</b>	<b>85.2</b>	<b>104.5</b>
Expenditure under Law Enforcement and Ensuring of State Security Section (in current prices / in comparable prices of 1999), mil rubles	51324	79802	131621	165999	244644
	51324	66391	92329	102144	135618
Growth (%) on the previous year figure	-	29.4	39.2	10.6	32.8
<b>Growth (%) on the 1999 figure</b>	<b>0</b>	<b>29.4</b>	<b>79.9</b>	<b>99.0</b>	<b>164.2</b>

\*Calculation in the comparable prices was done by the IET.

Unfortunately, as in the past years the Forecast of Social and Economic Development of the Russian Federation for the Year 2003 does include Section 8 (Ensuring of National Security by Economic Means), but the content of that section does not correspond to its title. Threats and risks to national security are considered only in the context of economic security. The economic aspect of repulsion of other risks and threats, including military ones, is not discussed.

Due to such an approach, the volume of military expenditure of the Russian Federation remains practically unjustified.

To justify the other approach, one can refer to the Concept of National Security of the Russian Federation which does not draw a line between civilian and military aspects and contains the following set of *Major Objectives in Ensuring National Security of the Russian Federation*:

- timely forecasting and identification of foreign and internal threats to national security of the Russian Federation;
- implementation of immediate and long-term measures aimed at prevention and neutralization of internal and foreign threats;
- ensuring of sovereignty and territorial integrity of the Russian Federation and inviolability of its borders;
- revival of the economy and pursuance of an independent socially oriented economic policy;
- breaking of scientific, technical and technological dependency of the Russian Federation on foreign sources;
- ensuring in the territory of the Russian Federation of personal safety of Russian nationals and other persons and their constitutional rights and freedoms;

- upgrading of the system of state authorities of the Russian Federation, relations between federal entities, local self-government and legislation of the Russian Federation, ensuring of harmonious inter-ethnic relations, strengthening of law and order and maintaining of social and political stability in the country;
- ensuring of strict compliance with the laws of the Russian Federation by all national, officials, state authorities, political parties and public and religious organizations.
- equitable and mutually beneficial cooperation by the Russian Federation with foreign states, primarily with leading ones;
- upgrading and maintenance of Russia's military potential at a relatively high level;
- strengthening of the regime of non-proliferation of nuclear weapons and means of delivery of these;
- taking of effective measures aimed at identification, prevention and suppression of intelligence and subversive activities by foreign states against the Russian Federation;
- radical improvement of ecological environment in the country.

Ensuring of national security and protection of interests of the Russian Federation in the economic sphere is a priority of the state policy.

Excessive secrecy has been the main obstacle to accurate and well-grounded execution of such comprehensive justifications. By now, it has largely been overcome. For that reason, the Government of the Russian Federation needs to justify military expenditure soundly in preparation of the 2004 federal budget.

At the same time, as was noted above in revision of the National Security Concept it is important to make adjustments to the list and especially the meaning of the principal objectives related to ensuring of national security. Though the need for certain adjustments is enough some other points in need of adjustment are still to be identified. The military budget should not be seen as a sheer burden on the national economy.