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BOFIT Russia Review Yearbook 2005

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Economic Developments

Russia's contradictory labour market trends

Russia's labour market has seen quite positive developments in recent years, albeit with regional variations. State Statistics Service estimates show the number of economically active working-age Russians (ages 15 to 72) as of end-November was up over one per cent on year to 73.8 million people. The number of unemployed, calculated using ILO methodology, was down 1.5 % y-o-y. In November 2004, some 5.6 million people were unemployed, about 7.6 % of the workforce. Despite a few spikes along the way, Russia's unemployment rate is about half of what it was in early 1999, when it exceeded 14 %. In contrast to the decrease in the ILO-based unemployment rate, the number of unemployed registered officially increased in recent years. In November 2004, there were about 1.8 million people registered as unemployed at state employment offices.

Russia's present labour market is characterised by large regional differences in unemployment, as well as shortages of educated and highly skilled labour. ILO-based unemployment figures are lowest (under 5 %) for Moscow and the Moscow region, St. Petersburg and a couple of other regions. The situation is worst in certain Caucasian regions and the Tuva Republic in southern Siberia, where unemployment rates exceed 15 %. High unemployment figures are in Russia usually related to political unrest or unfavourable industrial structure.

Qualified labour in Russia's private sector nowadays has power to demand higher wages and better working conditions. Top managers, in particular, can usually dictate the terms of their job, but it is also not very unusual for specialists of lower wage categories to have a say in their wage level and benefits.

Since the collapse of Soviet Union, Russia's labour force has declined twice as fast as the fall in total population. Despite positive developments last year, Russia's general population and with that the labour force is predicted to shrink in the longer term. Russia will thus need to improve labour productivity and working conditions, promote the health of its workers and bring in more foreign labour to at least partly meet current GDP growth forecasts.

Modest growth in agriculture

2004 appears to have been a year of very modest growth for Russian agriculture. For the year, production is estimated to have grown about 1.3 %.

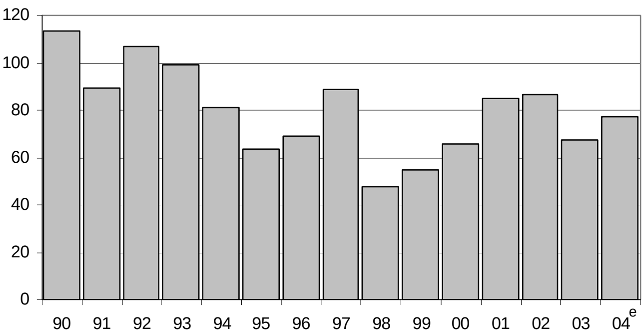
The situation was generally poorer in animal husbandry than in crop farming. The exception was poultry production, which has increased and gained profitability, thanks partly to import quotas imposed in 2003. On the other hand, the number of breeding cattle diminished rapidly and has contributed to a decrease in milk production.

This year, Russia increased its import quotas for beef, pork and poultry to allow for more meat imports. The disagreement between EU and Russia about various veterinary certificates from EU countries led to a short break in imports last summer. The matter now seems to be resolved; since the start of the current year, Russia requires a single veterinary certificate for all EU countries.

One of the brightest spots in agricultural production last year was the grain harvest, which likely surpassed 2003 harvest. Estimates put the net grain harvest at about 77 million tonnes, up from 67 million tonnes in 2003. The agriculture ministry reports that the harvest is sufficient to cover the needs of domestic food production and cattle breeding. Russia plans to export some 8 million tonnes of grain, mostly feed grain, this year.

In 2004, certain positive trends emerged in Russian agriculture. About two thirds of mid-sized and large agricultural enterprises are now profitable, up from 50 % in 2003. During 2004, there have been changes in the agricultural subsidy system, which have increased the number of investment credits. Farmers have also been more eager to take out state-subsidised insurance against crop failure. The unified agricultural tax that combines four earlier taxes has simplified taxation of agricultural enterprises since its introduction at the start of 2004.

Russia's net grain harvest, 1990–2004 (million tonnes)



Source: State Statistics Service

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.0	1-9/04
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	6.2	1-11/04
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	11.1	1-11/04
Unemployment, % (end of period)	9.3	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	11/04
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.3	135.9	163.6	1-11/04
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	75.4	84.5	1-11/04
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	33.9	29.1	35.8	40.8	1-9/04

Source: State Statistics Service, CBR.

Political environment changing

The year 2004 was marked by the Kremlin's growing influence in domestic political and economic affairs. As the year progressed, Putin consolidated his power with electoral system changes and replacements of key officials, often with backgrounds in the intelligence services.

The United Russia movement, effectively created by the Kremlin, took control in the new Duma that commenced its work at the start of last year. The movement has been highly successful in aligning Duma decisions with the Kremlin's wishes. This made the passage of legislation smoother than ever before in Russia's post-Soviet history.

Surprise reforms in full swing

Last year saw vigorous progress with two reforms, namely those of public sector administration and the social security system. Although the administrative reform had long been in preparation under various leaderships, its scope and rapid implementation timetable came as a surprise when it launched last spring. The massive reform has seriously hampered the everyday functioning of ministries and agencies. Furthermore, it does not appear to be meeting its goals of clarifying structures of public administration or lines of responsibility. Nevertheless, this year the reform will be extended to regional administrations.

Perhaps the biggest surprise move was reform of the social security system. The new system was launched this month after less than a year of preparation. An overhaul of the system had been long advocated by international expert organisations such as the World Bank. Russia's old social security system included a huge proportion of in-kind supports, i.e. free or discounted goods and services provided without means testing to a large chunk of the citizenry. The system was clearly unsustainable in the long run.

The reformed system provides citizens with monthly cash payments instead of free in-kind supports. Although in many cases citizens could not actually take advantage of free services to which they were in principle entitled (e.g. free medication, phone calls or spa treatment), people worry that the modest monthly cash compensation will be insufficient to procure even the most important services such as public transportation.

The reform transferred some of the responsibility for providing support to regional administrations. Thus, the level of the support now depends on the financial condition of each region. Some of the rich regions, e.g. big cities, can still afford to provide in-kind benefits.

Due to the generally low level of pensions in Russia, the largest affected group is pensioners, to whom in-kind benefits have been crucial for making ends meet. Indeed, the first days of 2005 have seen seniors engaged in widespread street protests. The protests have been the biggest since the troubled 1990s.

Tax reform: strong on design, weak on execution

The reform of the tax system is unique among the Russian reform initiatives in that it has been implemented in a coherent manner for several years. The chief deviation from original plans was caused by high world market oil prices and problems with oil companies' tax discipline in the last two years. These developments shifted the emphasis of the tax system in the direction of taxing natural resource extraction.

The tax reform was essentially completed at the start of this year, when the rate of the regressive social tax paid by employers was cut. Enterprises, which earlier suffered from frequent and unanticipated tax system amendments, welcome the completion of the reform.

On the other hand, arbitrary interpretation and implementation of tax laws by authorities seriously worsened business conditions last year. The obscure sale in December of Yuganskneftegaz, the main production unit of the troubled Yukos oil company, to cover alleged tax arrears was the culmination in the chain of unfortunate events.

Investment risk of Russian regions increases

Russia should be quite satisfied with its credit rating upgrades to lowest investment grade by *Moody's* and *Fitch*, as well as with its constant upward progress in *Euromoney's* country risk survey rankings. Unfortunately, the situation at the regional level is quite different. Judged by the annual investment climate survey by the Russian magazine *Ekspert*, investment risk in regions is growing. While the survey does not amount to a credit rating, it highlights factors affecting development of regional investment climates.

The survey is based on two main indicators – investment risk and investment potential, which in turn are compiled from several sub-indicators. The results for 2003/2004 indicate a clear change from a year earlier, especially with regard to investment risk. For the first time in nine years, none of Russia's 89 regions made it into the lowest risk category. Rising investment risk reflects e.g. changes in regional legislation due to administrative and social reforms, as well as changes in fiscal relations between the federal centre and the regions.

As to investment risk, Moscow city has fallen from second place in 2002/2003 to 15th in 2003/2004, although it remains among the best regions in terms of investment potential and as a destination for domestic and foreign investments. Resource-rich regions also continue to attract investment, despite their perceived high investment risk. According to the State Statistics Service, e.g. the Tyumen region's Khanty-Mansi autonomous area, which is rich in oil and gas, was the second top recipient of domestic and foreign investment in Russia during 2000-2002. In the latest *Ekspert* ranking, it placed fifth in terms of potential, but 40th in terms of investment risk.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2005 budget
Revenues [1]	12.5	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.2	1-10/04	17.8
Expenditures [1]	20.9	20.9	17.4	16.8	14.6	14.8	19.0	17.8	15.1	1-10/04	16.3
Balance	-8.4	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	5.1	1-10/04	1.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	25.7	20.8	9/04	
Foreign currency debt, $ bn	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.7	112.9	9/04	

[1] *Since 2002 the unified social tax is included in the federal budget.*

Source: Budget: IMF 1996–2000, State Statistics Service 2001–2004. Debt: IMF 1996–1999, Minfin 2000–2004.

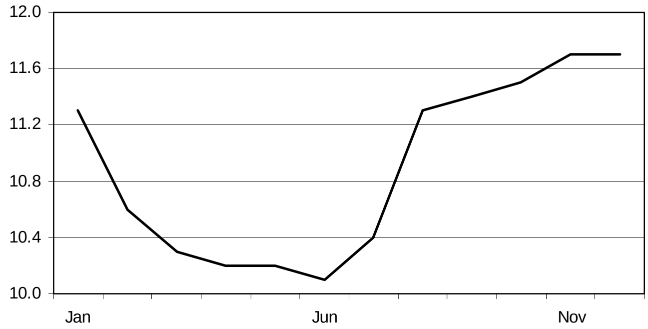
Inflation overshoots 2004 target range

After a significant year-to-year deceleration since 1999, consumer price inflation slowed only slightly in 2004, reaching 11.7 % at year-end. The stubbornly persistent pace of inflation was caused largely by massive export earnings from prevailing high international commodity prices.

There were some changes in the emphasis of monetary policy last year as the central bank tried to balance between the contradicting goals of containing the real appreciation of the rouble and suppressing inflation. Following president Putin's public comment on the excessive strength of the rouble last spring, the CBR began to pay greater attention to restraining the rouble's appreciation. Last summer, 12-month inflation began to accelerate and as the year progressed it became increasingly evident that the government's target rate of 10 % for 2004 inflation would not be met.

The rouble continued to strengthen in 2004, up over 5 % in nominal terms against the dollar. The rouble depreciated in nominal terms 3 % against the euro, while in real terms it appreciated also against the euro.

Consumer price inflation in 2004, 12-month % growth



Source: State Statistics Service

Oil production exceeded 2004 target

Despite a politically shaky year for Russia's oil sector, the sector performed quite well. Russia even denied Saudi Arabia its status as the world's top oil producer during the first half of 2004 (Saudi Arabia subsequently boosted production and re-established its pre-eminence). Russia seems to have slightly exceeded its production target for 2004. According to the State Statistics Service, during January-November, oil output average 8.9 million barrels per day, an increase of 8.9 % y-o-y for the period. This was well above the Ministry of Economic Development and Trade's August forecast of a 7.5 % y-o-y increase.

The export of crude oil will also apparently meet the year's target after a 13 % y-o-y increase was shown for the first ten months of 2004. Oil exports climbed to a level of 5.1 million bpd at the end of October.

The state oil pipeline monopoly Transneft expanded its pipeline capacity last year. Indeed, contrary to earlier years (and also contrary to statements of oil companies), Transneft reported it suffered from over-capacity. It seems that the progressive export taxation schemes for crude oil introduced in August and the uncertainty clouding the entire sector may have decreased enthusiasm among oil companies to push for further increases in oil exports even during a time of prevailing high world oil prices.

Adverse weather conditions and delays in the Bosporus straights have hindered the use of the full capacity of Russia's main oil terminal in Novorossisk on the Black Sea. To get around this bottleneck, the government has been building alternative export routes. During the beginning of this year, the Primorsk oil terminal on the Gulf of Finland and the adjacent Baltic Pipeline System are expected to run at full capacity (1.2 million bpd). The Bosporus logjam has made the Primorsk terminal temporarily the largest oil exporting harbour for Russian oil.

The government has also pushed ahead with its plan to extend the current pipeline grid eastwards. On New Year's Eve, the government announced its long-waited decision on constructing an oil pipeline stretching over 4,100 kilometres from Taishet in eastern Siberia to Nakhodka on the Sea of Japan. Transneft recently estimated the construction costs at around €8 billion, although some experts estimate actual cost will exceed €15 billion. Parts of the project are planned to be privately financed and the Japanese have declared their interest in participating in the financing. The government wants Transneft to submit a detailed pipeline construction proposal by early May.

The planned capacity of the pipeline is about 1.6 million bpd, which corresponds to nearly a third of Russia's current crude oil exports. As all of Russia's major export routes currently go via Europe, the new pipeline to the Sea of Japan will shorten the distance for Siberian oil to reach the American and Japanese markets. The government's decision was a disappointment for China, which had lobbied for the shorter alternative pipeline to Daqing, China. Plans for that pipeline are now on hold. The Russian government has instead committed to increased rail transports of oil to China.

Planned capacity of Transneft export pipeline grid 2003–2020, volumes in millions of bpd

Transneft export pipelines	**03**	**05**	**10**	**15**	**20**
Primorsk terminal (BPS)	0.6	1.2	1.2	1.2	1.2
Baltic and Polish terminals	0.1	0.3	0.3	0.3	0.3
Ukraine-Europe (Druzhba)	1.3	1.3	1.3	1.3	1.3
Black Sea grid	1.3	1.3	1.3	1.3	1.3
Caspian Sea grid	0.4	0.6	1.3	1.3	1.3
Taishet to Nakhodka			0.6	1.0	1.6
Western Siberia to Murmansk				1.0	1.6
Total	**3.7**	**4.7**	**6.1**	**7.5**	**8.7**

Source: Russian Ministry of Industry and Energy

Monetary indicators

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004,**	**as of**
Inflation (CPI), 12-month, %	22	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	
M2, 12-month growth, %	30	29.0	21.3	57.5	61.5	39.7	32.4	50.5	38.5	11/04
Average wage, $ (period average, except last)	154	164	108	62	79	111	142	180	246	11/04
Deposit interest rate, % (period average)	55	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	10/04
Lending interest rate, % (period average)	147	32.0	41.8	39.7	24.4	17.9	15.7	13.0	10.9	10/04
Forex reserves, $ bn (incl. gold)	15.3	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	12/04
RUB/USD exchange rate (end of period)	5560	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	12/04

Source: State Statistics Service, CBR.

Is the Kyoto treaty profitable for Russia?
by Kai Mykkänen*

When the Russian Federation ratified the Kyoto protocol on climate change on October 22, 2004, it saved the treaty. With Russia's ratification, the ratifying countries account for more than 55 % of the carbon dioxide emissions of the industrial countries. This was the condition that needed to be met for treaty to enter into force.

Russia's ratification was preceded by a long hesitation. Contradictory economic interests collided in the corridors of the Kremlin. While Russia's oil sector will suffer from the treaty, the Russian state will benefit through the sale of emission credits to Europe. The ratification was also a symbol of gratitude for EU support of Russia's WTO membership.

The Kyoto treaty allocates emission limits for all participating countries for the first Kyoto period of 2008–2012. For example, the EU is allowed 92 % of its 1990 emissions and Russia can have 100 % of its 1990 emissions without penalty. Participating countries can then buy or sell emission credits among themselves. Countries with high emission abatement costs may find it less costly to buy credits from countries with lower abatement costs, and thereby produce higher emissions than allowed by their original limits. Conversely, countries with low abatement costs can benefit by abating more than they originally agreed in Kyoto and selling their extra emission credits to others. In theory, countries will trade as long as the marginal abatement costs equalise in all participating countries.

Russia can profit with the sale of emission credits

Russia is likely to administer its international trade of emission credits under a state monopoly. In doing so, the Russian state keeps the revenues from credit sales and prepares to use monopoly power in the emission credit markets. The emission credit business has been estimated with several general equilibrium models that take into account the effects of the credit trade on energy markets. According to all estimates, Russia will be a net seller of emission credits for decades. Researchers at the Massachusetts Institute of Technology have applied a dynamic recursive EPPA-general equilibrium model to estimate the value of Russia's annual emission credit exports. The study puts the value of the business at about $3 billion, assuming Russia can effectively enforce its monopoly position together with Ukraine. In a fully competitive market, the state would make about $500 million from emissions trade (Babiker, Jacoby, Reilly, Reiner 2002).

There are three reasons Russia will be a net seller of emission credits. First, the Kyoto treaty uses a country's 1990 emission as the baseline for referencing its emissions during 2008–2012. Russia's emissions in 2008–2012 will quite likely fall below the 1990 level without any abatement actions – Russian industry basically collapsed in the early 1990s with the end of the Soviet Union. Indeed, thanks to the 1990 baseline Russia will receive extra "hot air" credits for free. Second, Russia successfully leveraged its crucial role in the Kyoto process to negotiate for itself a right to get more extra emission credits in the amount equalling the amount of the carbon dioxide that growing Russian forests have absorbed since 1990. Third, it is cheaper to reduce current emissions in Russia than in the West. Finns, for example, exploited all the cheap fixes to emissions reduction long ago.

Will Kyoto disrupt oil exports?

The Kyoto treaty will diminish demand for Russia's main export product if oil consumers try to reduce their need for emission credits by switching to cleaner fuels. Thus, Russia faces trade-off between earning revenues from selling emission credits and negative terms-of-trade effects in the oil market. On the other hand, one of the clean substitutes for oil is natural gas, a resource with which Russia is well endowed. If Europe moves to natural gas to meet its Kyoto treaty targets, the effects of the treaty for Russian energy sector could be much less negative than generally estimated.

According to most estimates, revenues from emission credit sales will exceed the loss of revenues to the oil sector caused by Kyoto treaty conditions. Calculations made with the GEMINI-E3 general equilibrium model put the net welfare effect of the Kyoto treaty for Russia at about $147 billion dollars in the case of full competition, $239 billion in the case of a monopoly that maximises the profits in the first period, and as much as $267 billion in the case of an intertemporal monopoly (Babiker, Jacoby, Reilly, Reiner 2002). Monopoly action, however, requires full cooperation with Ukraine, the projected second-largest net seller of emission credits. Estimates calculated for the period 2010–2040 and discounted to 1995 money find that ratification of the Kyoto treaty was clearly a money-making proposition for Russia.

On the other hand, the monetary amounts discussed here should not be taken too seriously. There are huge uncertainties with regard to both the supply and demand for emission credits that have not been addressed here. Moreover, when talking about welfare effects, it is important to consider possible relocations of polluting industries to the countries outside the Kyoto treaty (e.g. China, India and the US).

** The article is based on the author's thesis (Helsinki University, 2004).*

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Economic Developments

Economic growth decelerated slightly in 2004

According to the first official estimate of the Federal Statistics Service, GDP last year grew 7.1 %, decelerating only slightly from the 7.3 % attained in 2003. Such a minor annual deceleration came as a surprise after quarterly and monthly statistics showed a significant slowdown in the second half of 2004. However, this preliminary GDP estimate from the Federal Statistics Service is likely to be revised several times. The next estimate is due in April, and the final figure will be published sometime next year. Changes may appear even after that due to ongoing work on improving GDP statistical methodologies.

The fresh estimate illustrates the growing role of consumer demand in GDP expansion. During 2004, wholesale and retail trade and catering, as well as construction, grew 10 %. Housing construction in particular experienced strong growth. Transport and communications increased 9.5 % and industrial production 6 %. Fixed investment was up 11 %, a clear deceleration from nearly 13 % in 2003.

Growth expected to slow further

The general expectation among observers and the Russian authorities is that growth of the Russian economy will slow in the next few years. Most experts expect GDP growth in 2005 to come in at around 5.5 %.

The view is based on several assumptions, most notably that world market prices for oil and other raw materials will decline somewhat. Real appreciation of the rouble is expected to continue, which should hurt the position of manufacturers producing for the domestic market. Many experts warn that the worsening of business climate over the past year could affect investment. It is, however, difficult to quantify the effect. The postponement of important structural reforms last year (in particular in the natural monopolies sector) may affect longer term economic growth.

Mid-term economic policy program under review

Last summer, the Ministry for Economic Development and Trade was given the task of preparing a new mid-term economic program that identifies ways to diversify the Russian economy in order to reduce its dependence on raw material extraction. Autumn's deceleration of production growth heightened political interest in finding new approaches in economic policy.

The program, prepared under the leadership of economy minister German Gref, was approved in principle by the government in December. In late January, it was debated in the upper-chamber Federation Council, where it got strong criticism from many fronts.

The program offers three development scenarios, none of which achieves the much-heralded goal of doubling of GDP in ten years. This invited particular criticism from prime minister Mikhail Fradkov. The requirement for doubling the GDP has been the cornerstone slogan in official economic policy discussions since president Putin introduced it in 2003.

The program does not foresee the Russian economy growing faster than 4–5 % annually unless institutional reforms are continued and the quality of human capital improved. Furthermore, active state involvement in preparing strategic development projects for key sectors of the economy is necessary. If these preconditions are fulfilled, annual GDP growth would accelerate to some 7 % from 2010 onwards – assuming constant oil prices at around $33 per barrel.

According to observers, the program differs from its numerous predecessors in that it contains recommendations that go beyond traditional economic policies. The program states that the establishment of well-protected ownership rights in Russia will require reforms of the judicial system and strengthening of both independent media and civil society institutions. The program addresses these needs to a certain extent (e.g. it calls for improving transparency of the work of courts and limiting monopoly power in media).

Prime minister Mikhail Fradkov has said that the final review of the program will have to wait until after president Putin's state-of-the-nation address next month.

Lively economic policy discussion

The debate on the new economic program is the latest evidence of differing views on economic policy within the government. So far, no clear view on the future path of development has emerged, although the overall aim of continuing market reforms is shared by everybody. Semantically, the meaning of "market economy" appears to change depending on who is discussing it.

One of the centrepieces in the discussion is the role of the state in the economy. Economy minister German Gref considers it necessary to diminish state ownership and the degree of monopolisation of the economy. He has criticised the increasing importance of state enterprises, e.g. Gazprom, in the energy sector. Mr. Gref has also warned that economic growth may decelerate further due to the slowdown of reforms and the prevailing mistrust between businesses and the state. The recent state actions against oil major Yukos have had a particularly corrosive effect in this regard.

On the other hand, Gref favours state investment in innovation sectors as a way to enhance overall growth. Prime minister Mikhail Fradkov for his part has proposed cutting the VAT rate from the current 18 % to 13 % to boost production growth. Both measures would be financed from extra money collected in the stabilisation fund – a proposal finance minister Alexei Kudrin strongly opposes.

Macroeconomic indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004
GDP, %	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1
Industrial production, %	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	7.0	6.1
Fixed investments, %	-18.0	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9
Unemployment, % (end of period)	9.3	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6
Exports, $ billion	89.7	86.9	74.4	75.6	105.0	101.9	107.3	135.9	182.0
Imports, $ billion	68.1	72.0	58.0	39.5	44.9	53.8	61.0	75.4	94.8
Current account, $ billion	10.8	-0.1	0.2	24.6	46.8	33.9	29.1	35.8	58.2

Source: Federal Statistics Service, CBR.

Privatisation policies reviewed

President Putin assigned the Russian Audit Chamber in late 2003 to assess privatisation deals in the 1990s. The task has aroused concern in the corporate sector, which is worried that the revisiting of privatisation deals could even lead to re-nationalisation of assets. The Chamber's findings and recommendations were originally scheduled for Duma consideration in July 2004, but that date has been postponed several times. According to the latest information, official discussion will take place in April.

The evaluation focuses on the legal correctness of 140 large privatisation sales carried out between 1993 and 2003. During those years, major state-owned industrial and mineral extracting enterprises were transferred to private hands. Of particular concern are the deals made using "shares-for-loans" schemes, where private banks financed federal budget deficits with loans backed by shares of large enterprises. When the government failed to repay the loans, the banks then acquired the enterprises at low prices. This is how many current oligarchs (including Mikhail Khodorkovsky) built their fortunes.

The evaluation report (available on the Chamber's website since October) states that although privatisation efforts managed to raise the share of private enterprises to 60 % of all Russian companies by the end of the 1990s, they failed to create broad ownership bases, improve efficiency or attract sufficient investment. Moreover, throughout the 1990s, the state lacked a consistent privatisation policy, which resulted in conflicting and deficient laws, as well as a lack of oversight. On the other hand, the report notes that the government, too, has failed to promote efficiency in companies in which it still holds substantial stakes.

Sergei Stepashin, chairman of the Audit Chamber, stresses that the chief goal of the report was to examine past privatisations in order to avoid similar mistakes in the future. The report's recommendations for further action emphasise that deficiencies in legislation do not justify the unwinding of old privatisation sales. However, research on privatisation sales needs to continue and violators of laws in the state administration and the enterprise sector need to be brought to justice. The prosecutor's office has already received material for investigation. Mr. Stepashin has underlined that it is important that any actions taken on the basis of the report should not be politically motivated.

Little success in social sector reform

The launch of the social security reform at the start of the year seems to have failed, mainly due to poor preparation of the reform concept. Given that the current Duma tends to pass Kremlin-initiated laws quickly with little consideration or debate, the Duma has largely lost its function as a body that scrutinises and fine-tunes the bills before it. Furthermore, due to tight schedules, federal and regional authorities often have too little time for preparing the implementation of reforms. This was the case with the social security reform presented for Duma consideration only some six months before it was launched.

The reform introduced monetary compensation in lieu of former in-kind benefits that had been extended evenly to many segments of the population. In addition, the reform increased the role of regions in financing social assistance. The doubts regional authorities expressed when the draft law was discussed last summer were largely ignored, although it was already apparent that the capability of funding the new system varied considerably among regions.

Moreover, ahead of the introduction of the reform, the government failed to disclose that many of the benefits were in actual fact to be fully or partly cancelled and/or the number of people receiving benefits curtailed. The federal approach was apparently to adopt the reform quickly at the federal level and leave the important, but unpleasant, decisions on implementation (e.g. the implementation of means testing) to the regions. Obviously, regions were not prepared for that kind of task.

At present some of the wealthiest regions have decided to keep their benefits untouched for all inhabitants. Most regions are handing out certain money compensations for cancelled in-kind benefits, while the poorest regions cannot afford to offer even the basic support they legally should. This has hit the poorest segment of the population hardest.

The fact that some regions increased utility tariffs at the start of the year has further aggravated the situation. From the beginning of 2005, about a fifth of Russian regions raised utility tariffs by almost a quarter, and the rest of regions will do so later this year. Under a government decision, regions may increase utility tariffs as much as 25–27 % in 2005. After the increases some of the poorest regions have reached the point where they cannot raise utility prices without simultaneously increasing their social outlays. Under a new federal law, families are now entitled to social support when their utility payments account for over 22 % of their total income.

The wave of protests that emerged in various parts of Russia when people realized that their benefits had been cut should not have come as a surprise to the authorities. In the wake of the protests, the government decided in January that the annual pension increase, originally scheduled for April, would be moved to March and the amount of the increase doubled. Furthermore, additional subsidies will be paid from the federal budget to finance regional social spending. These measures represent a de facto backing away from stated reform principles.

The problems that arose in the social system reform may provide an instructive lesson for the government as it prepares reforms on education, public health care and municipal housing.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2005 budget
Revenues [1]	12.5	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.5	1-11/04	17.8
Expenditures [1]	20.9	20.9	17.4	16.8	14.6	14.8	19.0	17.8	15.2	1-11/04	16.3
Balance	-8.4	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	5.2	1-11/04	1.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	25.7	20.8	9/04	
Foreign currency debt, $ bn	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.7	112.9	9/04	

[1] *Since 2002 the unified social tax is included in the federal budget.*

Source: Budget: IMF 1996–2000, Federal Statistics Service 2001–2004. Debt: IMF 1996–1999, Minfin 2000–2004.

Mid-range foreign debt

In recent years, Russia has been able to prepay its public foreign debt thanks to large tax and export duty incomes generated from strong oil sales. At the end of January, Russia paid off its remaining $3.3 billion in IMF debt, which was scheduled to come due in 2008.

In 2004, Russia launched talks on accelerating retirement of Soviet-era debt owed to Paris Club members. The move reflected Russia's declared debt policy of replacing external public debt with cheaper domestic debt. Paris Club debt carries the highest interest rate of all Russian public foreign debt. Germany last year securitised part of Russia's debt owed to it through the Paris Club without consulting Russia, which served as additional motivation for Russia to seek reduction in its Paris Club debt. There was no progress, however, in reaching an agreement with the Paris Club as the creditor countries had low enthusiasm for Russia's proposed 10 % discount in exchange for an accelerated payback. The negotiations will continue this spring.

At the end of last September, Russia's public foreign debt stood at $113 billion or about 20 % of GDP. Total foreign debt (including private sector debt) equals some 35 % of GDP, which puts Russia in the category of moderately indebted countries. This is a considerable achievement for a country that just six years ago defaulted on its debt obligations.

Russia's public foreign currency debt as of September 30, 2004 (US$ billion)

Paris Club	44.4
Other official debt	7.8
Commercial debt	2.9
Debt to international financial organisations	9.8
Eurobonds	35.2
Domestic bonds	7.3
Debt to Vneshekonombank	5.5
Total	112.9

Source: Ministry of Finance

In addition to significant tax income, debt reduction has been made possible by Russia's stringent fiscal policies. According to advance information from the finance ministry, the 2004 federal budget surplus amounted to a record RUB 687 billion (about €18 bn) or 4.1 % of GDP, making last year the fifth year in a row when Russia achieved a budget surplus. The stabilisation fund into which part of oil extraction taxes and export duties are transferred when export prices are high ended the year with a balance of RUB 522 billion (over €14bn), which equals around 3 % of GDP.

Third investment grade rating for Russia

At the end of January, Russia received its third investment-grade credit rating from the international rating agency Standard & Poor's. The other two major rating agencies had already raised Russian sovereigns to investment grade (Moody's in October 2003 and Fitch in November 2004). The conferring of an investment-grade rating opens the door to large institutional investors. It also means that the Russian state and Russian firms can borrow at lower cost on international markets.

Standard & Poor's based its decision to upgrade on improvements in Russia's economic situation and its ability to service its debts. Russia's debt servicing capability has been enhanced by the surpluses in the federal budget and current account, as well as the central bank's huge foreign currency reserves and recent reductions in the foreign debt stock. The agency concluded that Russia's financial position is now so stable that it compensates for increased uncertainty caused by recent shifts in economic policy and the slowdown in economic reform.

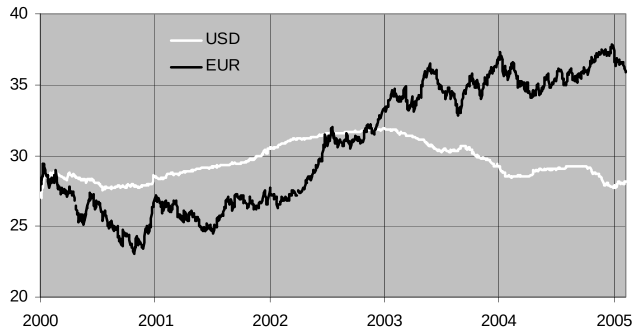
Change in exchange rate policy?

In early February, the Central Bank of Russia announced that it had ended the dollar targeting in the rouble's managed float and since February 1 used as a target a dollar-euro currency basket, consisting of 0.9 dollars and 0.1 euros. At their current exchange rates, this means that the share of the euro in the basket is about 12–13 %. The CBR also said the share of the euro will be gradually increased to reflect the euro's role in Russian foreign trade.

The introduction of the currency basket aims at reducing volatility in the rouble's external value. Analysts claim Russia actually abandoned the dollar targeting already some time ago, so the CBR's announcement only officially acknowledges the policy already in place. Hence, the practical implications will not be significant.

The CBR will continue its interventions on the forex market to steer the rouble. Last year the CBR's battle against appreciation pressure increased its foreign currency reserves by $48 billion. As of end-2004, the bank's foreign currency reserves stood at $125 billion.

Nominal exchange rate of the rouble vs. US dollar and euro



Source: CBR

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	12.6	1/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8		
Average wage, $ (period average)	164	108	62	79	111	142	180	237		
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8		11/04
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	10.4		11/04
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	124.9	1/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.08	1/05

Source: Federal Statistics Service, CBR.

Small business in Russia

by Tatiana Dolgopyatova*

The growth of small business in Russia was most intense in the first years of the 1990s, right after private ownership and individual entrepreneurial activity were legalised. Official statistics show that the number of small enterprises (SEs), their total output and total number of employees have not changed dramatically since the late 1990s.

Russia's 1995 Civil Code allowed for the formation of microbusinesses as sole proprietorships (i.e. "individual entrepreneur without registration as a legal entity," or PBYUL in Russian). This form entailed easier registration and taxation, and many start-ups chose it. Even many existing SEs were reregistered as PBYULs. Notably, official statistics do not cover PBYULs, and therefore significantly underestimate the role of the small business sector in the Russian economy. The Federal Statistics Service (formerly Goskomstat) publishes data only on the number of PBYULs, collected by tax authorities. According to estimates, PBYULs currently account for 6–7 % of total employment. Together with official data on SEs, these figures raise the proportion of employment in the small business sector to over 20 %.

Selected indicators on small business (thousands of units)

	1998	2000	2002	2003
Number of SEs	868	879	882	891
Number of hired staff	6,208	6,597	7,220	7,743
Number of registered PBYULs*	3,141	3,865	4,596	4,626

*including peasant farms

Source: Federal Statistics Service

Role of SEs in the economy (% of total)

	1998	2000	2002	2003
Hired staff	12	13	14	15
Output	7	5	7	8
Fixed investment	4.7	2.6	2.8	3.0

Source: Federal Statistics Service

Official statistics show that in 2003, about half of SEs were engaged in trade and catering. The share of SEs engaged in industry and construction was 13 % each. Trade and catering accounted for 31 % of total output in the SE sector, while the share of industry and construction was 47 %.

The SE sector demonstrates strong territorial heterogeneity. The major share of SEs is concentrated in large cities and developed regions. In 2003, 32 % of all SEs were based in Moscow or St. Petersburg. While Russia only had six SEs per 1,000 inhabitants on average, the number in Moscow and St. Petersburg was 18–19.

Factors enhancing growth of the SE sector...

Generally, the small business sector has demonstrated a good ability to adjust to changing conditions. Although the risk of liquidation is rather high, the associated costs are insignificant. An entrepreneur can establish a new business immediately and transfer the resources and employees to it.

SEs have diverse specialisations and can be engaged in two or three types of activity, although lately there are signs of a preference for one activity. Small businesses today often develop as part of a group of SEs owned by a single entrepreneur. As a rule, each firm within the group has its own specialisation. The business, however, is diversified.

Several surveys indicate that small enterprises conceal about a third to a half of their activities from the tax authorities. In many cases, SEs are simply used as shell firms for tax evasion of large companies. Intense ties with regional or local authorities soften the operating environment, for example, by improving access to resources and orders, and shielding firms from competition. Quite often these ties are supported by services exchanges and corrupt practices.

Establishment of networks within the small business sector helps regulate transactions and set the rules of interaction among business partners. An important advantage is access to non-banking loans, i.e. mutual private credits. On the other hand, the emphasis on personal ties and networks raises the barrier of entry to new businessmen, so most new SEs are established by experienced entrepreneurs. A recent survey showed that only a fifth of new firms were established by persons without previous experience in business.

... and factors hindering it

The SE sector appears to have stagnated somewhat since the late 1990s, due in part to the exhaustion of short-term advantages and considerable administrative barriers facing private businesses. According to an SE monitoring survey, excessive bureaucracy has eased over the past three years. However, for start-ups and potential entrepreneurs (who obviously do not get surveyed), the situation is rather bleak.

SEs must deal with increasing competition and elusive demand in most Russian regions. Scant demand does not justify expanding business in rural provinces. In large cities, competition with domestic and foreign companies has become significant in what has traditionally been SEs favourite niche, retail trade.

Economic growth has also driven up competition for production inputs (above all, labour and financial capital) between SEs and large companies. And in this struggle, SEs seldom come out winners. The logical alternative, cooperation between SEs and large enterprises, remains essentially untried. Few SEs are integrated into production chains due to high taxation, poor contract enforcement and the slow restructuring of large enterprises.

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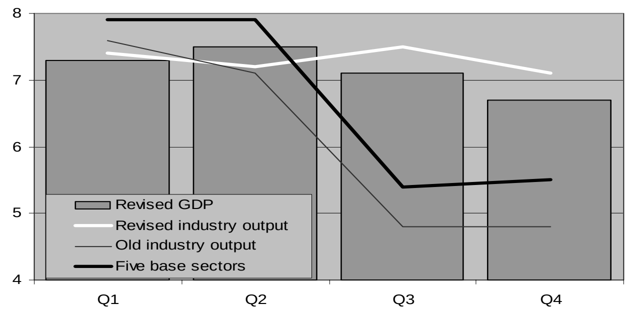
Economic Developments

GDP growth for 2004 revised up

Russian GDP grew 6.7 % in the fourth quarter of 2004 according to the Federal State Statistics Service (Rosstat). Rosstat also revised upwards its quarterly data for the second and third quarters. The second quarter was revised from an earlier reported 7.4 % to 7.5 % and the third from 6.4 to 7.1 %. After the revision, the preliminary GDP growth figure reported in January for all of 2004 was a more realistic of 7.1 %.

As Rosstat revised its methodology for calculating GDP to better comply with international practices, it also updated its base for calculating output. The reporting of the index of five base sectors was discontinued in January 2005. According to the old index of five base sectors of the economy (used earlier as a proxy for GDP), production grew 6.6 % last year. Increasing growth was seen only in retail sales and agriculture. Retail sales have continued to grow rapidly since 2000; last year they were up 12 % y-o-y. Agricultural output rose just 1.6 % and construction 10 %. Housing construction was the fastest growing branch of the construction sector. Freight transport volumes increased 6 % overall, with rail freight rising 8 % and pipeline transmission volumes up 6 %. Sea freight, on the other hand, plummeted 30 %. Rail shipments of crude oil and oil products increased just 2 % y-o-y.

Quarterly GDP, five base sectors and industry output for 2004, % y-o-y



Source: Federal State Statistics Service

Industrial production also revised up

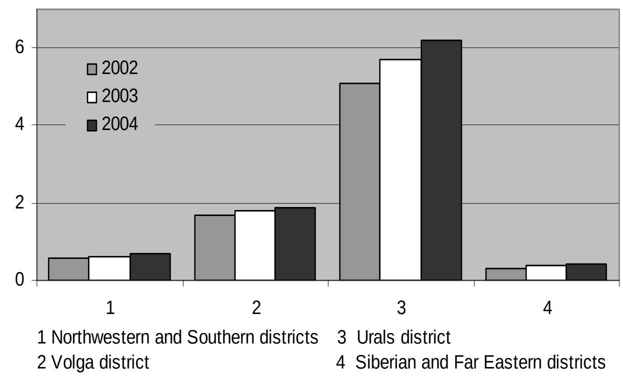
Rosstat output revision is largely the result of changing the methodology for calculating industrial output and now includes gas, electricity and water production. The output figure for 2004 was revised significantly upwards. Under the new regime, industrial output grew 7.3 % y-o-y in 2004. According to the old methodology, industrial output slowed in the third and the fourth quarter and averaged at 6.1 % for the entire year. As no detailed revised figures are yet available, the figures based on the old methodology are included here. The fastest growing industrial branches in 2004 were glass and ceramics (16 %), and machine-building and metal fabrication (12 %). Automobile production grew 10 % y-o-y. Fuel production rose 7 %. Other industrial segments enjoying robust growth included chemicals and petrochemicals (7 %), construction materials (5 %), ferrous metallurgy (5 %) and the food industry (4 %). Production fell in four key industrial branches, including light industry (down 7.5 %).

Crude oil production up

Rosstat reports that Russian crude oil production grew by 8.6 % last year. Oil production, including gas condensates, was 443 million tonnes (about 9 million barrels per day). The Urals federal district (with 68 % of the production) remained largest production area, with the Khanty-Mansy autonomous region alone accounting for 56 % of Russia's crude oil output. Production in the Urals district grew by 9.5 % y-o-y. The highest production growth was seen in the Siberian federal district (18 %) and the Northwestern federal district (19 %). The Siberian and Far Eastern federal districts – where most of Russia's unexploited reserves are believed to lie – are still small producers (only 5 % of total oil production). In the Far Eastern district, the fastest growing production area was the Sakhalin oblast with 11 % growth last year.

The Russian Ministry of Economic Development and Trade forecasts that crude oil production will grow 5 % this year and 3 % next year.

Oil production by region 2002-2004, million bpd



Source: Federal State Statistics Service

Macroeconomic indicators

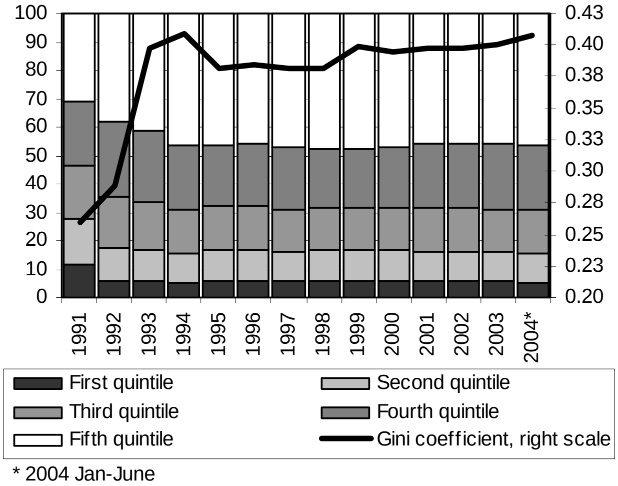
	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1		
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	2.1	1/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	7.0	1/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	8.6	1/05
Exports, $ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.2		
Imports, $ billion	72.0	58.0	39.5	44.9	53.8	61.0	75.4	94.8		
Current account, $ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.8	58.2		

[1] *New methodology from 1.1.2005, figures for 2001-2004 revised, not comparable with previous years.*
Source: Federal State Statistics Service, CBR.

Russia's poor get poorer, rich get richer

At the start of Russia's economic reforms in 1991, prices were liberalised and income disparities widened rapidly (see figure). Within just one year, the income share of the population quintile with the lowest incomes plummeted from 12 % to 6 %. During 1990s, this share remained fairly unchanged, but in recent years the poor have again begun to lose ground. The second and third quintiles have also found it hard going during the past ten years. Meanwhile, the top two quintiles have seen an entirely different trend. The fourth quintile has managed to preserve its share of total money incomes amazingly well, while the incomes of people in the top quintile have increased markedly. By the end of 1990s, those in the top 20 % of Russian society were earning almost 48 % of all income (up from 31 % in 1991) and that share has hovered around that level ever since.

Income distributed by population quintile in Russia



Source: Federal State Statistics Service, BOFIT

Rosstat reports for all of 2004 that real incomes of people in the top decile grew 12 % a year, while incomes in the lowest decile rose just 6 %. Besides, the incomes of the poorest people in the lowest decile fell substantially in real terms. Despite the fact that the share of persons living below the official poverty line fell from 25 % in 2003 to under 18 % in 2004, those living in poverty are now subject to an even harsher experience.

The Gini coefficient measures how much income distribution deviates from a perfectly equal distribution. The lower the figure, the more equal the income distribution. A coefficient value above 0.4 is generally seen as an indicator of high inequality. In Russia, the Gini coefficient was 0.26 at the beginning of 1990s, but soared to 0.41 by 1994. It thereafter decreased slightly, but has in the 2000s gradually returned to the 1994 level. Compared to other middle-income countries, Russian income inequality is not exceptional. Brazil's Gini coefficient in 1998 was 0.59, and China's was 0.45 in 2001. Compared to the EU, however, Russia is far behind. The EU's Gini coefficient in 2001 was 0.28 – a figure that has likely risen with the recent enlargement.

Economic policy discussion heats up

The differing views within the government on economic policy have become increasingly apparent, with the discussion centring on ways to sustain robust economic growth. After posting GDP growth around 7 % in 2004, the pace is widely expected to slacken to less than 6 % this year and decelerate further in 2007. The slowing is seen as inevitable, since international oil prices, which have spurred Russian growth, are unlikely to rise much further and capacity constraints hinder Russia from ramping up its energy export volumes. At the same time, internal sources of growth – investment and private consumption – remain insufficient to sustain GDP growth at levels that will achieve president Vladimir Putin's goal of doubling GDP in ten years.

In order to boost economic activity, prime minister Mikhail Fradkov is demanding that the VAT rate be cut from the current 18 % to 13 % starting from 2006. Calculations made by government officials show that such a reduction would add 1–2 percentage points per year to GDP growth. However, international experience is inconclusive as to whether tax cuts actually stimulate economic growth.

Economy minister German Gref, on the other hand, opposes tax cuts. He says the only ways to boost growth are to improve Russia's business climate, implement structural reforms and regulate monopolies. As it will be some time before these measures have an impact, economic growth is bound to decelerate in the next few years.

Fiscal prudence under threat

Russia has won international praise for its pursuit of stringent fiscal policies in recent years. Last year, Russia recorded a federal budget surplus of about 4 % of GDP.

However, there is now danger that Russia could slip from this virtuous path. Finance minister Alexei Kudrin opposes premier's plans to slash the VAT rate as the ensuing revenue loss would be so severe that Russia would have to dip into the stabilisation fund to cover budget spending. Yet the very idea of the stabilisation fund is to divert resources from current consumption when tax revenues are high so they will be available when budget revenues fall below normal. The notion of relaxing fiscal discipline when tax revenues are high runs counter to the purpose of the stabilisation fund. The finance ministry's counter-proposal would either leave the VAT rate unchanged or cut it by no more than 2 or 3 percentage points.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004,	as of	2005 budget
Revenues [1]	12.5	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.7		17.8
Expenditures [1]	20.9	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.3		16.3
Balance	-8.4	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4		1.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	25.7	20.8	9/04	
Foreign currency debt, $ bn	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.7	112.9	9/04	

[1] *Since 2002 the unified social tax is included in the federal budget.*

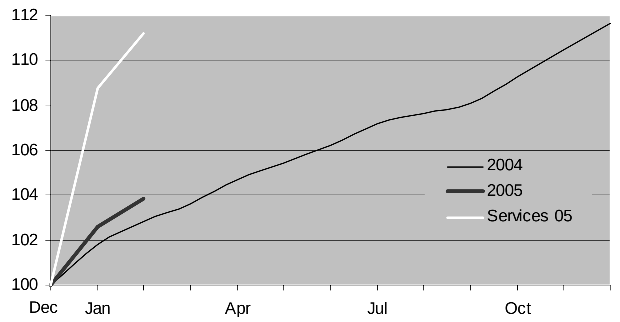
Source: Budget: IMF 1996–2000, Federal State Statistics Service 2001–2004. Debt: IMF 1996–1999, Minfin 2000–2004.

Inflation spikes in January-February

Inflation jumped to 12.8 % y-o-y in February, compared to 11.7 % at the end of last year. The higher inflation was mainly the result of price hikes in the regulated prices in the service sector. As whole the service sector prices soared in February on average 24 % y-o-y. The biggest price hikes were seen in housing and municipal services (36 % y-o-y), public transport costs also rose quickly (22 %). Prices in the Russian CPI typically jump at the beginning of the year due to scheduled hikes in administratively set prices for services, but this year's increases were particularly sharp (CPI rose almost 4 % since beginning of the year).

Food prices in February increased 12.8 % y-o-y, lead by higher prices for meat products (23 % y-o-y). Indeed, it was rising food prices, and particularly meat prices, during last autumn that were largely responsible for pushing inflation above the government's 10 % target last year. For other goods, February prices were up 7.3 % on average. Fuel prices rose fastest (28 % y-o-y). The government has declared that it will strive bring inflation down to an on-year rate of 8.5 % by December of this year.

Monthly CPI from beginning of the year (100 = Dec of previous year)



Source: Federal State Statistics Service

Record high trade surplus in 2004

High world prices for minerals, particularly oil, boosted the foreign trade surplus last year. CBR figures show the value of exports in 2004 was $183 billion and imports $95 billion. The trade surplus climbed to a record $88 billion.

Export earnings were up 35 % y-o-y. Exports to non-CIS countries climbed 33 % and 42 % to CIS countries. Preliminary balance-of-payments figures indicate that earnings from crude oil exports rose 48 % and oil products 33 % in 2004. Natural gas exports were up 12 % in value terms. According to Rosstat 57 % of exports were fuel and energy (including 32 % crude oil), and 17 % metals and metal products. Imports incomes increased 25 % last year. Imports from non-CIS countries grew 23 %, while imports from CIS countries rose 31 %. Rosstat figures indicate machinery and equipment accounted for 41 % of imports and foods and agricultural products for 18 %. The State Customs Committee reports that Russia's largest trading partners in 2004 were Germany, Belarus and Ukraine.

Banking regulation gets tougher

To decrease the mistrust towards the banking sector, the government proposed in February that the Duma amend banking legislation to raise bank capital adequacy requirements (the ratio of a bank's capital to its risk-weighted assets) from the current 2 % to 10 % at the start of 2007. A bank failing to fulfil the requirement would lose its operating licence. If a bank's capital adequacy ratio falls below 12 %, the CBR could take measures to correct the situation e.g. by imposing temporary outside management on the bank. While international rules typically call for an 8 % requirement for capital adequacy, in many emerging market economies, where banking sector credibility is still weak, authorities often find it prudent to set stricter requirements.

The average capital adequacy ratio in the Russian banking sector was 17 % in 2004. However, some small banks remained well below the new 10 % threshold.

Banking sector transparency increasing

After last summer's mini-crisis, a general deposit guarantee system was established for banks to enhance depositors' confidence. To be admitted to the scheme, a bank needs to pass an inspection by central bank auditors. The inspections are still on going and so far the CBR has accepted some 750 of Russia's 1,200 banks into the new system.

The establishment of a deposit guarantee system has helped increase transparency in the banking sector. Qualifying for the system requires that a bank declare its true owners – an unfamiliar procedure for many Russian banks. Under current banking legislation, the CBR has to be notified of a purchase of more than 5 % of a bank's equity, while CBR approval is necessary for a purchase of more than 20 % of equity. Because banks earlier ignored these requirements and in order to promote transparency, the CBR recently said it is considering the possibility of accepting delayed notifications of ownership changes without imposing sanctions.

Banking sector dominated by a few large institutions

The banking sector remains fragmented because small banks see little incentive or necessity of merging. Since mid-2001, newly established banks have been required to have a minimum charter capital of €5 million. For banks set up earlier, the minimum capital requirement is not defined in monetary terms. At the end of 2004, only 500 banks (around 40 % of banks) had capital exceeding €5 million.

Despite Russia's relatively large number of banks, the sector's operations are highly concentrated with the 50 biggest banks (which together hold over 70 % of the sector's assets). The five biggest banks together commanded 45 % of total assets in 2004.

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	12.8	2/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	30.4	1/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	252	1/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8		
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4		
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	134.2	2/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	27.77	2/05

Source: Federal State Statistics Service, CBR.

The political economy of Putin's Russia
by Pekka Sutela*

For years to come, Russia's ability to grow depends greatly – though not solely – on maintaining and increasing the extraction of natural resources, particularly hydrocarbons. Yet growth of hydrocarbon production is actually slowing, and several analysts argue that Russia faces stagnating and quite possibly declining crude oil production within a few years. To prevent this, huge investments on the order of tens of billions of euros annually will be needed – especially to open remote, unfriendly fields in Eastern Siberia.

Financing and managing such investment takes, not just in Russian thinking, giant companies. These behemoths have to be owned by somebody, and the alternatives are few. Russia, like many resource-rich countries, is highly averse to dominant foreign ownership, especially now with its resurgent nationalism. Finance and minority shares are naturally welcomed, particularly when it helps open new markets. Since the Khodorkovsky episode, it is clear the government finds private domestic owners a much less appetising alternative than they once were. Although exploitation licences, the state pipeline monopoly, foreign trade control, taxation and other means available conceivably offer adequate vehicles for state supervision, large owners can be unreliable when they have large-scale plans of their own.

As large-scale people's capitalism is not in Russia's cards for quite some time, it would appear that Russia's only remaining option is to boost state controls along with state ownership. This, in addition to having the benefit of seeming inevitability, also provides for windows of personal power and wealth to the few well-connected men in the regime entourage.

Like in the old Soviet days, there is an A-sector of priority industries upon which are concentrated state controls as well as access to major finance, skills and technology. Hydrocarbon, mineral and metal production are at the forefront of the A-sector (and current events surrounding the Forest Code seem to suggest that wood resources should be included as well). Some even argue that parts of the financial system, media and communications should also be included, although more for political than economic reasons.

But Russia can never become a Kuwait. The mere size of the population prevents the provision of an acceptable standard of living for the great mass of people solely on the basis of resources, whatever one's assumptions about the availability and future price of oil, gas and other basic commodities. One either has to be able to extract much higher value added from natural resources, or there needs to be a vibrant B-sector that can provide jobs and welfare. Notably, the B-sector, which includes many small and medium-sized companies, lacks an economic imperative that might justify strong state control. Even in the Soviet system, the B-sector tended to be treated as residual by central management. Modernly, few would argue for state ownership of service establishments and such.

This situation raises two possibilities. Either the B-sector will prove competitive in a relatively open post-European-choice economy or jobs must be somehow protected. It is clear to most Moscow strategists that the first alternative is the preferred one, assuming it is doable. Therefore, there is no contrast between tightening state grip on the A-sector and simultaneous furthering of a positive business environment for the B-sector. When this basic division of the economy exists, both approaches can coexist.

This division is highly risky, however. For one thing, the extent of the A-sector remains fluid, and it could enlarge further – say in finance – in ways that even constrain activities that are of no direct concern to the regime. Second, though the Jupiters of the Kremlin might only be interested in a narrow A-sector, the Oxen at the subnational level may all too willingly follow the example set in the centre and extract available benefits from what exists in their localities. There is anecdotal evidence for this. Finally, the B-sector might simply fail to develop the competitiveness necessary for the economy to take the risk of opening up. Until now, Russia has been unable to develop competitive new high-value-added industrial products or service-based exports.

There is an additional problem. The B-sector actually consists of two parts. Some enterprises are part of the Soviet industrial legacy. While important providers of jobs and regional revenues, they have generally entered their terminal, senile industry phase. Then there is the new B-sector, in some cases perhaps amendable to infant industry arguments. The near impossibility of distinguishing between the two in practice – one should remember the great potential role of technology-based spin-offs and others – makes arguments for temporary protectionism that much less appealing.

Creating the foundations for a future competitive B-sector is the reason why an economic liberal might still wish to work for a softly authoritarian political regime. But the lure of the authoritarian temptation still holds. Authoritarian regimes are well suited to excessive resource dependence. They are also consistent with the industrialisation model of the 20th century: a very high investment ratio with resources channelled into politically determined priority branches. Only democracy is consistent in the view that securing a thriving economy in the future requires a present emphasis on flexibility, innovation and creativity. That, if one trusts in the needs of economic development as a driving force of history, is a factor feeding into some optimism on Russia's very long-term possibilities. But then, we know all too well this is not the sole option available.

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Economic Developments

Growth in fixed investment slows

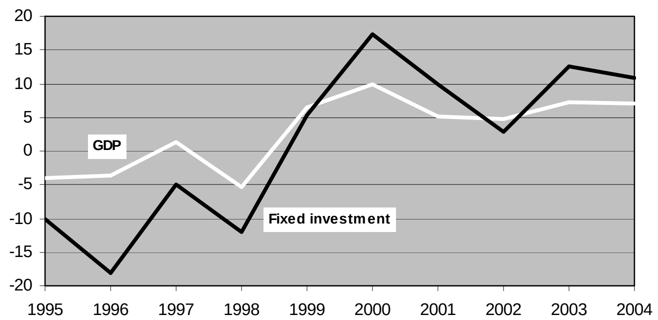
Russia's rate of growth of fixed investment has fluctuated greatly in recent years, largely following the rate of expansion in overall production. Last year investment growth dropped off slightly to 11 % and the first two months of the current year saw the on-year rate decelerating further to 7–8 % as against 13–14 % a year earlier.

A worrisome aspect of the slowing in investment is that it comes at a time when world market commodity prices are at record levels and Russian oil and metal companies are garnering huge earnings from exports. Extractive industries, along with most other industries, are in serious need of investment in order to increase production or at least maintain current levels over the longer run.

For the past few years, the share of fixed investment in Russian GDP has hovered around 18 %. This share is relatively low in international comparison, particularly when one takes into consideration Russia's huge investment needs.

The lack of adequate investment has set off a public discussion on the matter. Liberal members of the government blame increased uncertainty in the business environment during the past year as a major cause of the problem.

GDP and fixed investment (on-year % change)



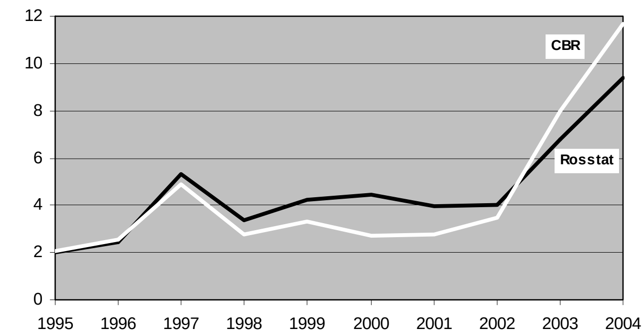
Source: Rosstat

Extractive sectors continue to dominate investment, although their share in overall investment has declined. In 2004, (data are available for January–September), the fuel sector received 19 % of all fixed investment, of which about two-thirds (11 %) went to oil extraction. The share of investment in the fuel sector, however, decreased two percentage points from the same period a year earlier. The share of investment in oil extraction decreased four percentage points. Ferrous metallurgy doubled its share in total investment to 4 %. In services, communications stood out with an increased investment share of 7 %. Transport continued to receive significant investment and had a 19 % share, due largely to active pipeline and port construction for energy exports.

Energy and Cyprus dominate FDI categories

The Federal State Statistics Service (Rosstat) reports FDI inflow to Russia was up last year 39 % and amounted to $9.4 billion, while in 2003 the increase was 69 %. Due to different compilation principles, these figures differ from the Central Bank of Russia's FDI figures, which are based on the balance-of-payments methodology and therefore preferred in international comparisons. Using the CBR figures, FDI inflows were up nearly 48 % last year and amounted to $11.7 billion.

FDI inflows according to the CBR and Rosstat, US$ bn



Source: CBR, Rosstat

Rosstat's various breakdowns of FDI provide some useful insights into FDI trends, although totals include uncertainties. Four sectors of the economy collectively received as much as 70 % of all FDI inflows into Russia in 2004. Oil and gas extraction led with a 42 % share, followed by metallurgy and manufacturing of metal products with 12 %, wholesale trade with 9 % and real estate, rental and business services with 7 %.

About 28 % of Russia's total FDI stock at the end of 2004 originated from Cyprus. In fact, this money is Russian money returning home. Cyprus has rapidly become an important source of FDI; it accounted for 13 % of Russia's FDI stock in 2001. Cyprus did not even make it into the list of Russia's top ten investor countries in 1995.

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1		
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	3.9	1-2/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	7.4	1-2/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	8.8	2/05
Exports, $ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	52.6	Q1/05
Imports, $ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	24.5	Q1/05
Current account, $ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	60.1	22.4	Q1/05

[1] *New methodology from 1.1.2005, figures for 2001-2004 revised, not comparable with previous years.*

Source: Federal State Statistics Service, CBR.

More spending pressure for Stabilisation Fund?

Since its inception at the start of 2004, the Stabilisation Fund has been at the centre of economic discussion. As of end-2004, its assets exceeded its original funding ceiling of RUB 500 billion ($18bn), meaning that any surplus beyond could be used for purposes other than covering budget deficits. The 2005 budget allows for covering the losses of the Pension Fund and redemptions on foreign debt from the Stabilisation Fund. In January, Russia repaid its debts to IMF ahead of schedule using some $3.3 billion of Stabilisation Fund resources. At the beginning of March, Fund assets stood at RUB 708 billion ($25bn).

During 2005, plenty of new spending needs have emerged. After the mismanaged introduction of the social sector reforms (see *BOFIT RR 02/05*), there has been pressure to correct the mistakes by giving regions more money from the Stabilisation Fund. Widespread protests resulted in government promises to raise wages and pensions, although not all these promises were incorporated into the 2005 budget. Pensions and budget-sector wages were increased more than planned in the first quarter. The government wants to double both by the 2008 presidential election.

Further pressure on Stabilisation Fund resources has come from plans to spur economic growth by decreasing the VAT and profit tax rates. The loss in revenue would be paid out of the Fund. According to the latest information, however, it appears the rate changes are on hold for the next few years. Instead, the government is now considering e.g. speeding up VAT compensation for capital investments and exports and introducing a special investment deduction of 10 % for enterprises buying new machinery.

Raising the Stabilisation Fund's threshold oil price in the 2006 budget from the present $20 to $23–27 per barrel has also been suggested. This move would leave more resources for covering rising budget expenditures. While this would slow the flow of money into the Fund, it could help in securing the Fund's assets for the future. After all, the fund was initially created to finance budget spending in times of low oil prices. The rapid economic growth of recent years seems to have blurred this initial aim.

Strong federal budget performance in 2004

As in previous years, the realised 2004 federal budget again showed a substantial surplus. In fact, the surplus was even larger than in the previous years (4.4 % of GDP) as a consequence of high commodity prices and tightened taxation on oil production and exports. This was seen in the huge growth of customs duties and natural resource payments. These two categories now account for almost 40 % of all federal revenues, compared to less than 30 % in 2003. Against this background, the government's aim to diversify the economy seems to be a real challenge.

Despite the fact that expenditures in relation to GDP declined in almost all major categories, spending still rose in real terms. The biggest gainers were law and order, administration and defence. As a result of the weak US dollar and increased loan redemptions, interest payments fell considerably both in real terms and in relation to GDP.

While the consolidated regional budget only showed a tiny surplus, with few exceptions, most revenues increased in real terms. From the standpoint of regional finances, the biggest loss was the slump in transfers. The other major hit came – quite surprisingly – from lower resource payments, which were up markedly in the federal budget. Nevertheless, as these revenues are channelled mainly to federal budget, their impact in regional budgets is seen only indirectly via increased profit tax revenues. This was the only source of revenue that increased from 2003 relative to GDP.

As in the federal budget, expenditures have declined as a share of GDP. In real terms, only road maintenance has decreased. The most positive sign is the decline of housing expenditures as a share of GDP, which seems to have been compensated by an increase of social policy outlays – a tendency well in line with the aim of transferring the burden of housing costs to the population.

Realised federal and regional budgets, % of GDP

Federal budget			**Consolidated regional budget**		
Revenues	2004	2003	Revenues	2004	2003
Total	20.4	19.4	Total	16.9	16.9
Tax revenues	18.8	18.0	Tax revenues	10.5	9.9
VAT	*6.4*	*6.6*	*Profit tax*	*3.9*	*2.6*
Customs duties	*5.1*	*3.4*	*Income tax*	*3.4*	*3.4*
Natural resource payments	*2.6*	*1.9*	*Property taxes*	*0.9*	*1.0*
Non-tax revenues	1.3	1.3	Non-tax revenues	6.2	7.0
Unified social tax (UST)	2.6	2.8	Transfers	1.6	2.3
Expenditures	2004	2003	Expenditures	2004	2003
Total	16.1	17.7	Total	16.7	17.3
Transfers*	2.4	2.8	Education	2.8	2.8
Defence	2.6	2.7	Health	1.9	1.9
Social spheres**	2.1	2.3	Housing	1.7	1.9
Law and order	1.9	1.9	Industry, energy, construction	1.8	2.0
Interest on debt	1.2	1.7	Social policy	1.5	1.3
UST	2.6	2.8			
Balance	4.4	1.7	Balance	0.2	-0.4

* mainly transfers to regional and local budgets
** mainly professional education and military and law enforcement pensions, but also health, social policy, mass media, culture and the arts spending

Sources: Rosstat, Minfin

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 budget
Revenues [1]	12.5	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	17.8
Expenditures [1]	20.9	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	16.3
Balance	-8.4	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	1.5
Foreign currency debt	31.6	30.2	50.1	87.7	55.3	44.4	36.2	25.7	18.3	
Foreign currency debt, $ bn	136.1	134.6	158.2	154.6	143.4	133.1	123.5	119.7	110.5	

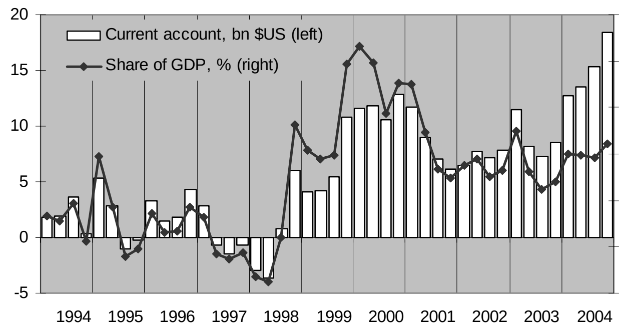
[1] *Since 2002 the unified social tax is included in the federal budget.*
Source: Budget: IMF 1996–2000, Federal State Statistics Service 2001–2004. Debt: IMF 1996–1999, Minfin 2000–2004.

Russian current account surplus continued to grow in 2004

In end of March, the CBR released the 2004 balance-of-payments figures. The data show Russia's 2004 current account surplus amounted $60 billion, or 10 % of GDP. Moreover, growth in the current account surplus accelerated towards the end of the year.

The strong surplus is largely caused by increasing oil export incomes during 2004. Crude oil and oil product exports alone brought export earnings of $79 billion and grew by 34 % from a year earlier. The CBR figures also reported a trade account surplus for goods of $87 billion, while the service account was $15 billion in the red. Overall foreign trade surplus was $74 billion.

Russian current account 1999-2004, quarterly



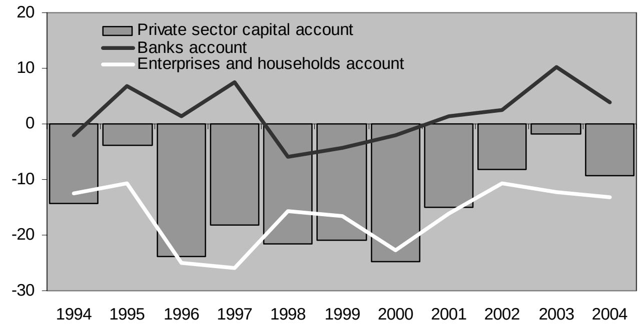
Sources: CBR, IFS

High current account surplus increased liquidity in economy

Russia's large current account surplus has also become problematic, since it increases liquidity in the economy. For an economy with huge foreign currency inflows, the ability to absorb that liquidity is crucial. Otherwise, the country may face large disturbances from e.g. inflation. So far the CBR has purchased massive amounts of foreign currency to restrain rouble appreciation. The balance-of-payments figures indicate Russia's foreign exchange reserves increased by $45 billion in 2004. The CBR's total foreign currency reserves stood at $125 billion dollars at the end of 2004, which equalled 21 % of GDP.

The liquidity inflow through the current account was partly neutralised by increased private capital exports from Russia. In 2004, the private sector capital account was $9.4 billion negative, down from $1.9 billion negative a year earlier. Private sector capital export is still modest compared to the late 1990s, but it is notable that the trend has changed and the deficit in the account is again increasing. In Russian politics and media, capital exports are usually termed "capital flight" from Russia. However, certain capital exports are normal for countries with high current account surpluses, as they help investors distribute investment risk.

Private sector capital account 1994-2004, US$ bn

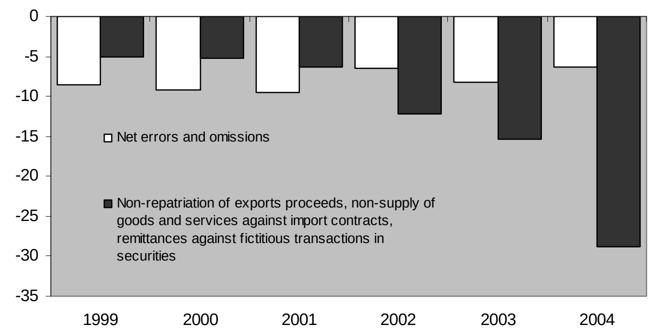


Source: CBR

Private capital export driven by enterprises and households

The large private sector capital deficit was driven by capital exports of non-financial enterprises and households. The banks account, in contrast, was positive. In 2004, the capital account of non-financial enterprises and households was $13.2 billion in the red. The deficit was largely caused by a deficit of $26 billion for the item "non-repatriation of export proceeds, non-supply of goods and services against import contracts and remittances against fictitious transactions in securities". This category considers many undefined and even grey capital transactions. The growth in this unspecified category has been significant; in 2003, it was just $15 billion negative. The other category that captures grey transactions is the net errors and omissions item included in the enterprises and households capital account. This was $6.4 billion negative, a decrease of 22 % from a year earlier. It is worth noting that private sector FDI and portfolio accounts were positive ($2 billion and $0.6 billion) as Russia imported more such capital than it exported in 2004.

Undefined and grey capital transactions accounts, US$ bn



Source:CBR

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	13.3	3/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	29.3	2/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	268	2/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.3	1/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.8	1/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	134.2	2/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	27.83	3/05

Source: Federal State Statistics Service, CBR.

Some insights for Russia's Stabilisation Fund

by Simon-Erik Ollus*

The typical purpose of a non-renewable natural-resource-based stabilisation fund is to help a government deal with its large, fluctuating income from natural resource use. Such funds aim at buffering fluctuations in budgetary revenues, achieving short-term fiscal targets and preparing for long-term spending needs. Most natural-resource-based stabilisation funds are based on oil income, but they may also be based on earnings from sales of, e.g. diamonds and copper. A good example is the Norwegian State Petroleum Fund, which, in addition to providing short-term fiscal stabilisation across the oil price cycle, acts as a mechanism for transferring wealth from current resource exploitation to future generations. In contrast, the Russian Stabilisation Fund is designed almost solely to serve short-term purposes.

The Russian Stabilisation Fund was established in February 2004 with the transfer of a share of RUB 106 billion in budget revenues from 2003 to initially capitalise the fund. The Fund is financed from the natural resource extraction tax and crude oil duties when the price of Urals-grade oil exceeds $20 a barrel. During 2004, the Fund grew faster than expected due to the rapid rise in world oil prices. By the end of 2004, the Fund's value was RUB 522 billion ($18bn), which was equal to 3 % of Russian GDP.

Under the Budget Code, the first RUB 500 billion accumulated in the Fund may only be spent on financing federal deficits that occur when the Urals oil price falls below $20/bbl. This initial RUB 500 billion represents the projected deficit caused by two consecutive years of low oil price (around $15/bbl). Above the 500-billion-rouble ceiling, the government is free to spend revenues for purposes agreed with the Federal Assembly. Such purposes presently include early repayment of foreign debt and spending on certain structural reforms.

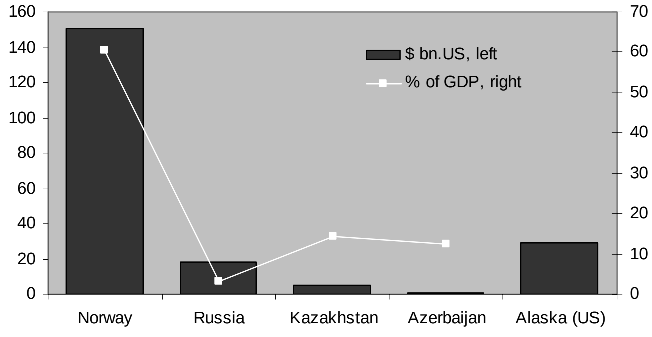
Like the funds in Norway and Kazakhstan, the central bank manages the Fund according rules set down by the Ministry of Finance. According to the current plan, revenues from the fund may only be invested in foreign securities defined by the government. A beneficial side effect of the arrangement is that investments from the stabilisation fund tend to stabilise the exchange rate, by helping to curb excessive money supply and, hence, inflation.

The history of oil-based stabilisation funds has so far been mainly disappointing. During the 1980s, when oil prices fluctuated severely, many countries got rid of their oil funds because governments found it hard to differentiate between temporary and permanent price changes and therefore when to ease up or crack down on collections. As stabilisation funds are usually outside existing budget systems, the misuse of the funds by insiders has also been a common problem. In a 2001 IMF study,** researchers found that in most countries with oil-based stabilisation funds the creation of a fund did not stabilise government income over fluctuations. Instead, they complicated fiscal policy. The study suggests that governments should concentrate on fiscal policy in a long-run context, focusing on maintaining a sustainable non-oil fiscal balance and restraining expenditures when oil prices rise. The study's notable exception was Norway. The State Petroleum Fund in Norway was considered successful precisely because it actually was large enough to absorb fiscal fluctuations and transparently administrated without rent-seeking. The Norwegian fund is by far the largest of all such funds and it is clearly designed for long-term stabilisation.

A quick comparison of the Russian Stabilisation Fund with other funds reveals that the Russian fund is both younger and smaller than its counterparts. Russia's original plan was a modest fund of RUB 500 billion, but it has so far continued to collect it beyond that limit. As it is managed by the central bank and used only according to political decisions, the risk of misuse is lower than in most oil-rich states. However, the pressure to ease up on collections grows constantly. The plans to invest in foreign securities is healthy, since investing in domestic markets carries the risk that volatility of resource revenues could spill over into the economy.

The lesson of the IMF study on stabilisation funds is that such funds cannot be a substitute for effective fiscal policy. Instead, funds should be seen as tools for stabilising fiscal policy over time. Because size matters here, the Russian government should strive to continue building the fund during periods of high oil prices and acknowledge the goal of long-term stabilisation. For Russia, the creation of a substantial stabilisation fund during this window of opportunity may prove more valuable than gold down the road.

Size of some natural resource based stabilisation funds in end of 2004



Source: Various central banks, IFS, CISSTAT

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** Davis, Ossowski, Daniel and Barnett (2001), "Stabilization and Savings Funds for Nonrenewable Resources," IMF Occasional Paper No 205.

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Economic Developments

Industrial production slows

After having stayed steadily at about 7 % in 2004, quarterly industrial production in the first three months of 2005 was up just 3.9 % from a year earlier. Most of the main industrial sectors did not achieve growth comparable to 2004, but there were a few interesting exceptions. Within the manufacturing sector, which was up 5.3 % overall, machine building grew almost 14 %, wood processing 8 % and production of vehicles 7 %. The generally low growth figures raised discussion as to whether they signal a permanent change or simply reflect transient factors. The Ministry of Economy linked the decrease to lower foreign demand and investment activity, as well as growing foreign competition.

Private consumption strong, but decelerating?

About half of Russia's GDP goes to private consumption, which since 2000 has been the main engine of the country's economic growth. In the past four years, private consumption has risen considerably faster than GDP. Of the other two main components of domestic demand, fixed investment growth in the 2000s has fluctuated from year to year, reflecting partly the presumed changes in the business atmosphere of Russia. Public consumption has grown quite steadily, but slowly, at an annual pace of some 2 %.

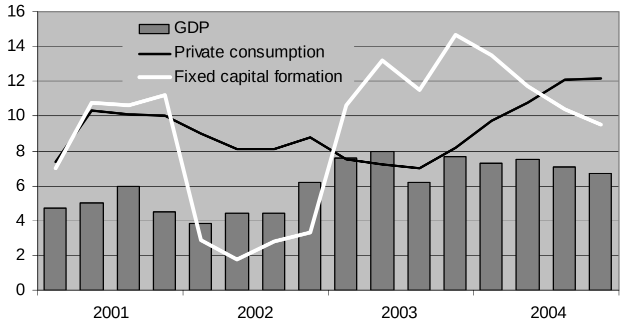
The strong growth in private consumption partly reflects increasing real incomes, which have grown annually on average by almost 12 % during 2000–2004. At the same time, retail trade turnover has increased in real terms by 10 % annually. However, the latest figures on both real incomes and retail trade point to slowing growth. In the first quarter of 2005, real incomes grew a mere 2.2 % (down from 13.6 % in 1Q04). Retail trade, however, was up 9.6 % in the first quarter, and only moderately down from the 10.4 % growth posted in 1Q04. Especially trade in consumer goods was remarkably buoyant, climbing 14.4 % y-o-y in the first quarter.

About 45 % of retail trade turnover is made up of food products and 55 % of other goods – a division that has remained quite stable throughout the 2000s. Meat and meat products are the major outlay in Russian household food purchases. For other consumption goods, a third of consumption currently goes to clothing and shoes. Other major categories are household furniture, home improvement materials and cleaning, transport, personal hygiene and medicines, and household appliances.

While about 60 % of total private consumption still consists of spending on goods, the importance of services has been increasing. Services presently account for almost a fifth of private consumption. The total turnover of retail trade in 2004 was almost $200 billion and the value of services amounted to $90 billion.

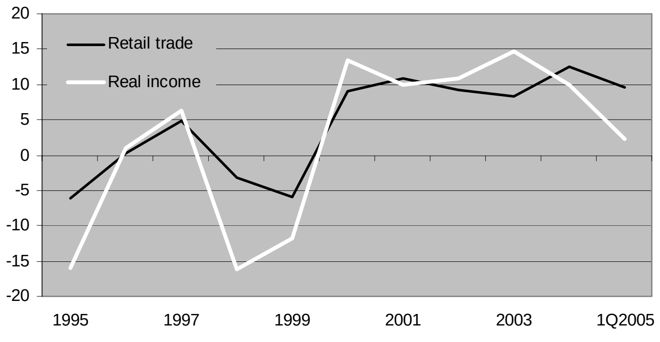
The structure of commercial services used by Russian households has changed slightly over the past five years. Of the major categories, the share of transport services has declined from over a quarter to about fifth. Telecommunications, in turn, have increased their share by six percentage points to over 17 %. Public utilities also account for some 17 % of the total commercial household services, up from 13 % in 2000.

GDP, private consumption and investment, % change from same quarter of previous year



Source: Rosstat

Change in retail trade turnover and real income, y-o-y change



Source: Rosstat

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1		
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	3.9	Q1/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	7.6	Q1/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	8.3	3/05
Exports, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	52.6	Q1/05
Imports, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	24.5	Q1/05
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	60.1	22.4	Q1/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

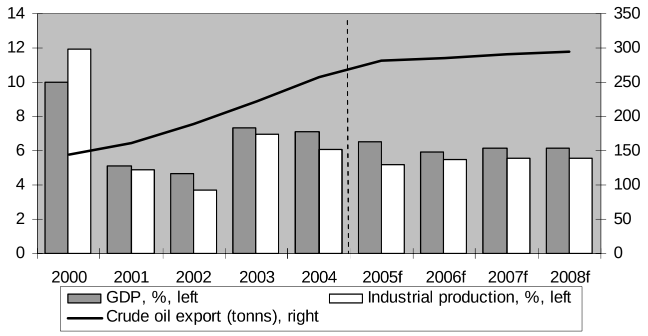
Sources: Rosstat, CBR.

Government agrees on medium-range forecast

The government approved in early April the economy ministry's economic forecast for 2006–2008. The forecast was first presented to the cabinet last December, but was sent back to the ministry several times for revision. Prime minister Mikhail Fradkov was particularly dissatisfied with the cautiousness of the growth figures, which, if realised, would jeopardise the president's declared target of doubling GDP in ten years. The more liberal finance minister Alexei Kudrin and economy minister German Gref warned that growth may slow if growth in oil production and oil exports decline. They consider the goal of a rapid doubling of GDP unrealistic.

The approved forecast has two versions: a baseline forecast that assumes annual growth of 4.5–4.6 % during 2006–2008, and an optimistic version that anticipates 5.9–6.2 % growth in the same period. The optimistic forecast is built on the baseline forecast, but they differ on assumptions for oil prices, investment trends and economic efficiency. The optimistic forecast also anticipates a proactive or innovative approach from the government side in promoting growth. The optimistic scenario occurs quite realistic in its figures and its growth target seems to be closer to that the government is anticipating for. The forecast also revises upward the expected GDP growth for 2005 from 5.8 % to 6.3–6.5 %.

GDP and industrial production annual growth and crude oil export forecasts in the optimistic scenario



Source: Rosstat, EconMin

Both scenarios estimate a slide in the oil price, with the price of Urals grade down to between $28/bbl and $33/bbl in 2006–2008, while in Q12005 the Urals crude price averaged at $43/bbl. The falling oil prices in 2006 would also affect the nominal value of exports in dollar terms, as over 40 % of Russia's export income are based on oil export. The scenario estimates that the growth in the volume of oil exports would slow to 1–2 % a year, which is more pessimistic than the economy ministry's earlier forecasts.

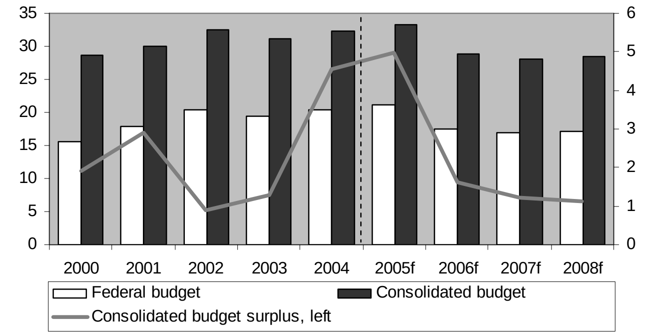
Under the scenarios, annual inflation is expected to be in the range of 8.5–10 % this year, declining gradually to 4–5.5 % in 2008. The real effective exchange rate of the rouble is expected to appreciate 8–9 % this year and then in the optimistic version appreciate by 2-3 % annually until 2008. The baseline forecast is based on a +/- 1 % annual appreciation for 2006-2008. However, the effective exchange rate of the rouble in the first four months of this year was already up 6.6 %.

Government approved financial plan targets for 2006–2008

According to the mid-term economic forecast, the basic parameters of its financial plan for 2006–2008 will function as a frame budget for the coming years. Budget surpluses are expected to fall to 1.8 % of GDP in 2006 and then drop further to 1.2 % in 2007 and 2008. In 2004, the budget surplus was about 4.3 % of GDP. Federal budget revenues are projected to drop from 20.4 % of GDP in 2004 to 17.8 % of GDP in 2006 and further to about 17 % in 2007–2008. The decline is largely counted on the expectation of a decreasing growth speed in oil production.

The government wants ministries to submit their budget proposals for 2006 using these approved parameters by the beginning of next month.

Budget revenues and consolidated budget surplus according to the optimistic scenario, % of GDP



Source: Rosstat, EconMin

Stabilisation fund cut-off price raised to $27/bbl

In approving its mid-term economic forecast, the government also raised the cut-off price for tax revenues to be channelled to the stabilisation fund from current $20/bbl to $27/bbl for 2006. The increase in the cut-off price was opposed by finance minister Kudrin, who even asked to have his objection recorded in the minutes. According to Kudrin the high cut-off price will hamper growth of the fund and lead to too much liquidity in the economy. He proposed limiting the cut-off price to a maximum of $25/bbl. The move has also been questioned by some international observers.

According to the target of the optimistic scenario, the government expects the stabilisation fund still to reach RUB 2,090 billion (USD 76 billion or 7.2 % of GDP) by January 2009. Under the baseline version, it would still reach RUB 1,200 billion (USD 43.4 billion). The fund held RUB 522 billion (USD 18.1 billion or 3.1 % of GDP) as of January 1 this year, and, according to preliminary data, RUB 857 billion on May 1.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of	2005 budget
Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	27.7	1-2/05	17.8
Expenditures [1]	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	16.5	1-2/05	16.3
Balance	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	11.3	1-2/05	1.5
Foreign currency debt	30.2	50.1	87.7	55.3	44.4	36.2	25.7	18.3			
Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	110.5			

[1] *Since 2002 the unified social tax is included in the federal budget.*

Source: Budget: IMF 1997–2000, Rosstat 2001–2004, EEG 2005. Debt: IMF 1996–1999, Minfin 2000–2004.

High liquidity in the money market

CBR preliminary data show Russia's current account surplus in 1Q2005 reached a record $22.4 billion. This was nearly twice as high as the $12.8 billion surplus in 1Q2004. Capital inflows also increase during the same period. FDI to Russia amounted to $5.4 billion ($4.8bn in 1Q2004) and gross external borrowing was $8.5 billion ($3bn in 1Q2004). Consequently, net capital outflow was very small in January-March this year. Due to the strong current account and small net capital outflows, the CBR's international reserves rose by $20 billion to $144 billion in early May.

The money market continues to be characterised by high liquidity. To keep the rouble from appreciating too much, the CBR has had to keep buying foreign currency and consequently provide large amounts of domestic liquidity. One consequence of this is that the money supply (M2) continues to grow rapidly. Another direct consequence of relatively high liquidity is visible in the sizable balances that banks hold in their correspondent accounts in the CBR. In recent months, total average daily balances have hovered close to RUB 300 billion ($10.8bn).

Negative real interest rates

As net capital outflows have at least temporarily fallen, the excess liquidity is likely to lead to lower interest rates, credit expansion and possibly higher inflation. Interbank credit rates have indeed been very low, with the overnight rate hovering around 1 % the past few months. Moreover, the CBR's refinancing rate has been 13 % since June 2004, which is slightly below the CPI inflation in March-April this year. The refinancing rate, of course, has little practical significance as banks do not need central bank financing in the midst of a flood of excess liquidity.

Commercial banking interest rates have, as a rule, been lower than the refinancing rate. The interest rates in retail banking have steadily decreased in recent the last years. The average real interest rate on deposits with maturities up to one year has been clearly negative ever since the 1998 crisis. During the last year the deposit rate has hovered around 4 % p.a. This may be explained (at least partially) by the nearly monopolistic position of Sberbank in the market for household deposits. The average rate for time deposits up to one year's maturity was 9.5 % in January-February 2005. Average real interest rates on loans to the non-financial sector with maturities up to one year have recently also turned negative (see chart opposite). Low real interest rates and a growing economy have encouraged more loan-taking. Commercial rouble credit to the corporate sector increased 44 % in 2004.

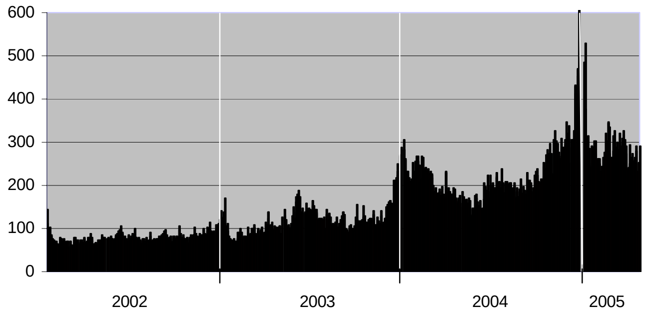
The low interest rates are mirrored in low yields for corporate and municipal rouble bonds. Yields for first-tier bonds have lately been around 7–8%, while the annual inflation in April was 13.4 %. Moreover, the domestic bond market has expanded rapidly. The value of outstanding corporate bonds increased by 75 % in 2004 and reached RUB 307 billion ($ 11 bn) in December 2004 – and the expansion continues this year. Growth nonwithstanding, however, the absolute volumes are still too small to be of any significant help in managing banking sector's liquidity.

Challenges for monetary policy

The monetary policy guidelines for 2005 state an inflation target of 7.5%-8.5% and real appreciation of the rouble of not more than 8%. Due to high current accout surpluses, achieving both is becoming even more challenging. The increases in export duties (from $83/tonne in February-March to $105/tonne for April-May), largely channeled into the stabilisation fund, certainly helped absorb liquidity. Even so, as of end-April both CPI inflation and rouble appreciation exceeded 6 % since the start of the year.

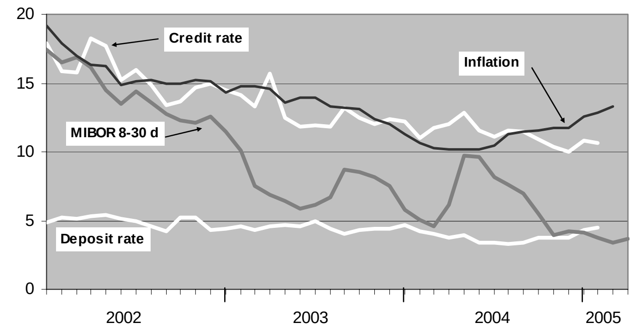
The CBR is hard pressed in its attempt to meet two monetary targets. If it wants to tackle excess liquidity that may in the end result in a credit bubble and consumption boom, it needs to raise interest rates. On the other hand, given the current exchange rate, such a move would likely increase capital inflows and defeat the initial aim.

Commercial bank balances for CBR correspondent accounts, 2002–2005



Source: CBR

Selected interest rates (% pa) and CPI (% y-o-y change)



Source: CBR

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	13.4	4/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	30.8	3/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	284	3/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.5	2/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.6	2/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	137.4	3/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	27.77	4/05
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	36.01	4/05

Source: Rosstat, CBR.

Reconsidering innovation in Russian firms

by Ksenia Yudaeva*

There is a widespread belief that Russian firms do not innovate. This view seems to derive from the treatment of innovation in industrially advanced countries as something that involves massive R&D spending and application of radically novel technologies. In contrast, the "distance to frontier" theory suggests that firms in economies farther from the world technological frontier may achieve rapid growth by copying technologies and products developed elsewhere. In many cases, a strategy of adopting and modifying existing technology produces faster growth rates than attempting to grow through vigorous investment in building a local knowledge base.

Rosstat applies a limited definition of innovation and reports that only about 9 % of Russian firms innovate. In contrast, our 2004 CEFIR-IET survey, which includes imitation, suggests at least 40 % of Russian firms innovate. According to both sources, over 60 % of innovations come in the forms of new equipment or products. Only about 30% of innovating firms reported that they conducted R&D. The CEFIR-IET survey also had firms distinguish as to whether their innovative products or technologies were imitations or originals. Among the 727 firms surveyed, 196 firms had innovation strategies based purely on imitation, 148 firms innovated solely through the introduction of novel products or technologies and 157 firms pursued an innovation strategy that incorporated both copying and originality.

Self-assessment and regression analysis

When asked why they innovate, most firms mentioned the need to improve profitability or decrease costs. Increasing market share and gaining access to new markets was also stated to part of the development strategy for over 60 % of innovating firms.

Lack of finance was reported as the largest obstacle to innovation. Since retained earnings are the main source of funding for innovation, it was hardly surprising that over 80 % of firms identified lack of finance as a serious obstacle to innovation. Lack of external funding, whether through government support or private funds, was the second most important factor. Less than 25 % of firms saw a shortage of qualified personnel and management as a significant barrier.

Regression analysis on both datasets confirms the hypothesis that credit constraints are an important obstacle to innovation. Profit turned out to be positive and significant determinant of probability of innovation. Competition has an inverted U-shape effect on innovation. A small amount of competition pressure initially increases the likelihood the firm will innovate, but eventually competition becomes so intense it erodes profitability to an extent that it is detrimental for innovation.

Comparison between imitators and innovators revealed that innovators seemed less worried about profitability than imitators. We suggest two explanations for this finding. First, access to non-government external funding may in itself be considered an innovation by some Russian firms; such funding was simply unavailable in the Soviet era. Those that see themselves as innovators may simply be more proficient at raising such money than imitators. A second interpretation is that the group of innovators is likely heterogeneous. In addition to "true" innovators, the classification may include "survivors," i.e. non-profitable firms that hope to survive through introducing new products. In fact, these new products may well be imitations, and the claim of original innovation merely reflects the firm's lack of technological knowledge.

Finally, the likelihood a firm will imitate is positively associated with the likelihood that the firm has a foreign-educated manager or a manager that has participated in training abroad. In other words, imitators tend to follow a "westernisation" strategy, whereby they copy foreign products and managerial techniques. Imitators also do fewer marketing studies than innovators. Probably they simply assume there will be a high demand for imitations of foreign products anyway.

A silent revolution

We conducted a new round of the CEFIR-IET innovation survey early this year. The results indicate that the innovation rate is increasing. Over 60 % of the nearly 800 firms responding said that they had introduced new products within the past three years. About 40 % of respondents also reported they had made organisational changes and conducted personnel training.

The increase in imitation largely accounted for the higher innovation rate. Thus, although aggregate statistics are silent on this, Russian industrial firms are apparently undergoing a massive restructuring both from the technological and organisational standpoint. As predicted by the "distance to frontier" theory, this restructuring is mainly based on imitation strategies, i.e. firms are introducing products and technologies that are close substitutes for existing ones. Only a small proportion of firms introduced novel products.

Given Russia's technological backwardness, technology adoption is an efficient growth strategy at this stage. However, this does not mean that the government does not have to think about creating infrastructure and an institutional environment that promotes the efficient use of human capital. Strengthening Russia's knowledge base will gain urgency as the country's technological position improves.

** Director for Policy Studies, CEFIR, and scholar in residence, Carnegie Moscow Center. The article is based on the "Imitations and Innovations in a Transition Economy," by K. Kozlov and K. Yudaeva, mimeo, CEFIR.*

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Economic Developments

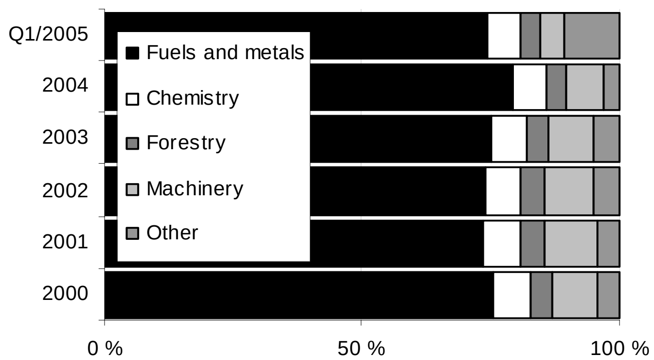
Fuels and metals make up 79 % of exports…

Russia's trade balance had a record-high surplus of $87.2 billion in 2004. Based on CBR data, it seems possible that a new record will be achieved this year. During 1Q05, exports increased by 41 % and imports by 25 % compared to the same period last year. The trade balance posted a surplus of $28.1 billion in the first quarter, a figure $10 billion higher than a year ago.

According to Rosstat, the share of energy resources (oil, oil products, gas, coal, coke and electricity) and metals in total exports in 1Q05 was 78.9 % up from 74.3 % a year ago. The increased share of the raw materials in total exports is mainly caused by the sizable increase in world market prices of Russia's basic export items. Crude oil is the most extreme example. While the value of crude oil exports increased by 42 % y-o-y in 1Q05, export volumes stayed at the level of 1Q04. Machinery and equipment accounted for less than 5 % of total exports.

The structure of exports has stayed relatively stable over recent years. Russia is still overwhelmingly a raw material exporter and consequently extremely sensitive to fluctuations in world market prices. New export items are yet to be seen. Equipment for nuclear power stations and aircraft account for over half of non-CIS machinery exports.

Structure of Russia's exports 2000-2005



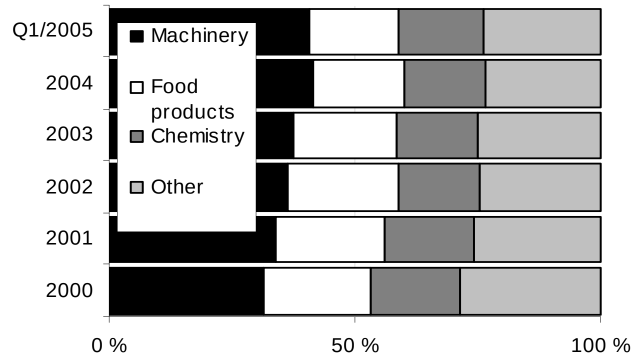
Source: Rosstat

…while cars and machinery dominate imports

Basic consumer goods continue to dominate Russian imports. According to Rosstat information, the share of machinery and equipment in total imports has steadily increased from 31 % in 2000 to 42 % last year. Much of the machinery is not investment goods, but rather consumer goods such as passenger cars and mobile phones. In 1Q05, the fastest growth was registered in car imports; the number of foreign cars imported into Russia increased 66 %.

Consumer goods, rather than investment goods or raw materials, also dominate other major import categories. Import restrictions notwithstanding, foodstuffs continue to be the second largest group of import items. Russia continues to import meat and meat products, chicken and fish in large quantities. Also the volumes of alcoholic beverages imported have increased rapidly. Pharmaceutical imports are the largest item in the chemical products category.

Structure of Russia's imports 2000-2005



Source: Rosstat

EU-25 dominates Russia's foreign trade

Russia's main trading partner is unquestionably the EU. Since enlargement in May last year, the EU has accounted for about half of Russia's foreign trade turnover. In 2004, 50 % of Russian exports were directed to the EU and 45 % of Russian imports came from the EU area. During the first four months of this year, the EU's share of trade turnover has (due to increasing oil prices) risen to 54 %. CIS countries account for about 15 % of Russia's exports and around 23 % of imports.

According to Federal Customs Committee, Russia's main trading partners in January-April this year were Germany, the Netherlands, Italy, Ukraine and China. Finland was Russia's eighth largest trading partner.

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1		
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.2	1-4/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	9.6	1-4/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.9	4/05
Exports, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	52.6	Q1/05
Imports, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	24.5	Q1/05
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	60.1	22.4	Q1/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*
Sources: Rosstat, CBR.

Russia signs debt deal with Paris Club

After the collapse of the Soviet Union, Russia agreed to service Soviet-era foreign debt in exchange for all Soviet property abroad. Although the debt was rescheduled several times in the 1990s, Russia has consistently met its repayment schedule throughout the 2000s. In mid-May 2005, Russia struck a deal with the Paris Club of creditor nations on early repayment at par of $15 billion of the debt. As the prepayment program is voluntary, Russia has yet to sign bilateral agreements with the creditor countries affected. However, the majority have indicated their willingness to go along with the arrangement. The finance ministry reports that Russia's foreign currency debt as of end-March amounted to $108 billion, of which the debt to Paris Club members stood at about $46 billion (nearly half was owed to Germany).

High oil revenues have provided Russia with the luxury of paying down debt in advance. Russia calculates the early payments will save as much as $6 billion in interest payments by the end of 2020. Moreover, the fact that Stabilisation Fund reserves will be used for paying down debt rather than finance domestic spending will help reduce inflation pressures. As an aside, the move also heads off further selling of bonds linked to Soviet-era debt. Russia was not pleased when Germany last summer repackaged some of its Paris Club debt as Aries Notes.

Budget planning to become long-term and performance-oriented

The reform of Russia's budget system has continued for several years. Along with reforming relations between the federal centre, regions and localities, a top priority is to make the use of state funds more effective. The purpose is to give budget organisations at regional and local levels more freedom to decide how to use the funds allocated to them, while making them responsible for the consequences of their decisions (performance-oriented budgeting). Budget resources until now have mainly been allocated by indexing the resources of the previous year. In the future, tentatively from the beginning of 2006, the efficiency of the use of expenditures will be measured by certain qualitative or quantitative indicators. The results will have an effect on the allocation of resources in the following years. Starting from 2006, Russia will also move to three-year budget plans, which e.g. allows for better follow-up of programs lasting longer than a year.

As a part of the budget reform, the Duma approved at the end of 2004 a law on changes to budgetary classifications. These amend the structure and contents of revenues and expenditures for all budgetary levels. The new classification system should encourage performance-oriented budgeting through improved transparency. International comparisons should become easier, as classifications start to approach international standards for financial statistics.

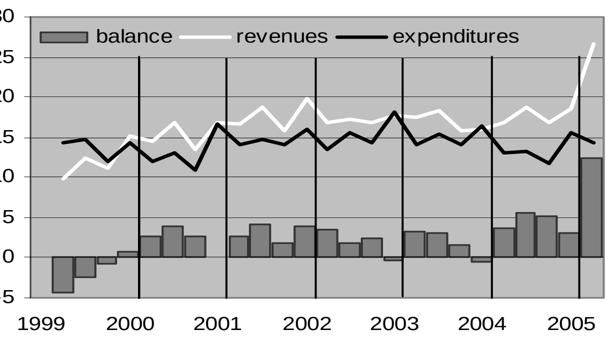
First quarter federal budget surplus larger than ever

Compared to first-quarter budget performance of previous years, the surplus in Q105 was exceptionally large. Budget revenues stood at over 28 % of GDP, while expenditures were below 17 % of GDP (and thus producing a surplus of 12 % of GDP). The favourable situation was produced mainly thanks to additional revenues from redemption of tax arrears by the Yukos and Sibneft oil companies and from the auction of Yuganskneftegaz. Other reasons for the substantial surplus were high oil prices and changes in oil taxation. In January-March, Urals-grade crude sold at well over $40 a barrel, up from $27 in early 2004. The oil export duty regime was also restructured in August 2004 to charge higher duties in case oil prices exceed $25 per barrel. From the start of 2005, the basic mineral tax rate on oil rose 15 % to 400 roubles per tonne.

Despite the surging revenues, expenditures were kept under control. In real terms, expenditures in Q105 were only slightly higher than a year earlier. Spending priority was given to budget sector employees, pensioners and other special groups, which, due in part to bungled social sector reforms, were given more funds from federal budget than planned.

In the future, there will be greater pressure to spend. At the start of June, the government approved an amendment to the 2005 budget boosting social sector spending. Preliminary information indicates the decision will increase 2005 budget expenditures by some 10%. As the threshold oil price for the Stabilisation Fund will be raised from $20 to $27 per barrel at the beginning of 2006, there will be even more opportunities for budgetary spending. Both the president and prime minister strongly support increasing social sector outlays, while also calling for measures to combat rising inflation.

Federal budget indicators (% of GDP)



Source: Compiled from information provided by the Economic Expert Group

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

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Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	28.1	1-3/05	17.8
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Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	114.4	108.3	03/05	

[1] *Since 2002 the unified social tax is included in the federal budget.*
Source: Budget: IMF 1997–2000, Rosstat 2001–2004, EEG 2005. Debt: IMF 1996–1999, Minfin 2000–2004.

Russia starts redeeming Paris Club debt next week

The Russian Federation will commence early repayment of Paris Club debt on June 11. The $46 billion Soviet-era debt will to begin with be cut by an instalment of $13 billion and financed out of the Stabilisation Fund. Another $2 billion will be credited to debtors within the next two years. The implications of rapid debt reduction on sovereign bond ratings are favourable as long as other macroeconomic factors such as the budget and current account surpluses and oil price retain their positive character.

Readjustments in exchange rate policy

On May 16, the CBR increased the euro component in its dollar-euro currency basket, which is used to guide the rouble's market value. The euro's weight was increased to 0.3 and the dollar's weight lowered to 0.7. The widely anticipated move reflects euro's increasing importance in Russian foreign trade. When the currency basket was introduced on February 1 this year, the euro had a weight of 0.1

The CBR will continue to steer the exchange rate to avoid excessive revaluation of the national currency. The rouble's real effective exchange rate appreciated 7.4 % in the first five months of this year. Measured against the euro, the rouble's real exchange rate appreciated by 11.3% in January–May. It is becoming increasingly clear that achieving the monetary policy target of holding real appreciation of the rouble to 8 % in 2005 has become a major challenge.

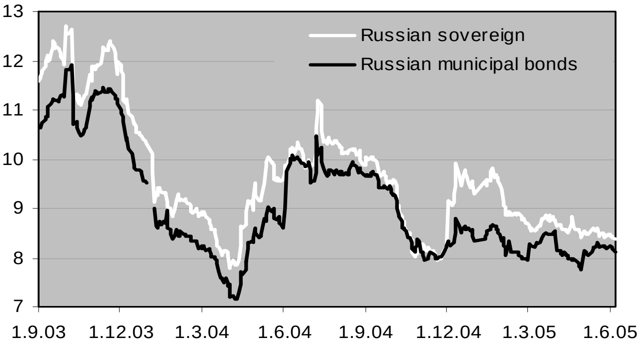
CBR Deputy Chairman Alexei Ulyukayev announced this week that the central bank is prepared to allow the rouble exchange rate to appreciate by up to 10 %. This seems to reverse chairman Sergei Ignatyev's statement of a week earlier that the CBR was ready to fight rouble appreciation as it hurts domestic producers' competitiveness.

Bond markets grow in nominal terms

The large increase in liquidity in the Russian economy is evident in the fact that rouble-denominated government bonds keep attracting investment at zero or negative real interest rates. Figures for Russian government domestic debt (GKO-OFZ securities) shows that, in the first five months of this year, the value of outstanding domestic government debt has risen by just over 7 % and exceeded RUB 811 billion ($ 29.3 billion) on June 1. The increase corresponds exactly with year-to-date inflation in the economy. The average daily turnover of government paper in January–April was below RUB 1 billion.

The structure of the debt has undergone dramatic changes in the past five years. Today, most (70 %) government debt is in bonds with principal amortisation; constant and fixed coupon bonds make up practically all of the remainder (10 and 20 %, respectively). The yields on government paper have been stable at 7–8 %. Interestingly, major corporate borrowers such as RAO UES and Gazprom boast yields below 5 %. Also some municipal bonds such as Moscow City produce yields below sovereign paper.

Average weighted yields of Russian sovereigns and municipal bonds



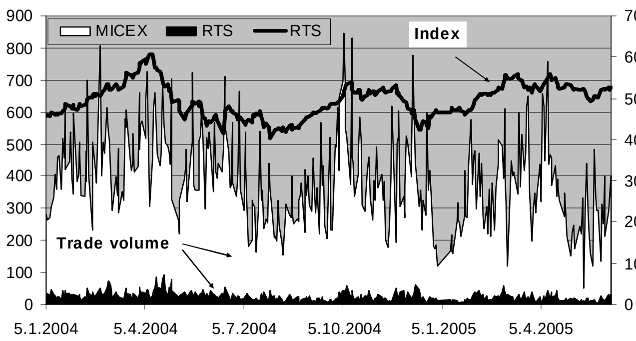
Source: Cbonds

Equity markets calm

The RTS index started the year at 607 points, and after 18.5 % increase reached its highest point this year (720) in early April. During late April and May the index declined somewhat and it now stands at just above 674. The Yukos affair has not greatly affected the stock market indices lately as the weight of Yukos in RTS index has already decreased to half a percentage point.

Average daily volumes on the RTS and MICEX stock exchanges declined somewhat during the first five months of the year. Average daily volume on the MICEX was about $ 275 billion in January-May this year, some 15% below the average daily volumes in 2004.

RTS stock exchange index, right scale and RTS and MICEX trading volumes, US$ bn, left scale



Source: MICEX, RTS

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	13.6	5/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	31.7	4/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	292	4/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.2	3/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.5	3/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	147.4	5/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.09	5/05
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	35.20	5/05

Source: Rosstat, CBR.

Is lower output growth here to stay?
by Simon-Erik Ollus*

The growth of industrial production is usually a good estimate for GDP growth in Russia, as industrial production is by far the largest single production component in the GDP. Rosstat reports that industrial production accounted for 27 % of the GDP in 2004. The World Bank, however, point out that the actual contribution to GDP is probably much higher due to transfer pricing. Rosstat attributes just 20 % of industrial production to the fuel industry, while the World Bank puts its real weight at close to 50 %. Hence, movements in industrial production correlate closely with those in oil production.

In January-April 2005, industrial production grew just 4.2 %, dropping off the 4.9 % GDP growth pace of the first quarter as indicated by preliminary statistics. The decline in industrial production growth got under way in mid-2004 and has remained modest ever since. Moreover, the growth rates in extractive industries (includes both fuel and metals) have declined since the latter half of 2004.

Notably, the significant decline in oil production growth rates has continued for eight months in a row. After five years of steady production growth of about 10 % annually, growth has recently tapered off to 3–4 %. The reasons behind the declining growth rates are many, but capacity constraints, the business climate and taxation certainly have contributed. This lower growth reflects maxed out Soviet-era capacity and the lack of investment in developing new fields. Moreover, the Yukos affair has done little to improve the business climate or encourage desperately needed new investment.

Growth in export volumes of Russia's main export item, crude oil, has also declined. Rosstat figures show that crude oil export volumes increased only 0.6 % y-o-y in Q1, compared to 15 % in 2004 and 18 % in 2003. This decay is obscured by high world oil prices, which lifted Russia's oil export earnings 42 % y-o-y in Q1. Even if higher oil prices continue to lift export earnings, the GDP-boosting effect of oil production should ultimately fade.

If growth rates in resource-based production decline further (or even stay at their current modest levels), Russia will need very high growth rates in manufacturing to sustain GDP growth above 7 % – the president's officially declared target. However, this does not seem to be the case. Also the manufacturing sector growth started to decline at the end of 2004. Of the main components of industrial production only the water, gas and electricity are showing increasing growth rates. Even so, the weight of this component is rather small.

Previous cycle driven by oil prices

During the last downturn in industrial production growth in 2001–2002, overall economic growth slowed significantly. With industrial production growth again faltering, the question arises: Is the current trend also temporary?

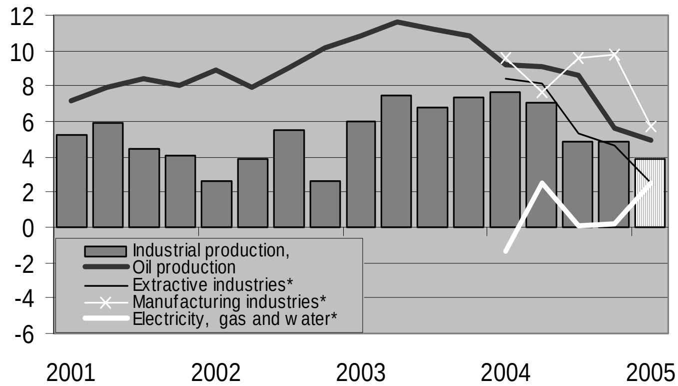
The 2001–2002 slowdown mainly reflected decreased export incomes caused by a temporary drop in world oil prices – oil sector production still grew at a pace of 8–9 % a year. Moreover, export volumes grew 11–14 % a year, even as prices fell and cut export earnings. As a result, annual GDP growth in 2001-2002 fell to around 5 % and industrial production to 3 %.

Compared to the last slowdown, world oil prices are now at record highs. Indeed, Russia's trade surplus continued to swell in Q1 of 2005. This time around, however, oil production growth is falling. Should world oil prices stop climbing, or even decrease, export earning will flatten or fall. In its mid-term forecast from April, the economy ministry warned that oil production and export growth will decline and that the trade surplus will shrink in coming years.

Temporary or permanent?

The worrisome aspect of declining in oil production and export volumes is that crude oil will eventually cease to be the driver of high GDP growth. The reasons behind slower growth this time seem to be domestic rather than external as in 2001–2002. Consequently, maintaining very high growth rates in the coming years will require steps to improve the investment climate in the extractive industries and moves to boost growth in other industrial sectors. If output growth continues to slow in the fuel industry and manufacturing industries fail to pick up the slack with higher growth, it may well be that the lower growth of recent months is here to stay.

On-year change in industrial production and sub-components, %



**Sub-component series available only from the beginning of 2004.*
Source: Rosstat

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Economic Developments

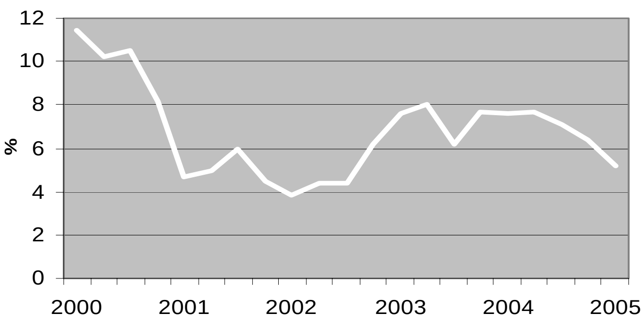
No changes in GDP structure during 2004

According to revised data released by Rosstat, GDP last year grew by 7.2 %, nearly the same pace as in 2003. The reported value of GDP in 2004 was RUB 16,752 billion (€468 billion or $582 billion at official exchange rates). The figure puts Russia's annual GDP on par with the Netherlands.

Nearly 60 % of GDP was generated by the service sector. Industrial production accounted for close to 30 %, construction and agriculture both about 6 % of GDP. It has been argued that the official statistics are likely to give far too little weight to industrial production due to the widespread practice of transfer pricing used in extractive industries. The statistics may indeed underestimate the contribution of extractive industries (7.7 % in 2004) and overestimate the share of trade (21.3 % in 2004) in GDP.

Consumption accounts for around 65 % of GDP use, investments 18 % and net exports about 12 %. Despite the recent consumption boom, these shares have stayed relatively constant over the last four years. This investment level is fairly low considering the amount of investment Russia needs just to keep up with repair and maintenance of basic infrastructure and industrial facilities – not to speak of greenfield investment. Russia's investment level is comparable to most OECD countries but far lower than those observed in rapidly growing economies in East Asia.

On-year change in quarterly GDP 2000-2005, %



Source: Rosstat

Growth slowed in the first quarter of 2005

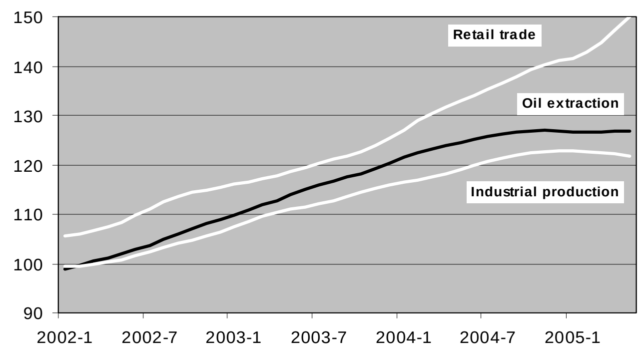
While growth in all main areas of economic activity accelerated significantly in 2004, GDP growth began to slow already in the latter part of last year. The deceleration was especially pronounced in crude oil production, possibly due to uncertainties in the business environment and capacity constraints in the oil sector. The preliminary Rosstat data for the first three months of this year indicate that the GDP growth rate has declined to 5.2 %.

With growth rates in industrial production and investment declining, Russia appears to have entered a period of consumption-driven growth. In 1Q05, the service sector was engine behind continued growth. All of the components of GDP production rising faster than average were service-related (i.e. retail and wholesale trade, restaurants and hotels, and transport and communications). During the boom in 2003 and 2004, leading sectors also included industrial sectors such as the extractive industries and manufacturing.

Record high oil prices, continued growth in real wages and possibly a move to a more accommodative fiscal stance are all likely to fuel consumption growth in the coming months. Decelerating growth in industrial production indicates that a large share of the increase in demand is bound to be directed towards imported goods.

It is unlikely that industrial growth picked up enough in 1H05 to achieve GDP growth rates similar to the past two years. To revive growth, measures to prop up investment will be needed. Nevertheless, various estimates expect the Russian economy to grow at a respectable 5 % annually for the next couple of years. That is several percentage points higher than even the optimistic estimates for economic growth in the world overall. Continued growth together with real appreciation of the rouble makes Russia a rapidly growing export market for its trading partners also this year.

Industrial production, oil extraction and retail trade, % growth, to January 2002, seasonally adjusted



Source: Rosstat

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	5.2	Q1/05
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	3.6	1-5/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	8.9	1-5/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	5/05
Exports, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	72.7	1-4/05
Imports, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	34.2	1-4/05
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	60.1	22.0	Q1/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*
Sources: Rosstat, CBR.

Russian federal extra-budgetary funds in the 2000s

Russia's public sector consists of federal-, regional- and local-level operations, as well as federal and regional extra-budgetary funds. In 2003, the overall public sector revenues amounted to 37 % of GDP and expenditures almost 36 %. While the exact number and size of the regional funds is unknown, the revenues and expenditures of the three main federal extra-budgetary funds – the Pension Fund (PF), the Social Insurance Fund (SIF) and the Medical Insurance Fund (MIF) – have been hovering around 6–9 % since the late 1990s.

The PF has long been the largest of the funds (5–7 % of GDP in 1998–2004). At the end of 2004, there were 38 million pensioners in Russia, mostly receiving standard employee pensions paid out of the PF. Only about 1 % of pensioners received pensions from non-state funds.

The financing of Russia's social security system comes out of the SIF. About two-thirds of SIF expenditures in 2004 were benefit payments – mostly temporary disability benefits and maternity allowances. The federal MIF, on the other hand, acts as an umbrella for regional MIFs. Almost 90 % of its resources in 2004 went to smoothing financial imbalances among regional funds. MIF financing also goes to information-technology projects and training of territorial fund administrators.

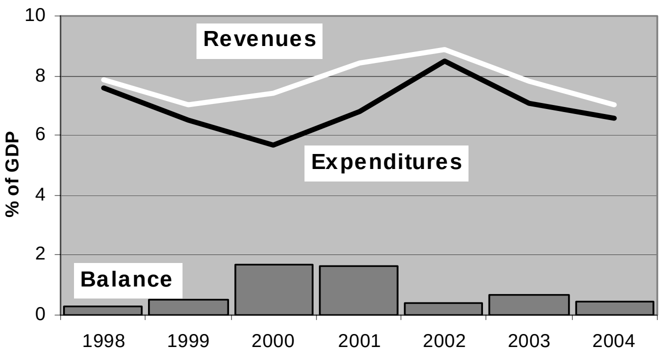
The PF is financed mainly out of unified social tax (UST) revenues and federal budget resources, while the other two funds rely almost solely on the UST. The UST, a regressive tax paid by employers, was introduced at the start of 2001 to consolidate various social payments. From the beginning of 2005, the UST top rate has been cut from nearly 36 % to 26 % of the wage bill and the number of wage categories diminished. With the change, the average effective UST rate is estimated to have dropped from 30 % to 25 %. The PF gets the bulk of tax proceeds (almost 80 %). About 10 % goes to the SIF, 3 % to the federal MIF and 7 % to regional MIFs.

The funds have shown slight surpluses every year since 1999. Naturally, the reduction in the UST will lower contributions this year. Part of the PF deficit should be covered by transferring resources from the Stabilisation Fund, although it is still unclear how the remainder will be financed. President Putin has also called for sizable increases in real pensions by the end of 2008. This means that without additional financing from the federal budget or continued reliance on Stabilisation Fund resources, the PF could face substantial underfunding problems in coming years.

Real pensions increased almost 6 % in 2004. As of April 2005, the average monthly pension was about 2,300 roubles (64 euro), up 8 % y-o-y in real terms. Despite the pension hikes, the average Russian pension is tiny by European standards. Almost a fifth of Russia's pensioners continue working beyond pension age.

In addition to pressures to increase pensions, Russian demographic trends burden the pension system. The number of employees has fallen over 6 % since 1992, while the number of pensioners has gone up by more than 8 %. Although the financial strain of the PF has somewhat eased during recent years due to a slight decrease in the number of pensioners, there are still only about 1.7 employees per one pensioner. In 1992, the ratio was over two to one.

Russia's main federal extra-budgetary funds -revenues, expenditures and balance*, % of GDP



Source: Rosstat
**Pension Fund, Social Insurance Fund, Medical Insurance Fund; surpluses from previous years included in the revenues of subsequent years.*

Changes planned for funded pensions

Since 2002, when the reformed pension system was introduced, part of pension contributions have been funded on behalf of the future pensioner. Under the pension law, the funded part is earmarked for citizens born after 1966. Its amount depends on wages, but at maximum is some 5 % of the yearly wage sum. Every participant is free to transfer the funded part to a private investment fund approved by the PF. The resources of people unwilling to use private management funds are invested by Vnesheconombank (VEB). Until now the majority of Russians have not even bothered to declare about their wishes and have let the VEB invest about RUB 75 billion of their funded pension payments.

The regulations require that VEB invests pension monies mainly in government bonds or securities backed by the government. It has been suggested, however, that VEB surrender to private management funds its monopoly as investor of funded pensions that have not been transferred. At least part of the resources now handled by VEB could be invested by private funds selected on a competitive basis. At the same time, the variety of investment instruments could be broadened to include e.g. securities of Russian regions or corporate stocks.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of	2005 budget
Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	27.1	1-4/05	17.8
Expenditures [1]	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	16.5	1-4/05	16.3
Balance	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	10.6	1-4/05	1.5
Foreign currency debt	30.2	50.1	87.7	55.3	44.4	36.2	25.7	19.6	18.6		
Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	114.4	108.3	03/05	

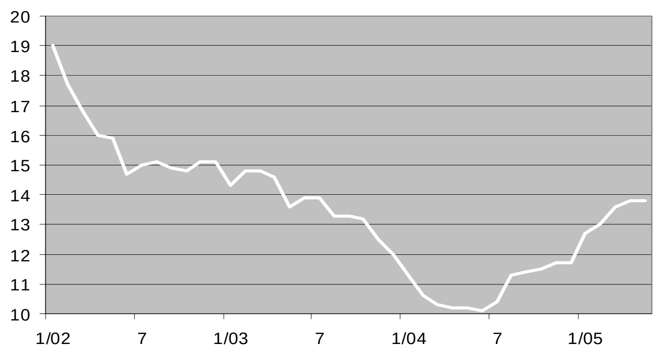
[1] *Since 2002 the unified social tax is included in the federal budget.*
Source: Budget: IMF 1997–2000, Rosstat 2001–2004, EEG 2005. Debt: IMF 1996–1999, Minfin 2000–2004.

Services and foodstuffs driving inflation

Inflation was still 13.5 % y-o-y in June, despite a slight drop in on-month inflation in recent months. In the first five months of the year, consumer prices rose 8 % (compared to 6.1 % in 2004) – and making it highly unlikely that the government will succeed this year in restraining inflation within its target range of 8.5-10 %. The largest price increases were observed for services (22.4 % y-o-y in June) and foodstuffs (14.9 % y-o-y), while prices of other goods climbed more modestly (6.4 % y-o-y). High inflation in services resulted mainly from hikes in regulated prices for housing and municipal services at the start of the year. The increase in food prices was led by higher prices for fruits and vegetables and meat products. The inflationary pressures for fruits and vegetables probably reflect last year's modest harvest, while the rise in prices for meat products has mainly been caused by strict import quotas.

Regional variation in price levels is significant. The price of the basket of basic consumer goods and services in May varied across federal districts from 4,104 roubles (117 euro) in Privolzhsky federal district to 6,060 roubles (172 euro) in the Far East district. The reference consumer basket in the Chukotka autonomous region (Far East district) costs nearly three times more than the same basket in the Lipetsk region (Central district).

CPI inflation 2002-2005, y-o-y growth



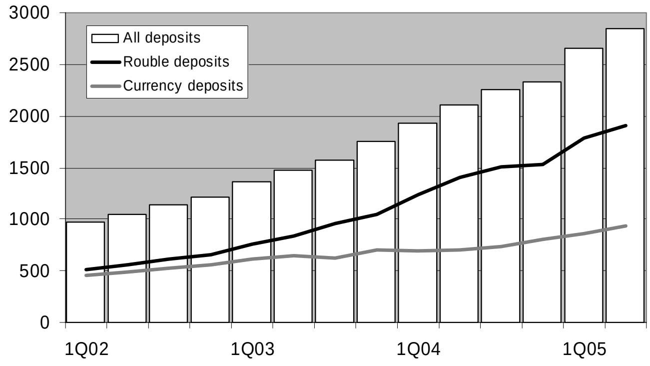
Source: CBR

Two-thirds of bank deposits in roubles

The total stock of deposits at commercial banks was 2,850 billion roubles (€82bn) as of April 1, 2005, which corresponds to close to 15 % of GDP – a quite modest level by international standards. Deposits, however, grew at an annual rate of nearly 40 % in 2002–2004. In the first quarter of 2005, deposit growth slowed somewhat.

Rouble deposits have grown twice as fast as currency deposits over the past three years and the share of currency-denominated savings has decreased steadily from about one-half in 2002 to the current third. This is most likely due to the rouble strength and revived confidence in the domestic currency. Household deposits currently form 75 % of the total deposit stock. The time structure of deposits has shifted so that deposits for over one year now account for half of the total deposit stock. Three years ago the corresponding share was just 23 %.

Total bank deposits 2002-2005, billion roubles



Source: CBR

Strong growth in household loans

Strong economic growth, low real interest rates and a consumption boom have fuelled a rapid credit expansion in recent years. Russian retail banks have increasingly adopted western-style consumer services. Consumption credits and car loans are have become increasingly available to the average consumer. Consequently, credits to households have been growing extremely rapidly. In 2002–2004, growth in rouble credits to households averaged 70 % a year. Households now account for 15 % of the total credit stock of commercial banks, which presently is about 4,500 billion roubles (€130bn).

Credits to the enterprise sector have also risen rapidly. In the past three years, growth in corporate credit has soared nearly 30 % annually. Long-term credits (over one year) have slowly become increasingly available to companies. Nevertheless, only about 40% of corporate credits are currently granted for periods exceeding one year. Less than a third of corporate credits are denominated in foreign currencies.

Large Russian enterprises do, however, mainly rely on foreign financing for their long term investments. Borrowing from international markets by Russian enterprises has increased rapidly and currently foreign loans to Russian enterprises amount to €66bn.

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	13.3	6/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	33.0	5/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	292	5/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	4/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.3	4/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	151.8	6/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.67	6/05
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	34.52	6/05

Source: Rosstat, CBR.

Russia's financial situation
by Seija Lainela*

Since the 1998 crisis, when the Russian state defaulted on its financial commitments, Russia has been able to dramatically improve its financial situation and international creditworthiness. All of the three major international rating agencies currently give Russia an investment-grade credit rating, which means that Russian debt is considered safe enough even for risk-averse institutional investors.

Russia's public sector external debt now amounts to 18 % of GDP, which is quite modest by international standards. The country's total public debt (i.e. including domestic debt) amounts to around 20 % of GDP.

This positive development is first and foremost due to high international oil prices that have swelled tax revenues in the 2000s. Russia's domestic fiscal policy is also to be commended, as the government has been able to keep budgetary expenditures under control. The federal budget has been in surplus for six consecutive years now.

Public foreign debt to be brought to the minimum

Despite its moderate debt, Russia intends to significantly reduce its foreign indebtedness. The government has declared cutting foreign indebtedness one of its mid-term fiscal policy goals. This reduction is to be achieved in part through early repayments of foreign loans. In particular, Russia wants to relieve itself from non-marketable debt – the most expensive part of its debt. The category mainly consists of Soviet-era debt owed to the Paris Club of official creditors.

The table below presents Russia's external debt breakdown at the end of the first quarter of the current year.

Russia's external debt, 31 March 2005, US$ billion

Total	*221.4*
Public sector debt:	100.8
State:	92.9
Federation:	91.3
New Russian debt:	38.0
International financial organisations	5.9
Currency denominated securities	27.9
Rouble denominated securities	0.0
Others	4.1
Debt of the former Soviet Union:	53.3
Paris Club	40.6
Debt to former socialist countries	2.6
Others	10.1
Regions	1.5
Central Bank	7.9
Private sector debt:	120.7
Banks	34.6
Enterprises	86.1

Source: CBR.

The favourable budgetary situation has allowed Russia to make significant early debt repayments this year. In January, Russia repaid all of its outstanding debt of $3.3 billion to the IMF and in May it agreed with the Paris Club of official creditors on early repayment of $15 billion of its $41 billion total debt.

Differing opinions on the necessity of early debt repayments were heard in Russia during the negotiations with the Paris Club. Opponents to the deal maintained that it would be more beneficial for Russia to use the money on social spending or infrastructure investment. Several cabinet members have expressed similar views.

According to the Ministry of Finance, early debt repayments will significantly reduce Russia's interest expenditures in the years to come. In addition, the policy helps fight inflation by channelling part of the budget surplus abroad.

Finance Minister Alexei Kudrin announced in the spring that Russia might make a new proposal to the Paris Club on further early debt repayments before the end of this year.

Borrowing policies remain cautious

In another move to decrease the public sector's foreign indebtedness, the Russian government is diminishing borrowing from abroad. In recent years, Russia has taken only few foreign loans. The government's monetary policy program for 2006–2008 envisages no new borrowing on international financial markets unless the economic situation worsens dramatically.

The taking of tied loans from foreign governments and international financial organisations is also restricted. Tied loans may only be taken for projects already commenced or agreed. No new projects involving tied financing will be launched.

Burgeoning private sector foreign debt

Although Russia's public foreign debt declines, total foreign debt continues to grow due to active private sector borrowing. Private sector debt already accounts for more than half of Russia's total foreign debt.

The Ministry of Finance has recently noted with concern the rapid growth of private sector debt. Both banks and nonfinancial enterprises increased their borrowing from abroad by more than a third last year. Most of this borrowing comes in the form of bank credits. Bonds account for less than 10 % of enterprises' foreign borrowing, but their growth is rapid.

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Economic Developments

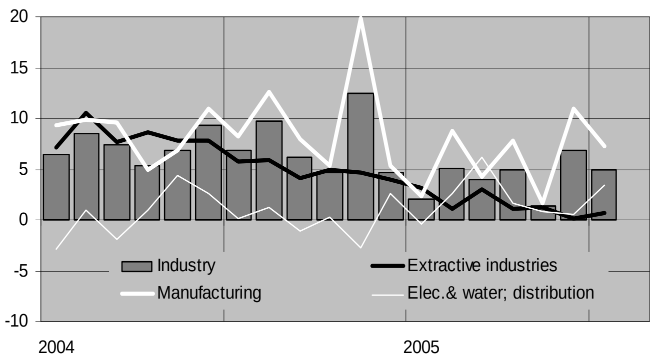
Manufacturing drives industrial production

In January-July, industrial output grew 4.1 % y-o-y, compared to 7.2 % in the same period a year earlier. While the pace of industrial growth has significantly decelerated from last year, the chart below provides little evidence to suggest a general deterioration in the situation of industrial producers in recent months.

However, certain industries have seen lower growth. Extractive industries continue to perform relatively poorly; crude oil output rose just 2.5 % y-o-y in the first seven months of this year and only 1.1 % in July. This contrasts sharply to the situation a year ago when oil production climbed at over 9 % y-o-y. Gas production remains roughly in the same level as a year ago and other extractive industries and electricity sector have only shown slow growth at best.

The poor performance of extractive industries has been somewhat offset by higher growth in manufacturing, although the situation within manufacturing is also uneven. In January-July, higher-than-average growth rates were recorded for producers of electrical appliances (particularly TVs) and machine building, mechanical forest industry, oil refining and the food industry. The situation in clothing manufacture remains poor as output continues to decline. Output of transportation equipment continues to increase, although passenger car production has declined this year (after two consecutive years of increase).

Industrial output and core components in 2004-2005, % change y-o-y



Source: Rosstat

Record foreign trade surplus in the first half of 2005

In the first half of 2005, the value of Russia's exports of goods was $112 billion, which is 39 % more than in the same period a year earlier. The strong export performance was due mainly to higher oil prices, with oil and energy exports now accounting for almost 60 % of Russia's exports. Metals and metal products cover 17 %, chemical products 7 % and forest industry about 4 % of Russian exports. Machinery and transportation equipment presently account for about 8 % of Russian exports.

Imports to Russia in January-June increased 28 % to $54 billion. The main import items included machinery and vehicles (40 % of imports), foodstuffs (19 %) and chemical products (16 %).

Some 85 % of Russian foreign trade is conducted with the countries outside the CIS area. The European Union currently accounts for a half of Russia's foreign trade (Germany 10 %, Netherlands 8 %, Italy 7 %, Finland 3 %, and France 3 %). China's share is 6 %, while the US accounts only for 3 %. Among CIS members, Ukraine (6 %) and Belarus (5 %) are Russia's most significant trading partners.

Russia' trade balance in the first half showed a $58 billion surplus compared to $38 billion in the same period a year earlier. Consequently, this year's surplus is shaping up to set an all-time record.

Pace of investment may be picking up

Rosstat reports relatively strong growth in fixed investments continued throughout the first half of the year (almost 10 %), although it was slightly off the pace of the same period a year ago (over 12 %). Notably, investment growth accelerated to 11 % in July. Activity in the construction sector, which is investment-related, rose by almost 6 % in January-June (14 % in the 1H04). In July, construction activity jumped 13 % y-o-y.

Foreign direct investment (FDI) figures from Rosstat show that FDI into Russia in the first half of this year amounted to $4.5 billion, or 31 % more than in the same period last year. Later this month the Central Bank of Russia will release its balance-of-payments figures, which include an alternative assessment of FDI inflows in January-June. In recent years, the FDI figures from the CBR have been consistently higher than those provided by Rosstat.

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	5.2	Q1/05
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.1	1-7/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	9.7	1-7/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	6.8	7/05
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	112.5	H1/05
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	53.6	H1/05
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	60.1	46.4	H1/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

Sources: Rosstat, CBR.

2006 budget spending boosted

In mid-August, the government approved the main parameters of the 2006 federal budget. Like all budgets in the 2000s, it shows a considerable surplus, mainly from high raw material prices. What clearly differs from previous years is the fact that non-interest budget spending increases markedly (up 45 % from the initial 2005 budget). The increase in the threshold oil price for the stabilisation fund from the present $20 to $27 next year will free up additional resources for budgetary spending instead of amassing them in the stabilisation fund.

Spending on health care, salaries of public sector employees and members of the military, as well as pensions and student stipends, will be raised incrementally next year. The military will receive more financing for renovation of facilities and procurement of new equipment. Additional funds will also be spent on development of public infrastructure. Preliminary information on the 2006 budget indicates that over RUB 600 billion ($21 billion, or 14 % of expenditures) will be directed to various public investment projects – a doubling of the amount in the initial 2005 budget.

Federal budget initial parameters

	2006 draft	2005 budget
Revenues , % of GDP	20.7	17.8
Expenditures, % of GDP	17.5	16.3
Interest payments	*0.8*	*1.4*
Surplus, % of GDP	3.2	1.5
Average exchange rate (roubles per dollar)	28.6	30.0
Inflation (year-end, %)	7 – 8.5	7.5 – 8.5
Average oil price, Urals (dollars per barrel)	40.0	28.0
GDP (RUB billion)	24,380	18,720

Source: Russian government

New investment fund to be established

To attract private investors to joint public-private investment projects, the government has agreed in principle on the establishment of an investment fund. The fund is expected to contribute to stable economic growth and diversification of the Russian economy. Its resources would come from oil export revenues and interest savings from early repayment of foreign debt. The financial plan for 2006–2008 allocates about RUB 70 billion ($2.5 billion) yearly to the fund.

The fund is designed for infrastructure projects and projects related to institutional reforms and innovation systems. Fund resources may also be used for fixed capital investments in enterprises or for state guarantees. The economy ministry will select appropriate projects with the help of foreign consultants. Selection will be made on a competitive basis using both qualitative and quantitative indicators. However, the final decision lies with the government.

Latest round of early payment to Paris Club completed, stabilisation fund swells

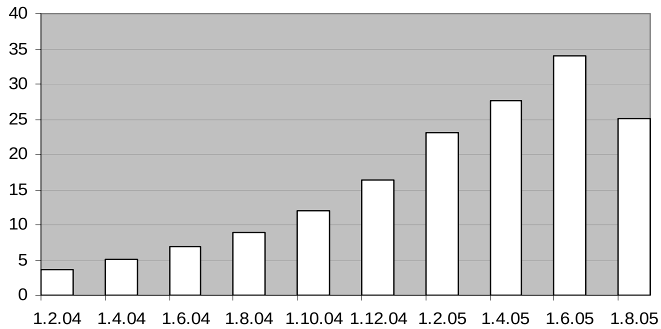
As of end-August, Russia had paid the full $15 billion of the latest round of settlement of its Paris Club debt as agreed in late spring. Early debt payment of this magnitude is unique in Paris Club history and indeed fairly exceptional generally.

The advance payments came out of the stabilisation fund, which stood at $721 billion roubles ($25 billion) in early August (and after most of this summer's prepayment instalments had already been made). Presently, Russia's Soviet-era debt, which mainly consists of Paris Club liabilities, amounts to some $28 billion.

The smooth debt buy-back process, savings in interest payments, as well as Russia's improved image as a borrower, may encourage Russia to start further negotiations on early repayments. Indeed, finance minister Kudrin has already suggested that Russia might propose another round of early payment of its remaining Paris Club debt. According to preliminary information, Russia will next year allocate some $8 billion for the foreign debt repayment. The 2006 budget draft also foresees some RUB 41 billion ($1.4 billion) applied to debt repayment from the stabilisation fund during the year.

With the price of Urals oil exceeding $60 per barrel in August, Russia can surely afford early amortisation of its foreign debt. Previous forecasts on the growth of the stabilisation fund have been consistently below actual performance. Current projections assume the fund will have assets of $40 billion at the end of 2005 and $78 billion at the end of 2006 (i.e. equivalent to more than 9 % of predicted GDP). In comparison, Russia's public debt (foreign plus domestic) at the end of 2006 is projected to be worth $119 billion (14 % of GDP). Public foreign debt is expected to decline to below $80 billion (about 9 % of GDP).

Stabilisation fund assets (US$ billion)



Source: Minfin

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of	2005 budget
Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	25.8	1-6/05	17.8
Expenditures [1]	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	15.6	1-6/05	16.3
Balance	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	10.2	1-6/05	1.5
Foreign currency debt	30.2	50.1	87.7	55.3	44.4	36.2	25.7	19.6	18.6		
Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	114.4	108.3	3/05	

[1] *Since 2002 the unified social tax is included in the federal budget.*
Source: Budget: IMF 1997–2000, Rosstat 2001–2004, EEG 2005. Debt: IMF 1996–1999, Minfin 2000–2005.

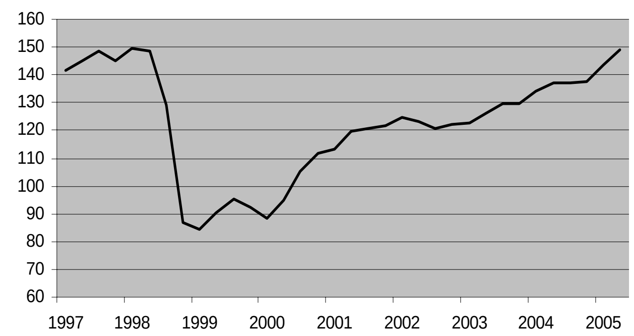
Euro gets more weight in currency basket, rouble continues to strengthen

At the beginning of August, the Central Bank of Russia further increased the euro's weight in the dual-currency basket it uses to steer the external value of the rouble. The weighing increased the euro's weight from 0.30 to 0.35, and correspondingly reduced the dollar's weight to 0.65. The currency basket was officially introduced last February at a weighting of 0.1 euro and 0.9 dollar. The euro's weighting has since been gradually increased in line with the CBR's goal of bringing greater stability to the rouble's external rate over the short term. In relation to changes in the composition of the currency basket, the CBR also announced plans to begin euro trading on the MICEX. Dollar operations, however, will retain priority in implementation of foreign exchange policy.

The rouble's real appreciation, reflecting a flood of foreign currency into Russia from oil export earnings, has exceeded the expectations of policymakers. The CBR reports that the real effective (foreign-trade weighted) exchange rate climbed 8.2 % in January-August. In real terms, the rouble this year has gained 13.9 % against the euro and 2.9 % against the dollar.

The figure below indicates that the rouble's real exchange rate recovered to its pre-1998 devaluation level this summer. However, the current situation is completely different from August 1998; given prevailing high commodity prices, one would expect to see the rouble rise continue (see Opinion on page 4).

Rouble's real effective exchange rate (index; average 2000 = 100)



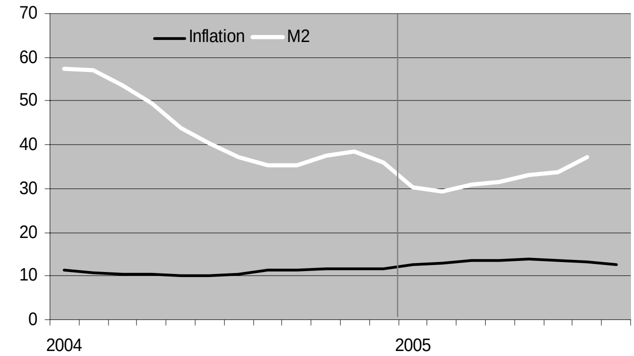
Source: IFS

Inflation eases somewhat as prices declined in August

According to Rosstat, August consumer prices declined slightly (-0.1 %) from July due to a nearly 13 % seasonal decline in prices of fruits and vegetables. Even so, 12-month inflation is still running at 12.4 % (compared to 11.3 % in August last year).

It is also notable (see chart below) that the money supply growth has recently accelerated. Partly this reflects the fact that the CBR's foreign currency reserves have increased by $25 billion this year to $150 billion as of September 1.

Consumer prices and money (M2) growth, % y-o-y



Source: Rosstat, CBR

Stock markets hit new records

After a relatively volatile period without clear trends in 2004 and the first part of this year, Russian stock prices surged this summer. The RTS index has recently tested new highs, breaking the 900-point level at the beginning of September.

While energy companies are mainly responsible for the RTS' new-found strength, share prices of raw material producers, telecom companies and Sberbank have climbed this summer. The RTS index compounds US dollar price developments of 50 leading Russian stocks. Presently, the heaviest weights in the index go to Lukoil (16 %), Sberbank (14 %), Norilsk Nickel (14 %), and Surgutneftegas (11 %).

RTS stock exchange index 2003-2005

Source: RTS

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	12.4	8/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	37.2	7/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	325	7/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	3.9	6/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.9	6/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	149.6	8/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.55	8/05
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	34.88	8/05

Source: Rosstat, CBR.

Dutch Disease: Diagnosing Russia

by Peter Westin *

Russia is the second-largest oil producer in the world. Yet even as high oil prices bring the country obvious benefits, dependence on oil and gas revenues foreshadow a textbook case of Dutch Disease. There is no question that Russia currently displays several symptoms of Dutch Disease, including real exchange rate appreciation and a booming service sector, but the most severe effect – de-industrialization – has yet to occur.

Rouble remains undervalued

The answer to the puzzle lies in the real exchange rate. Although most transition countries experience a real exchange rate appreciation following an excessive devaluation at the beginning of their transition process, recent studies, perhaps not surprisingly, have come to the conclusion that Russia's current real appreciation is driven by strong world commodity prices. Thus, although the real exchange rate has recovered to its pre-1998 crisis level, the signs are that the rouble remains undervalued.

Three separate measures for establishing the purchasing power parity (PPP) exchange rate suggest the rouble will continue to appreciate. First, calculating the PPP exchange rate in a traditional manner renders a nominal exchange rate of 20.5 roubles to the dollar (compared to the current official rate of 28.5/$). A second approach is to take the ratio of central bank liabilities to gross international reserves, which gives an implied PPP exchange rate of 14.2/$. Finally, the least scientific Big Mac index devised by the *Economist* magazine shows an even stronger undervaluation, with an implied PPP exchange rate of 13.6/$.

As the theory behind PPP exchange rates is subject to criticism, it is useful to complement the above approach with an alternative analysis. Due to lack of historical exchange rate data, studies on transition countries sometimes use the development in the average dollar wage as a proxy for real exchange rate movements. Russia's average wage, expressed in dollar terms, is currently $300 per month, compared to $180 per month in July 1998. Thus, the average wage has increased much faster than the real exchange rate and is now well above the pre-1998 crisis level.

However, a comparison of Russia's dollar wage with that in other transition countries at a similar stage of development points towards an undervalued rouble. For comparative purposes, we use average 2004 rates and assume that GDP per capita is a good proxy for development. In 2004, Russia's GDP per capita was $4,048 and the average wage was $237 per month. The table to the right lists a number of transition countries and their average dollar wage when GDP per capita was approximately $4,000. For all countries the dollar wage was higher than in Russia, which implies rouble undervaluation.

Economy supports continued appreciation

As the real exchange rate returns to its pre-1998 crisis level, there are worries the rouble may be moving into overvaluation territory. We argue that a simple comparison of the economic situation in 1H05 with 1H98 shows that Russia's economy is now distinctly different from just before the crisis. The average oil price was $45.4/bbl in 1H05, compared to just $12.9/bbl in 1H98. Both the budget and current account are strongly in the black, whereas Russia ran deficits in 1998. The economy is also growing now rather than declining as in 1H98. This, in our view, strongly supports the argument that the rouble will continue to strengthen.

The most encouraging sign, however, is the continued growth in what are dubbed lagging sectors in Dutch Disease terminology. Breaking down industrial production, we see that the natural resource sector is currently growing at a quite moderate pace, while manufacturing – which is made up of domestically oriented and import-competing sectors – enjoys strong growth and offers further proof that Russia has yet to succumb to the disease. Part of the reason for this is that Russia's manufacturing sector remains small and produces mainly for domestic consumption, so it does not compete on the global arena, thus mitigating the impact.

If global commodity prices remain high, Russia will continue to face the threat of contracting Dutch Disease. We believe that while the threat is not imminent, to avoid contagion, Russia needs to push ahead with reforms and maintain a tight fiscal policy, including building up its stabilisation fund. Furthermore, economic diversification is paramount, although this is admittedly a challenging task given rising oil prices have only increased Russia's dependence on black gold.

Nominal dollar wage at $4,000 GDP per capita

	Year GDP/capita about $4,000	Avg. monthly wage (US$)	Years from start of reforms
Czech Republic	1994	243	5
Estonia	2001	315	8
Hungary	1994	323	5
Latvia	2003	311	11
Lithuania	2002	274	10
Poland	1997	323	7
Slovak Republic	1998	284	9
Russia	**2004**	**237**	**12**

Source:Federal Statistics Service; Central Bank; ILO, IMF; Aton estimates

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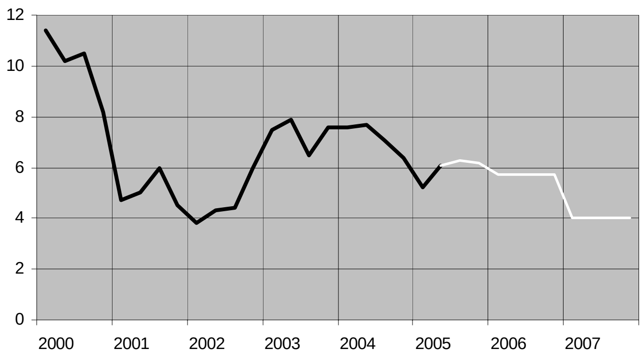
Economic Developments

GDP growth in 2005–2007

In connection with its latest bi-annual economic outlook for the Finnish economy, the Bank of Finland also released its view on the Russian economy in 2005–2007 (see figure). We expect, after slower growth in the first half of this year, that the Russian economy will pick up to 6 % average growth in 2005. Growth will remain robust throughout next year, but then gradually decelerate to around 4 % at the end of the forecast period. This figure represents Russia's long-term potential growth assuming stable oil prices.

Our view on Russia's economy is based on the assumption that the average price of the Brent crude oil increases from about $57 per barrel this year to $64 in 2006, then returns back to around $54 in 2007. Thus, while increasing oil prices should promote growth this year and next, this effect will gradually erode towards the end of the forecast period. Nevertheless, Russia's current account surplus will remain significant. As we do not foresee any major changes in monetary and exchange rate policies, Russia's financial markets stay very liquid and inflation relatively high. Thus, the current policy to keep the rouble's nominal exchange rate stable means that the rouble will continue to appreciate in real terms. This will cause additional downward pressure on economic growth.

Russian GDP growth, % y-o-y (Bank of Finland 2005– 2007 forecast)



Sources: Rosstat, Bank of Finland

Given strong economic growth, relatively high energy prices and the ongoing real appreciation of the rouble, Russia's import demand will remain robust in coming years. Incidentally, Finnish Customs reports that in July Russia overtook Sweden and Germany as Finland's most important export market for the first time in the post-Soviet period.

Current account surplus up 70 % from a year earlier

According to the first half 2005 balance-of-payments statistics released recently by the CBR, Russia's current account surplus surged to a record $45 billion, an amount that corresponds to about 13 % of Russia's first half GDP.

Regarding financial flows, foreign direct investment into Russia more than doubled from previous year to over $11 billion. Thus, there is considerable discrepancy between the FDI figures from the CBR and Rosstat, which just reported that FDI into Russia in the first six months of this year amounted to only $4.5 billion. In spite of recent media coverage concerning increased portfolio investment into Russia, portfolio inflows overall remain relatively modest. In the peak year 1997, total portfolio investment in Russia amounted to $45 billion.

The huge current account surplus and better balanced financial flows than in previous years have resulted in a surge in the CBR's foreign exchange reserves. In September, the central bank's reserves topped $156 billion.

Russia's balance of payments, US$ billion

	H1/2004	H1/2005
Current account	**26.3**	**44.7**
Trade balance, goods	38.1	57.7
Exports, f.o.b.	*80,5*	*112.0*
Imports, f.o.b.	*-42.4*	*-54.3*
Services balance	-5.7	-5.7
Investment income	-5.7	-6.8
Other items, net	-0.4	-0.5
Capital and financial account	**-22.5**	**-3.9**
Capital Account	-0.9	-1.3
Financial account	-21.6	-34.9
Direct investment to Russia	*4.6*	*11.4*
Portfolio investment to Russia	*4.0*	*5.0*
Other items, net	*-30.2*	*-18.9*
Net errors and omissions	**-3.7**	**-8.4**
Change in reserves ("-" increase)	**-11.8**	**-32.4**

Source: CBR

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	5.7	H1/05
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	3.7	1-8/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	9.7	1-8/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	6.5	8/05
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	122.8	H1/05
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	70.8	H1/05
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	60.1	44.7	H1/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

Sources: Rosstat, CBR.

Budget performance continues strong

There was a large federal budget surplus in the first half of 2005. Despite considerable revenue growth, expenditures as a share of GDP were held in check. Expenditures rose, however, in real terms.

Higher revenues from customs duties and natural resource payments were mainly responsible for 1H05 revenue growth, and helped overcome the slump in revenues from the reduced unified social tax rate. On the expenditure side, transfers to regional and local budgets rose considerably, mainly to prop up social spending. Spending on defence and the social sphere measured as shares of GDP remained steady, while expenditures on law and order rose and debt-servicing costs fell (see next page). The Duma approved a supplementary budget at the end of June to increase net expenditures by RUB 76 billion ($2.5bn). Its impact was not reflected in the 1H05 budget assessment.

Realised H1/05 federal budget, % of GDP

Revenues	H1/05	H1/04	Expenditures	H1/05	H1/04
Total	**25.8**	**20.6**	**Total**	**15.6**	**15.9**
Tax revenues	22.8	16.2	Transfers**	4.5	2.7
*VAT**	*8.4*	*6.3*	Defence	2.6	2.6
Customs duties	*7.3*	*4.9*	Social sphere***	2.1	2.1
Natural resource payments	*4.0*	*2.6*	Law and order	2.0	1.8
Non-tax revenues	1.5	1.6	Interest on debt	1.1	1.4
Unified social tax	1.4	2.8	Unified social tax	1.4	2.8
Balance	**10.2**	**4.7**			

* includes VAT on production in Russia as well as on imports
** mainly transfers to regional and local budgets, not including unified social tax (UST)
*** mainly professional education and military and law enforcement pensions, but also health, social policy, mass media, culture and the arts spending

Sources: Rosstat, Minfin

Assessing Putin's second-term reforms

During president Putin's first term (2000–2004), the Duma passed a large body of important legislation. Since the beginning of his second term in spring 2004, Putin's legislative emphasis has been on reforms in administration, the social sector, taxation and resource use.

The administrative reform launched in 2003 seeks to streamline the duties of federal organizations, as well as diminish the number of civil servants, eliminate bureaucracy and reduce corruption. Putin last year introduced a new three-tier federal system wherein ministries are responsible for preparing legislative proposals, federal services act as supervisory bodies and federal agencies produce state services. He also reorganised the presidential administration.

Following the Beslan tragedy, Putin decided to strengthen the role of federal government even further. At the end of 2004, he assumed authority to select gubernatorial nominees. The political significance of minor parties was curtailed by abolishing the one-party districts and increasing the threshold minimum membership for political parties.

The results from the administrative reform have been mixed at best. Although the number of ministries has been cut, the overall number of federal organisations has increased. The number of state and local bureaucrats has also risen despite the public sector's relatively smaller contribution to GDP. Critics of the reforms charge that the functioning of federal organisations has been seriously hampered by poorly thought-out reforms, while corruption and bureaucracy are as rampant as ever.

Along with the administration reform, budgetary relations among federal, regional and local administrations have been modified. Even so, progress in reform of budget relations has been temporarily halted after a recent Duma decision gave regions the option to postpone implementation of changes under the act on local administration until 2009. The most visible change in the budget sector has been the big pay hike for civil servants.

Putin's intended reforms for the social sector, housing and education remain on the back burner. An attempt to monetise certain Soviet-era benefits at the beginning of 2005 ended up provoking widespread regional protests. It is still unclear to what extent the state will abandon its initial plan to increase the role of regions and individual Russians in financing the targeted benefits.

Tax reform has been a constant theme since the end of the Soviet Union. Putin expects the main framework of the tax system to be in place by the end of his second term. Legislation to decrease the VAT rate and increase the profit tax, as well as amendments to the laws on property tax, taxation of small enterprises and real estate tax, are already at the reading stage in the Duma or on deck for submission to the Duma. The revised law on inheritance and gift tax enters into force at the start of next year.

Major revisions to legislation on natural resource use are also under way. Half a dozen drafts for a new *forest code* were proposed over the past couple years, with first reading of the latest version passed by the Duma in April. Draft laws on *mineral and hydrocarbon use* and changes to the *land and water codes* are set to be passed by the Duma. On the other hand, amendments to the act on *production sharing* have languished since their first reading in March. Reform of the electricity and gas sectors has also dragged. The most controversial issues in natural resource-related legislation are private ownership and the treatment of foreign enterprises. Both topics consistently provoke heated debate and deadlock in the Duma.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of	2005 budget
Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	25.1	1-7/05	17.8
Expenditures [1]	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	15.8	1-7/05	16.3
Balance	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	9.3	1-7/05	1.5
Foreign currency debt	30.2	50.1	87.7	55.3	44.4	36.2	25.7	19.6	17.8	6/05	
Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	114.4	107.6	6/05	

[1] *Since 2002 the unified social tax is included in the federal budget.*
Source: Budget: IMF 1997–2000, Rosstat 2001–2004, EEG 2005. Debt: IMF 1996–1999, Minfin 2000–2005.

Institutional progress in the banking system

The *deposit insurance scheme* introduced in December 2003 to protect Russian savers effectively entered into force on September 27, the Central Bank of Russia's deadline for banks to join the system. Of the 1,150 banks that applied for acceptance into the deposit insurance scheme, 927 were admitted. Thus, over 200 banks failed to fulfil the access criteria that included factors such as liquidity, risk management and ownership transparency. These banks will no longer be allowed to accept new individual clients. The fact that every fifth bank was not allowed to join the deposit insurance system was widely considered evidence that the CBR strictly applied its admission criteria.

Banks belonging to the deposit insurance scheme collectively represent 99 % of all deposits from private persons in Russia. The deposit insurance agency has drawn up plans to increase the deposit guarantee per depositor from the current 100,000 roubles (€2,900) to 280,000 roubles (€8,200) over the next two years. Participating banks finance the system by paying into the deposit insurance fund a quarterly premium of 0.15 % of the average value of their deposits in the previous quarter. The contribution will fall to 0.05 % of quarterly deposits when the fund reaches 5 % of insured deposits. Authorities have yet to release rules on how the insurance fund money will be invested.

Russians' confidence in insured banks is expected to increase, and thereby intensify competition within the banking sector. Whereas depositors earlier chose their bank mainly on the basis of reputation, they are now expected to shop around for the most competitive interest rates. A potential downside of the scheme is increased moral hazard, as banks may feel encouraged to take on risk.

Regarding other recent changes in the banking sector, a new *act on credit history* entered into force in June. Under the new credit history act, all banks must provide the credit information of its customers to at least one credit bureau. Credit bureaus then sell the collected credit history data on to banks and other lending agencies. Banks can determine which bureau is holding customer information interesting to them from a register maintained by the Central Bank of Russia. So far, four credit information providers have been established. Two are subsidiaries of international credit reporting agencies, one is a subsidiary of state-owned Sberbank, and one is owned by a consortium of major private banks.

Legislators hope the credit history act will improve the ability of banks to evaluate the creditworthiness of their customers. By reducing risks in the credit market, the new law should also help lower interest rates and promote lending. Nevertheless, problems may ensue from the fact that information on individual and corporate customers with accounts in several banks is held in different registries.

External debt of enterprises on the strong rise

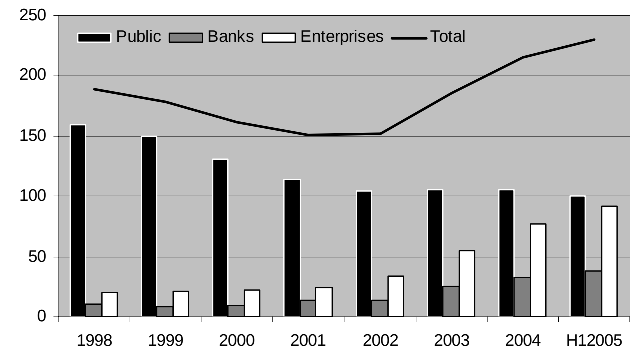
The latest CBR data show that the gross external debt of the Russian Federation at the end of June was $230 billion. Russia's foreign debt has been increasing relatively fast since 2002 due to enterprise sector borrowing.

As indicated in the figure below, Russian enterprises in recent years have been quite active in international debt markets. Their borrowing from international markets exceeds $15 billion in the first half of 2005, with the total stock of Russian enterprises' foreign debt climbing to $92 billion at the end of June. Most of this financing has come in the form of long-term loans. Equity financing is excluded from the foreign debt figures.

Two record corporate debt deals have also taken place recently. In September, Rosneftegas (the holding company of state oil company Rosneft) announced it had agreed on a three-year $7.5 billion syndicated loan from four Western banks to complete payment on Gazprom shares it acquired earlier. Soon after, Gazprom informed it had taken a $12 billion syndicated loan from six Western banks to purchase Sibneft, Russia's number-five oil company. Obviously, borrowing from international financial markets is currently a very attractive alternative for large Russian companies as the spread between Russian and US bonds is historically low and there is upward pressure on the rouble.

The government, in contrast, is trying to pay down its $91 billion debt as fast as possible. Early payment of some $15 billion of Russia's Soviet-era debt to the Paris Club of sovereign creditors has reduced that debt to about $28 billion. The government plans to continue debt prepayments next year to strengthen Russia's fiscal and monetary stability.

External debt of the Russian Federation, $ billion*



* Public debt comprises the general government plus the CBR. Enterprise debt does not include equities. There are some differences between the public sector debt figures of the CBR and Minfin (see debt figures in page 2).

Source: CBR Bulletin of Banking Statistics, BOFIT

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	12.2	9/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	40.4	8/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	301	8/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	3.8	7/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.0	7/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	159.6	9/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.50	9/05
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	34.38	9/05

Source: Rosstat, CBR.

EU–Russia relations: roadmaps and beyond

by Pekka Sutela *

Finland and Germany assume their European Union presidencies in the second half of 2006 and the first half of 2007, respectively. It will be an interesting time for EU-Russia relations, not least because both countries have a vital interest in Russian developments. EU-Russia relations are contractually regulated by the Partnership and Cooperation Agreement (PCA) negotiated in the early 1990s and implemented in 1997. In 2007, either side may annul the PCA. If they do not, the agreement automatically extends a year at the time.

Time for a new approach

It is hard to justify prolonging the PCA. While it played a useful role as the sides got to know one another and technical arrangements and a framework for cooperation were put in place, the PCA today is burdensome and clumsy – a product of by-gone times. Organisation-wise, the negotiations mechanism detailed in the PCA has long been inoperative. Moreover, much of its substance will be obviated when Russia joins the World Trade Organisation (WTO). Although the target date again seems to be shifting, Russia still might become a WTO member in 2007. Among the stickiest issues still unresolved is access to Russian financial markets, particularly insurance (where US negotiators are pushing hard for concessions). Even the EU-Russia common understanding reached in May 2004 could be endangered if Russia, as now seems probable, fails to increase rates for domestic industrial users of natural gas to a level that at least covers long-term marginal production costs.

Russia has already indicated that the PCA should not be continued, and similar thinking is spreading within the EU. While the alternative preferred in Russian discussion seems to be to negotiate another fundamental agreement, possibly as long and complex as the PCA, this is probably not the path to be taken. The EU has no such agreements with other major partners. Negotiating such a deal with Russia would thus be an unnecessary diversion of time and energy.

New architecture for EU-Russia cooperation

At a general level, it should be sufficient to have a joint political declaration that outlines the goals, values and mechanisms of cooperation. At the more detailed level, EU-Russia cooperation should be regulated by the four common spaces accepted last May. The roadmaps outlined, while rather technical and all-encompassing, should be seen as action plans that can continuously evolve as circumstances change, set goals are reached and new challenges emerge. It also means determining priorities, outlining schedules and assigning responsibilities.

The first roadmap alone, which defines the Common Economic Space, includes a long list of dimensions reaching from regulatory policy through trade facilitation, telecommunications and information society, energy and environment to cooperation in space. It would be wrong, however, to dismiss this common space outline as a grab bag of existing, even traditional, concerns. Consistency can be readily realised and the goals of cooperation made comprehensible to citizens by choosing a few long-term goals around which the roadmap could be further structured. Those can hardly be anything else than the facilitation of the two priority freedoms: mobility of people and commodities. In the post-PCA landscape, the twin goals of visa-free travel and free trade should be overall long-term economic goals of EU-Russia cooperation.

Nobody expects that these goals will be reached immediately. Neither is it clear how much immediate societal and political support these goals will have. Protectionism remains a powerful force, and might even increase when the prospect of liberalisation becomes real. But quite evidently, these freedoms are an ultimate economic good and the essence of economic integration. The other two will follow.

The political declaration and the roadmaps do not exhaust the contractual structure of EU-Russia cooperation. There are a number of issues concerning common rules, where legally binding, usually sectoral, agreements are needed. They reach from veterinary questions to readmission agreements and beyond. Naturally, the EU or its member states and Russia will also cooperate in a large number of multilateral agreements and forums. Addressing, say, global environmental issues would be much facilitated if the EU and Russia were able to formulate joint positions.

Moreover, the four-space cooperation approach is not the whole story. The current Northern Dimension (ND) action plan, which also ends in 2006, needs to be renegotiated. ND was originally a political device to draw attention to North-Eastern Europe, but today the emphasis has shifted to more practical levels. On one hand, ND is about partnerships in environmental and social and health fields. On the other, it encompasses all cooperation that countries, the EU and even civil societies have in the relevant geographical area. Simply put, ND should be seen as covering all Russian and rest-of-Europe cooperation in North-Western Europe. In this view, ND should take priority in specifying the four-space context for North-Western Europe.

Finally, not all matters are between Russia and the EU; there is also room and need for bilateral initiative and policy.

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Economic Developments

Output recovering, non-tradables sector drives growth

In the third quarter of 2005, Russian economic output recovered after a slowdown in the first half of the year. Rosstat's aggregate output indicator comprising five core production sectors rose 6.6 % y-o-y in July-September against 5.1 % in the first half of 2005. While aggregate output growth remained strong, it was not evenly distributed among sectors. During the first three quarters, retail trade (12 % y-o-y) and construction (8 %) expanded robustly, while the other three core sectors (industry, transportation and agriculture) increased their production only 2–4 %. Moreover, a closer look at industrial output reveals that the extraction industries and many manufacturing sectors competing with imports (particularly clothing) are among the worst performers. This suggests that current growth is concentrated in the non-tradables sector and that producers of tradables are beginning to feel the pressure of the strong rouble (see Opinion, page 4).

The pace of economic development also varies considerably across regions. In January-September, industrial output growth in the Central Federal District (17 %) clearly outpaced the Russian average of 4 %. This was mainly due to developments in the city of Moscow (18 %) and the Moscow region (36 %), which together account for 13 % of aggregate Russian industrial output. Industrial production in the Northwestern (11 %) and the Southern Federal District (6 %) also grew faster than average. Output in the Far Eastern District declined one percentage point from the previous year.

Investments outpace output growth

In this decade, investment demand has grown much faster than total output growth (see figure). The sole exception is 2002, when low international oil prices hit the Russian economy and investments. For January-September, fixed investment was up 9.9 % y-o-y, which compares to 11.6 % in the same period a year earlier. In spite of relatively high growth of investments in this decade, the investment ratio (investment/GDP) of 18 % is still relatively low compared to many other emerging economies as well as what is appropriate for the Russian economy's needs.

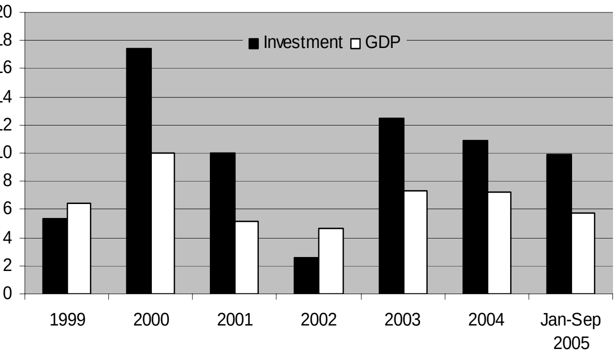
In the first half of 2005, 20 % of all fixed investment went to transport; communications received 5 %. Manufacturing industries received almost a fifth of aggregate investment; metallurgy and metal products, food industry and energy refining accounted for over half of all fixed investment in manufacturing. The combined share of wood and paper industries in manufacturing investment was only 6 %, a lower share than in the first half of 2004. These figures underscore the still difficult investment environment in the forest sector (problems with the forest code, the unclear role of the state and strategic sectors, unsettled ownership issues and the lack of infrastructure).

The share of extraction industries in total fixed investment has declined to less than 18 %, reflecting lower growth in investment in oil extraction. Thus, the turbulence around the oil sector has directly affected investment. The current situation poses a major challenge to the Russian state and oil companies as the growth in oil output has slowed significantly from last year.

Roughly a fifth of total fixed investment went to various real estate, housing and communal services. The rest of investments were divided among construction (4 % of total investment), agriculture (3 %), retail and wholesale trade (3 %), and numerous smaller sectors.

In January-June this year, the Central Federal District accounted for 24 % of total fixed investment, and was followed by the Urals (17 %), Volga (15 %) and Northwestern (13 %) districts. Investment rose fastest in the Far Eastern (39 % y-o-y, most likely due to the Sakhalin energy projects) and the Siberian (23 % y-o-y) districts. In the Central and Urals districts, fixed investment declined from a year earlier.

GDP and fixed investment (on-year % change)



Sources: Rosstat, BOFIT

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	5.7	H1/05
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	1-9/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	9.9	1-9/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	6.8	9/05
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	178.4	1-9/05
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	85.6	1-9/05
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	60.1	69.1	1-9/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

Source: Rosstat, CBR

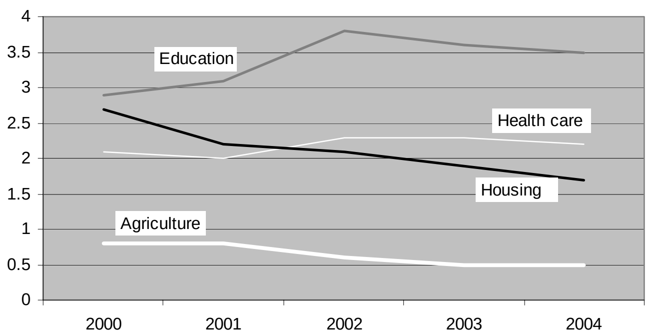
National projects – what, when and why?

In an early September speech to the cabinet, parliament and council of state, president Putin continued the themes of his two most recent state-of-the-nation speeches, pointing out that the current favourable economic conditions should be exploited to increase living standards of ordinary Russians. To reach this goal he called for new national development programs for health care, education, housing and agriculture – sectors he designates as top priority.

Following Putin's speech, the government allocated an additional RUB 115 billion (€3.2bn, or 0.5 % of GDP) to the 2006 federal budget for these priority sectors. Half of the sum will go to health care, a fifth each to housing and education, the remaining 10 % going to agriculture. During 2000–2004, the priority sectors together received yearly financing worth about 8–9 % of GDP. Thus, next year's increase is actually fairly modest. Higher spending is planned for 2007, but after that the financing is still open.

The main focus is currently on how the development programs will be put into practice and overseen. The main implementation responsibility lies with the regions, which must draw up their own plans. A Coordination Council has also been established to follow the reforms. The council will be led by Putin himself and will include several key ministers, leaders of the president's administration and a number of regional governors. After clumsy attempts to monetise certain Soviet-era benefits at the start of 2005, one only hopes the new programs will not be remembered merely as a Putin-initiated campaign that failed to deliver proper results.

Total budget spending on "priority" sectors (% of GDP)



Health care: new equipment, pay hikes and improved services

Russia's alarming demographic trends and the poor health of its population constitute major obstacles to rapid and sustainable long-term growth. Since the collapse of the Soviet Union, reforms in the public health care sector have generally been cosmetic. As a result, the health sector is financially strapped and the quality of health care delivery is quite variable at the regional level. Only a handful of regions are in a position to finance basic medical services; most face large financing deficits.

The national development program concentrates mainly on financing new equipment, motivating people to improve their health, broadening vaccination programs, introducing new forms of payment for health care employees and enhancing access to high-cost medical services.

Housing: more loans and quality construction

Less than 10 % of Russians are presently in a position to acquire an apartment that meets average social standards. The average waiting time for the nearly 5 million families queuing for a new apartment is 15–20 years. This backlog reflects both the low level of construction and inadequate loan supply. In order to improve the situation, the housing development program for 2006–2007 seeks to increase the supply of mortgage loans, stimulate construction activity, improve the quality of building, as well as help indigent people get proper housing and make it easier for people to move around the country.

Education: new forms of cooperation, retraining, technology

The national development program for education seeks to reform the educational system from the bottom up. It calls for cooperation among public education institutions, students, parents, NGOs, etc. to generate proposals on reforming education. Talented students and distinguished teachers will receive greater recognition. Schools and universities are urged to draw up development programs to retrain teachers, modernise equipment and develop educational materials and techniques. New universities will be established in the Southern and Siberian federal districts to provide qualified labour for large projects, increase entrepreneurial activities and introduce modern technologies. New business schools will be launched in Moscow and St. Petersburg. The army will start to provide vocational training. Given the above promises one can only ask whether they are in line with available resources.

Agriculture: favouring domestic production

Agriculture has consistently been one of the worst performing sectors in the post-Soviet period. After falling throughout the 1990s, agricultural production revived in the early 2000s only to fall back to annual output growth in the range of 1–2 % in the last two years. The problems of agriculture are manifold and overlap with larger social issues.

The agricultural development program is intended to reform cattle farming to decrease dependence on imported meat and meat products, which currently is about a third of domestic demand. Small business creation and on-going support for them will also be encouraged. Finally, the program strives to increase the number of large holding companies specialised in highly mechanised agricultural production.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of	2005 budget
Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	24.8	1-8/05	17.8
Expenditures [1]	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	15.8	1-8/05	16.3
Balance	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	9.0	1-8/05	1.5
Foreign currency debt	30.2	50.1	87.7	55.3	44.4	36.2	25.7	19.6	17.8	6/05	
Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	114.4	107.6	6/05	

[1] *Since 2002 the unified social tax is included in the federal budget.*
Source: Budget: IMF 1997–2000, Rosstat 2001–2004, EEG 2005. Debt: IMF 1996–1999, Minfin 2000–2005.

Russian banks have a fair way to go in terms of corporate governance

Standard & Poor's recently published a survey of transparency and disclosure of 30 largest Russian owned banks. Those conducting S&P's Russian Banking Corporate Governance Project were generally disappointed with the way Russian banks treated these fundamental issues. S&P researchers studied all public information such as annual reports, banks' web-based disclosures, as well as statutory filings with the Central Bank of Russia web service and the Federal Financial Markets Service (Russia's securities regulator). They found a dearth of relevant information available to investors and the general public. Based on 102 measures related to ownership structure and shareholder rights, financial and operational information, and board and management structure and processes, Russian banks had an average score of just 36 %, i.e. percentage of disclosed items that could be ticked off the S&P checklist. In comparison, the world's ten largest banks had an average score of 81 %.

Russian banks typically failed to reveal actual beneficial owners or shareholder capital and structure, or disclose shareholder rights, and board and management remuneration. The CBR has yet to impose effective legal measures to compel Russian banks to improve on their disclosure practices. Moreover, its recommendation to move from Russian Accounting Standards to International Financial Reporting Standards (IFRS) has been adopted by only a few banks. Most banks still get by transforming their RAS accounts to IFRS with their CBR-provided conversion table.

This summer, the CBR introduced its non-binding Code of Corporate Governance which advises banks on ways to improve their disclosure practices. One explanation for the lack of disclosure standards is that only a few Russian banks are publicly listed. Out of the 30 surveyed banks, only four have listed stock, and of those, only Sberbank's is truly liquid. By all indications, the most transparent Russian-owned bank, Vneshtorgbank (rating 56 %), is planning an IPO for 2006.

Many of the largest Russian banks belong to complex industrial-financial conglomerates. This explains to some degree their reluctance to disclose information concerning e.g. shareholder structure, related-party lending and risk management procedures. Ownership concentration in large banks is very high; all 30 banks have at least one shareholder with a 25 % stake. Also the state features prominently in the ownership of the banks. S&P calculates that the state accounts for close to half of the aggregate ownership capital of the largest 30 banks.

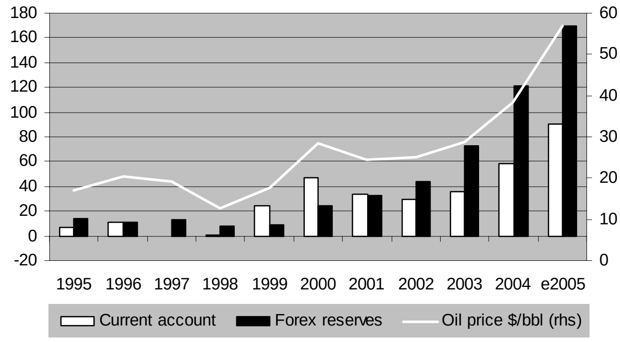
Huge external and fiscal surpluses boost credit ratings

The CBR reports that Russia's current account surplus surged to almost $70 billion, or about 13 % of estimated GDP, in January-September. The huge current account surplus and improved balance in financial flows compared to recent years has resulted in a ballooning of the CBR's foreign exchange reserves, which stood at $165 billion at the beginning of November.

In addition to external balance, sizeable oil revenues increased the fiscal surplus. For the first nine months of the year, the federal budget surplus was about 8 % of GDP. Russia's Stabilisation Fund totalled $38 billion at the beginning of November (7 % of January-September GDP) and is expected to exceed $50 billion by the end of this year. During the summer months, Russia prematurely paid down some $15 billion of its Soviet-era debts to the Paris Club of sovereign creditors. Moreover, the Russian authorities have indicated that Russia aims to make additional repayments of some $15 billion in 2006.

Given the above figures and developments, it is hardly surprising that credit rating agencies Fitch and Moody's recently upgraded Russia's creditworthiness to one notch above their minimum investment-grade ratings. However, in connection with its latest upgrade in late October, Moody's cautioned that any further ratings boost would require that the government make significant efforts to improve the efficiency of public administration, as well restart stalled economic reforms, develop its budgeting system, improve operation of courts and the justice system, fight corruption and reduce inflation.

Russia's current account and foreign exchange reserves ($ billion) and oil price (Brent $/bbl) in 1995 -- 2005



Sources: CBR, BOFIT

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	11.8	10/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	42.0	9/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	310	9/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	3.9	8/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.5	8/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	165.0	10/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.42	10/05
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	34.53	10/05

Source: Rosstat, CBR.

The impacts and consequences of rouble appreciation

by Dmitriy Plekhanov*

A prominent feature of Russia's economic situation over recent years is steady import growth (15–30 % per year in volume terms), which has consistently surpassed domestic production (4–12 % per year). Strong import growth and the rouble's ongoing appreciation in real terms pose a major challenge to domestic producers. In particular, the recent dynamics of auto sales in Russia shows that the price differential between domestic models and western imports, after adjusting for the higher quality of the latter, is close to zero.

At the macro-level, several exchange-rate measures suggest the rouble is now close to what is referred to in the literature as "the equilibrium level." For example, according to the real effective exchange rate index, the rouble has recovered to 99 % of its pre-1998 crisis level. Moreover, international comparison of Russia's price level with other countries, taking into account the level of economic development, reveals the rouble is presently undervalued by only 5 %. There is now wide acceptance that the Russian currency, supported by high world commodities prices, can only appreciate further. The recently published draft of "Monetary policy guidelines for 2006" by the Central Bank of Russia states rouble appreciation could be as much as 9 % next year.

Industry-level impacts of rouble appreciation

As the rouble moves from under- into over-valuation territory, it is important to realise that the exchange-rate level, rather than the rate of appreciation, has increasingly become the main determinant of competitive pressure on domestic enterprises. This shift raises the issue of the exchange rate's impact at the industry level. In January 2005, the Institute for Complex Strategic Studies (ICSS), in cooperation with the Institute for the Economy in Transition (IET), conducted a survey of Russian manufacturing enterprises. The main aim of the ICSS-IET survey was to assess the possible impact of rouble appreciation and the exchange-rate level at the micro-level.

The survey results indicate the exchange rate is an important indicator for domestic producers. Part of this undoubtedly reflects the rapid import expansion of recent years. As predicted by theoretical models of the exchange rate's impact on enterprises, greater import penetration into domestic markets raises the sensitivity of Russian producers to exchange rates. When asked to give a preferable exchange rate (amount of roubles per US dollar) only a third of respondents said rouble depreciation was needed if imports represented less than 25 % of their market. However, 47 % of firms in more import-oriented markets selected this option.

Exchange-rate pressure can differ from one branch of industry to another. To capture changes in industry competitiveness induced by currency movements, industrial real-exchange-rate indexes for Russia were constructed. In 2003–2004, a period of rapid rouble appreciation against US dollar (16 % per year in real terms), the most significant appreciation at the industry level was observed for the light manufacturing sector, which competes with products from dollar-pegged economies such as China. As appreciation of the rouble against the euro picked up in 2005, the exchange rate pressure shifted to the chemical industry, which competes primarily with imports from the euro area. The ICSS-IET survey showed that the responses of enterprises on the profitability and sales reduction in 2004 were positively correlated with the appreciation of industrial exchange rates.

Need for real adjustment at the enterprise level

The consequences of fighting inflation with rouble appreciation can be damaging to the Russian economy. As a rule, enterprises last year tended to reduce prices in markets where the estimated import share was relatively high (over 50 %). Thus, inflation can be reduced with the help of exchange-rate appreciation only at the expense of further loss of market share of domestic producers.

Since import growth and rouble appreciation in real terms have remained strong in 2005, it is important to estimate the potential response of Russia's industrial sector to rising competitive pressures. When asked how they plan to compete with import products, most firms mentioned quality enhancement (63 % of firms surveyed). However, only 25 % of domestic producers said they planned to create new products in response to competition from imports. Notably, the decision by domestic firms to create new products was not dependent on import penetration. This suggests that any opportunity for stimulating innovation through import competition is probably quite limited.

Maintaining the competitiveness of domestic producers requires capital-intensive measures such as quality enhancement and product range differentiation. However, as the majority of small and medium-sized enterprises face shrinking profitability and limited access to credit financing, opportunities for new investment are scarce. At the same time, 54 % of surveyed firms indicated that a reduction in labour costs was needed to maintain price competitiveness. Consequently, import growth and rouble appreciation may lead to efficiency-enhancing adjustments by Russian enterprises at the expense of increased uncertainty for workers.

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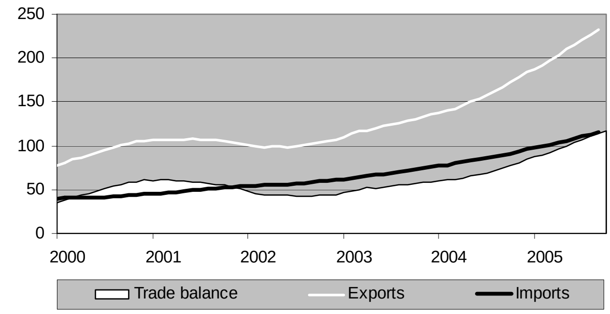
Economic Developments

Trade surplus surges as export growth outpaces imports

In January-September, the value of Russian exports rose 38 % compared to the same period a year ago to $178 billion, or $230 billion during the last twelve months (see figure). At the same time, imports increased 28 % to $86 billion (or $115 billion on annual level). As a result, the trade surplus surged almost 50 % from last year to $92 billion at the end of September.

Russian foreign trade, US$ billion, 12-month moving sum



Source: Rosstat

The acceleration of growth in dollar exports is due to oil price developments. In volume terms, the situation looks different. While the export volumes of some major commodities have grown robustly, gas exports have risen less than 4 % and exports of crude oil actually declined by 2 % in the first three quarters compared to 2004. Nevertheless, Russia's dependence on energy and raw material exports has recently increased further as the value of machinery and transport equipment exports declined by 8 % in the first nine months. Machinery and transport equipment currently account only for 3 % (5 % in 2004) of Russia's total exports to non-CIS countries and 17 % of its exports to the CIS region.

In contrast, machinery and transport equipment is by far Russia's most important import category, accounting for almost half of imports from non-CIS countries and 26 % from CIS countries. In January-September, machinery imports rose on-year by a third and the number of passenger cars imported increased by 48 %. Food and agriculture products accounted for 17–20 % of Russia's total imports.

China trade apparently increasing

Besides the sharply reduced role of the CIS producers in the Russian market, another notable development in recent years has been China's emergence as a major supplier to Russia. China's increased presence is felt particularly in Russia's light industry, where the output of textiles and garments is in decline.

Market shares of some major importers to Russia, %

	1995	2000	1-7 2005
CIS	29.1	34.2	20.3
NON-CIS	70.9	65.8	79.7
Germany	13.9	11.5	13.4
Italy	4.0	3.6	4.4
France	3.3	5.6	3.8
Finland	4.4	2.8	3.0
USA	5.7	7.9	5.0
China	1.9	2.8	6.1

Source: Russian customs, Rosstat, BOFIT

Quality of Russian trade statistics still poor

Despite some fluctuations of market shares among other major exporters to Russia, the poor quality of statistical data makes it difficult to confirm ranking changes among the countries listed above. To avoid custom duties and other taxes, Russian importers extensively use forged import documents to reduce the value of the goods they aim to get into Russia. This practise applies only to Russian customs as the authorities of the exporting country receive true documents. A quick comparison of the EU and Russian trade statistics in 2004 reveals that EU countries on average reported about 70 % higher export figures to Russia than what was reported by Russian customs as imports from the respective EU countries. Moreover, the situation seems to be equally bad at other border points around Russia. For example, the Chinese authorities report that China's exports to Russia in January-July this year were $6.0 billion; Russian custom statistics indicate only $3.1 billion in imports from China.

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	5.7	H1/05
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	3.9	1-10/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	9.9	1-10/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.6	10/05
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	199.7	1-10/05
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	96.9	1-10/05
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	60.1	69.1	1-9/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

Source: Rosstat, CBR.

Federal budget 2006 sealed

The 2006 federal budget was approved in the final fourth reading at the start of December. In the final reading, the budget act can only be passed or rejected. Compared to 2005 initial budget, 2006 revenues rise in real terms over 40 % and expenditures some 30 %. However, compared to the expected budget performance this year, budgeted real revenues in 2006 will actually decrease, while expenditures are anticipated to grow about 15 %. The large expenditure increases mainly apply to the “power sector” (the military and law enforcement) and national priority projects (health care, education, housing and agriculture).

Federal budget parameters

	2006 budget	2005 budget
Revenues , % of GDP	20.7	17.8
Expenditures, % of GDP	17.5	16.3
Interest payments	0.8	1.4
Surplus, % of GDP	3.2	1.5
Average exchange rate (roubles per dollar)	28.6	30.0
Inflation (year-end, %)	7 – 8.5	7.5 – 8.5
Average oil price, Urals (dollars per barrel)	40.0	28.0
GDP (RUB billion)	24,380	18,720

Source: Russian government

The fiscal balance of Russian state could hardly be better than today – and contrasts strikingly with the situation just after the 1998 financial crisis. Preliminary figures suggest realised federal budget revenues for January-October exceeded the budget target by over a third. Even with higher spending, the budget surplus was a healthy 5 % of GDP.

Discussion has arisen over how best to use the federal government’s ample financial resources. In October, a group of leading investment bank economists warned the Russian government that an excessive relaxation of its fiscal stance could lead to an inflation spiral. They said it was vital to assure government expenditures were directed to projects that would have long-term positive impacts on the economy, and that the issue needed to be framed in terms of quality, rather than quantity, of expenditures.

VAT – to cut or not to cut?

This year’s lively debate on taxation has concentrated on whether economic growth might be spurred by decreasing the tax burden. Underlying this discussion is president Putin’s stated goal of doubling GDP within a decade.

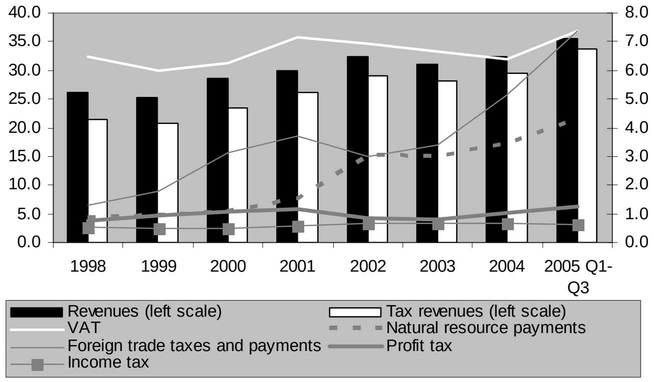
Prime minister Fradkov and his supporters argue that reducing the value-added tax from its current 18 % to as low as 13 % by 2007 would stimulate economic growth and that higher growth would at least partly compensate for revenue losses. Moreover, if the government needed more money, it could use e.g. revenues from customs duties, which are growing briskly. Opponents, led by the finance and economy ministries, respond that the economic stimulus would be negligible. They claim a VAT cut would spur already booming consumption and fuel inflation, which has exceeded government targets for years. As a compromise, the finance ministry has suggested lowering the VAT to 15 % in 2009, when the next three-year budget period begins.

The VAT has provided one of the government’s largest revenue streams in the post-Soviet era. Even in fiscally troubled years, VAT revenues held steady as a share of GDP (see chart). In January-September 2005, VAT revenues corresponded to well over third of federal budget revenues and a fifth of consolidated budget revenues.

When the VAT rate was cut two percentage points to 18 % at the start of 2004, the revenue loss in relation to GDP was slight. A lowering to 13 %, however, would slash revenues. Since the approval of the 2006 budget, it is further clear that government spending will increase along with scheduled salary and pension hikes for many years ahead.

Thus, while slashing the VAT appears imprudent, the government is hard pressed to suggest any other easy measures to promote economic growth. Moreover, the debate masks thornier issues. For example, if one compares the business environment in Russia with those of leading market economies, it is apparent that the biggest differences relate to bureaucracy rather than tax levels. Thus, while Russia’s tax burden has decreased by about 1 % of GDP in recent years, some surveys suggest Russian businessmen would prefer less red tape than lower taxes. Indeed, when compared to the overall average tax burden in OECD countries, Russia’s 34–35 % of GDP (plus payments to extra-budgetary funds amounting to 6–8 % of GDP) is not particularly high. The same applies to both VAT and profit tax rates. Russia’s maximum profit tax rate is 24 %, compared to 35 % in the US, 30 % in Japan and the UK and 26 % in Germany.

Consolidated budget revenues



Source: Rosstat

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of	2005 budget
Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	24.1	1-9/05	17.8
Expenditures [1]	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	16.5	1-9/05	16.3
Balance	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.6	1-9/05	1.5
Foreign currency debt	30.2	50.1	87.7	55.3	44.4	36.2	25.7	19.6	12.5	9/05	
Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	114.4	86.8	9/05	

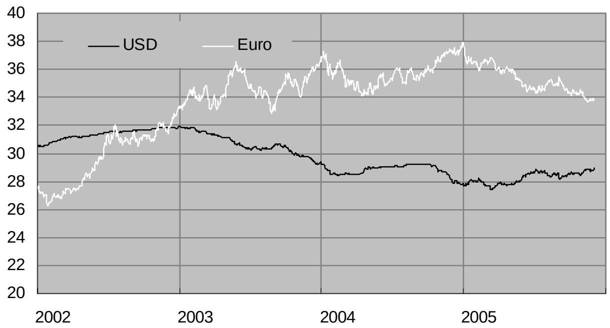
[1] *Since 2002 the unified social tax is included in the federal budget.*
Source: Budget: IMF 1997–2000, Rosstat 2001–2004, EEG 2005. Debt: IMF 1996–1999, Minfin 2000–2005.

Rouble climbs sharply against euro

While the rouble this year has depreciated slightly against the dollar in nominal terms, it has appreciated rather sharply relative to the euro (see figure). Given Russia's relatively high inflation, the rouble has strengthened in real terms against both major currencies. The rouble's real exchange rate in October was 1.1 % stronger on year against the dollar and up 15.9 % against the euro. The real effective (trade-weighted) exchange rate of the rouble climbed 9.3 % during the first ten months of 2005.

The Central Bank of Russia has recently been more explicit in its pronouncements on allowing the rouble to strengthen in nominal and real terms in order to fight inflation. Referring to recent studies, the CBR argues rouble appreciation should not have any significant impact on economic growth. Despite the altered stance on the real exchange rate's impact, the CBR's basic monetary stance is unlikely to change much in the short run. In three to five years, however, the CBR expects to move to a monetary regime that relies more heavily on inflation targeting and a floating exchange rate.

Nominal exchange rate of the rouble vs. US dollar and euro



Sources: Reuters, BOFIT

Further increase in euro weighting in currency basket

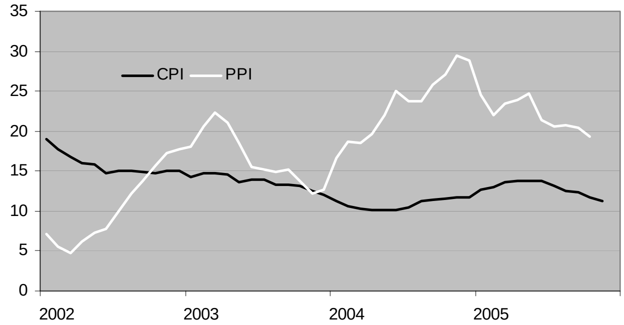
At the start of December, the CBR raised the euro's weighting in its currency basket from 0.35 to 0.40. The weighting of the dollar was decreased to 0.60. It was the fourth boost in the euro's weighting since the dual currency basket used to guide the external value of the rouble was officially introduced last February. The central bank has remained consistently committed to gradually increasing the weighting of the euro to reflect the actual role of the euro in Russia's external economic relations. As a result of the new exchange rate mechanism, the rouble's exchange rate against the euro has been less volatile than earlier, while the volatility of the dollar rate has increased somewhat.

Wage costs rise outpaces inflation

In November, consumer prices (CPI) were 11.2 % higher than a year ago. Despite the recent deceleration of inflation, consumer prices this year are expected to increase almost as fast as in 2004. Producer price inflation (PPI) continues to run much higher than CPI inflation (although that pace has slowed significantly recently).

Rouble wages continue to rise much faster than prices. Over the past three years, average real wages have increased at about 10 % a year. In the same period, average salaries increased 27–32 % a year in dollar terms.

Russia's inflation 2002-2005, y-o-y change, %



Source: Rosstat

Russian equities outperform other emerging markets

Robust economic growth, a strong fiscal situation and high oil prices are reflected in prices of Russian equities. The RTS index of key Russian stocks hit a new peak of 1086 on December 12. The RTS index has increased by 75 % from the start of the year. Stock prices in Latin America have increased on average 50 % this year, while shares in emerging Asian markets were up less than 20 %.

Russian (RTS) stock exchange index 2002–2005

Sources: RTS, Bloomberg

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	11.2	11/05
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	39.9	10/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	314	10/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	3.8	9/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.5	9/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	11/05
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	11/05
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	11/05

Source: Rosstat, CBR.

Re-emerging statism and Russia's future challenges
by Jouko Rautava*

While Russia's strong economic performance in this decade is largely due to high international oil prices, one should also give credit to economic policy, which has been much more market-oriented, decisive and disciplined than most people dared to hope when the Putin administration came to power. Even so, there has been a significant policy shift during president Putin's second term as reforms and liberal economic views have given way to active state intervention.

Confusing new trends of economic policy

In an open letter issued in late September, economists at leading Moscow banks and brokerages warned prime minister Fradkov on the dangers of loose fiscal policy in the midst of snail-paced structural reforms. Related to this very exceptional warning on fiscal policy, an indicative example is the recent introduction of the four national projects which aim to improve the situation in health care, housing, education and agriculture. Nobody denies the need to focus on these sectors, but there are good reasons to challenge an approach resembling a generic Soviet-era campaign. How efficiently can promised billions be allocated if the current administrative system is as inefficient and corrupted as it is reputed to be and there is no progress in administrative reforms?

Enterprise sector policy changes are even more visible than shifts in fiscal policy. Although there is great uncertainty about specific intentions, there is no doubt that the current political elite seek to significantly increase the role of the state in the economy. In particular, the distinction between strategic and non-strategic sectors has become extremely loose and confusing. Initially, only energy companies, producers of certain metals and the television media were included under the "strategic" definition. Today the definition has been extended to include telecommunications, the financial industry and heavy machinery manufacturers.

Since the re-nationalisation of Yukos' assets, the march to concentrate Russia's strategic energy reserves in the hands of state-owned Gazprom and Rosneft has continued. Gazprom's recent acquisition of Sibneft was essentially a de facto nationalisation of the latter. State-controlled electricity giant UES has also acquired a controlling stake in Power Machines after the Duma's economy committee refused to sell shares to the German Siemens. The latest news regarding the intention of the Kremlin to increase its influence in Avtovaz and Kamaz suggest that car industry has also come under the strategic sector definition.

Not long ago, Russian authorities emphasised the need to split up and reform key state monopolies in order to increase their efficiency and enhance competition in the economy. The rhetoric today has less to do with reform of state enterprises, but rather focuses on using state-controlled conglomerates as instruments for promoting the interests of the political elite. As a result, state monopolies are presently expanding into new business areas and their dominance in the economy is growing. Obviously, these developments do not help to reduce notoriously close relations between politics and businesses, and lower rank authorities all over Russia are eager to follow the Kremlin example.

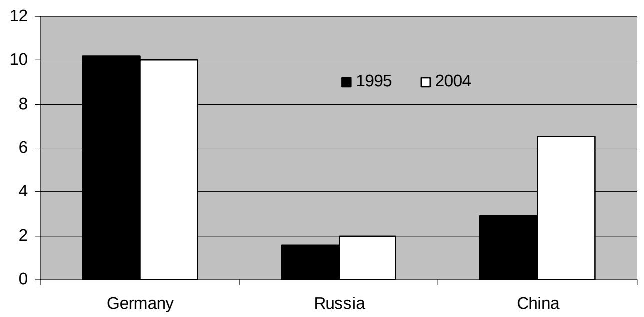
Recent trends in economic policy indicate that Russia is not committed to developing a truly open market economy that relies on private ownership and competition. This is well reflected in slow progress of WTO negotiations and tensions in EU-Russia relations.

Statism no answer to long-term challenges

Russia's long-term economic challenges may be easier to visualise if we consider the country is sandwiched between two economic superpowers – China and the EU. China's enormous and fast growing markets are strongly advantaged by lower wages and an explosion in technical expertise. The EU boasts high productivity and advanced technology, as well as huge markets and mature institutions. Russia is an important energy and raw material supplier to China and the EU, but it has difficulties to compete with these powerhouses on other fronts.

It is difficult to see how the recent changes in economic policy promote Russia's position relative to its powerhouse neighbours. Indeed, growing state control is likely to harm development of the Russia's private sector – by far the most dynamic sector and the engine of economic growth. Thus, there are considerable risks related to the state led development strategy, while doubtful benefits of statism are hardly able to balance these risks.

Shares of world exports in 1995 and 2004: Russia, the EU (Germany) and China, %



Sources: World Development Report 1997 and 2006, BOFIT

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