

# Russian Economic Recovery in Jeopardy

By the German Institute for Economic Research (DIW) and the Institute for the World Economy at the University of Kiel (IfW)

After a lean stretch that had lasted almost a decade, Russia will soon be able to look back on two years of economic growth. The rate of growth was actually higher than expected, so the optimistic forecasts for 2000 made by the Institutes last spring ('growth of 5% would not be surprising') will even be exceeded. Having made progress on macroeconomic stabilisation, the Russian government has now finally committed itself to dealing with the structural problems that have long been badly neglected and thus especially to improving the conditions for investment.

A number of extremely urgent structural issues indeed need to be resolved, because it would be a mistake to believe that the strong growth will continue more or less automatically. Moreover, the recent upturn can by no means be attributed exclusively to the increased world market prices for crude oil and the depreciation of the Russian rouble. Rather, the Russian

economy also gained a cost advantage after the 1998 crisis – without explicit action on the part of the government – that many observers had always longed for in eastern Germany: a drastic reduction in real wages.

The depreciation of the rouble resulted in import substitution, so that the fall in real wages in no way led to a decline in domestic demand. Instead, it effected an extraordinary rise in company profits, which in turn led to strong investment growth. On this view, the sustainability of the upturn will be threatened, especially if it is not understood that the current constellation of real economic growth of around 7% and real investment growth of almost 20% can be reconciled with the recent real wage growth of well over 20%, at best, only in the short term.

## Rapid recovery

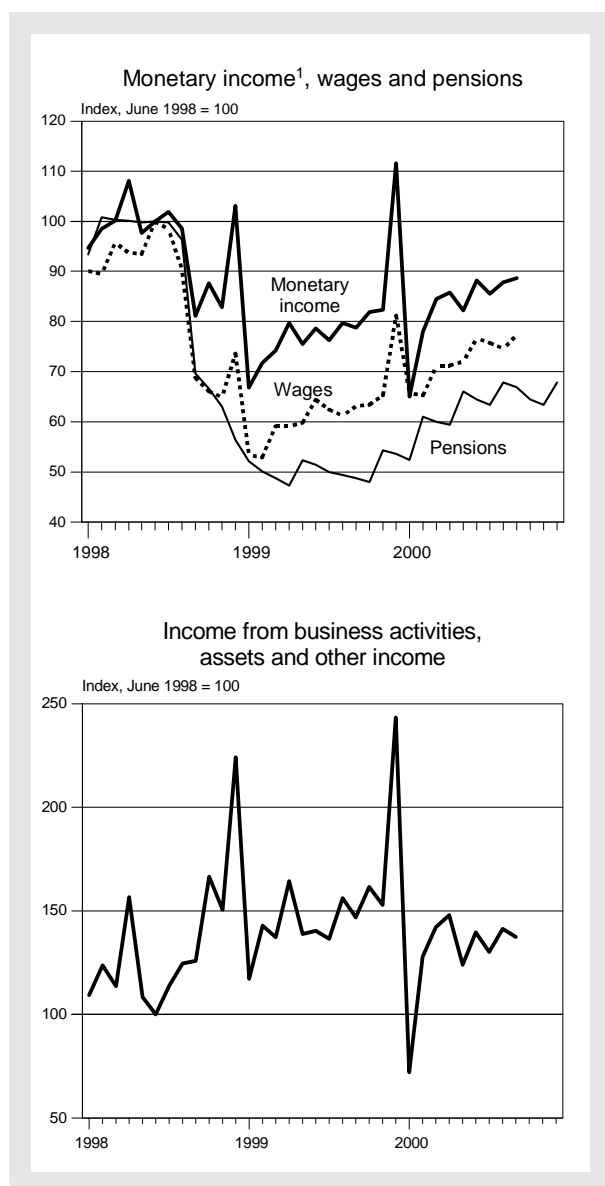
The increase of around 7% in Russian GDP in 2000 will amount to more than double the growth rate in 1999, the first year of the recovery. The rate of increase of gross fixed capital formation will be a full four times the previous year's rate (cf. table 1).<sup>1</sup> The chronology of the

Table 1  
Selected Economic Indicators, 1990 to 2000  
Change on previous year and share, respectively, in %

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	
											I to III	Jan.to Oct.
GDP <sup>1</sup>	-3.0	-5.0	-14.5	-8.7	-12.7	-4.2	-4.9	0.8	-4.9	3.2	7.3 <sup>7</sup>	7 <sup>7</sup>
Industrial output <sup>1</sup>	-0.1	-8.0	-18.0	-14.1	-20.9	-3.3	-4.0	2.0	-5.2	8.1	9.7	9.8
Agricultural output <sup>1</sup>	-3.6	-5.0	-9.0	-4.0	-12.0	-8.0	-5.1	1.3	-13.2	2.4	4.0	3.7
Gross fixed capital formation <sup>1</sup>	0.1	-15.0	-40.0	-12.0	-24.0	-10.0	-18.1	-5.0	-6.7	4.5	17.5	19.6
Volume of goods transport <sup>2</sup>	-	-7.4	-23.6	-5.0	-24.3	-10.2	-17.7	-9.8	-5.3	5.5	-	-
Volume of goods transport <sup>3</sup>	-	-7.4	-13.9	-11.5	-14.2	-1.0	-4.6	-3.4	-3.4	5.2	5.0	5.0
Retail trade turnover <sup>1</sup>	12.0	-3.2	-3.0	1.9	0.1	-7.0	-4.1	4.7	-3.3	-7.7	8.3	8.4
Market services for final consumers <sup>1</sup>	10.2	-17.0	-18.0	-30.0	-38.0	-18.0	-5.8	3.3	-0.5	2.4	6.4	-
Nominal monetary income per capita	18.0	120	750	1030	360	158	46.1	22.7	5.8	58.3	32.4	32.5
Real monetary income of private households <sup>4</sup>	-	7.5	-50.5	11.2	13.0	-15.0	-0.8	6.3	-16.9	-15.8	9.3	9.4
Nominal wages and salaries	15.0	81.0	994	878	276	114	57.3	20.2	10.6	43.4	49.8	49.2
Real wages and salaries	-	-3.0	-33.0	0.4	-8.0	-28.0	6.4	4.7	-13.4	-22.8	23.6	23.3
Real pensions	-	-	-48.1	30.7	-3.2	-19.5	8.7	-5.4	-	-39.4	26.1	-
Consumer prices <sup>5</sup>	6.0	160	2 510	840	215	131	21.8	11.0	84.4	36.5	19.2 <sup>8</sup>	20.1 <sup>9</sup>
Industrial producer prices <sup>5</sup>	4.0	240	3 280	895	233	175	25.6	7.5	23.2	67.3	35.2 <sup>8</sup>	35.5 <sup>9</sup>
Merchandise exports (US-\$)	-	-	-	11.3	13.2	20.1	9.3	-0.3	-15.9	1.3	48.1 <sup>10</sup>	46.7
Merchandise imports (US-\$)	-	-	-	3.1	14.0	20.6	12.9	7.0	-19.8	-31.7	7.9 <sup>10</sup>	9.0
Unemployment rate <sup>6</sup>	-	-	5.2	6.0	7.7	9.0	9.9	11.2	11.9	11.7	9.9	10.0

1 Real. — 2 Tonnes. — 3 Tonne-kilometres. — 4 1991 to 1993: December to December of previous year; 1994 to 1999: annual average. — 5 1990: annual average; from 1991: December to December of previous year; thus, these figures cannot explain the discrepancy between, for example, nominal and real wages. — 6 At the end of the period; on ILO definitions. — 7 Estimated. — 8 January to September 2000 annualised. — 9 January to October 2000 annualised. — 10 January to August 2000.  
Source: Goskomstat.

Figure 1  
Real Income of Private Households,  
1998 to 2000<sup>1</sup>



<sup>1</sup> Total monetary income of private households.  
Sources: Goskomstat; Institutes' calculations.

recovery can be summarised as follows: Immediately after the crisis of August 1998, the Russian rouble initially depreciated sharply, which led to massive increases in (rouble) prices for imports and a resulting rapid and sharp decline in import volumes. The sharp

<sup>1</sup> Unless indicated otherwise, the figures presented here are taken from publications by the State Committee for Statistics (Goskomstat). The reliability of these data has been discussed often in previous reports.

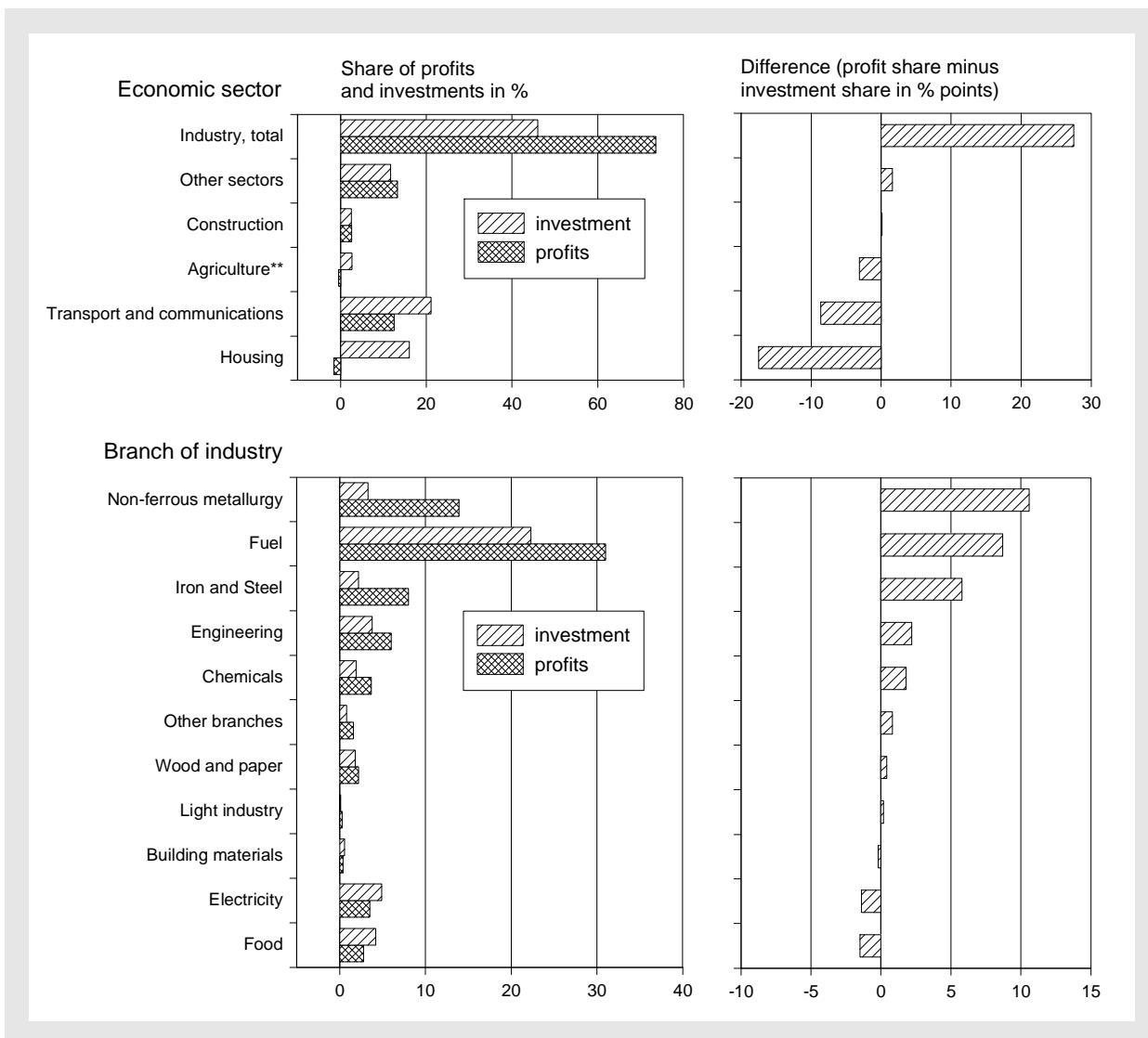
price hikes that accompanied the depreciation led to a swift decline in real wages (of well over 30%) and real pensions (of around 50%). Although the result was decreased demand, the depreciation also caused such a substantial demand shift towards domestic products that Russian manufacturers very soon (as early as the end of 1998) began to report output growth. As a result, first GDP and later also investment activity began to increase during 1999. The expected export growth (in both US-\$ and volume terms) due to the higher world market prices for oil and the rouble's depreciation did not manifest itself perceptibly until the last quarter of 1999. The substantial increase in the trade surplus which set in earlier was due exclusively to the decline in imports. In 2000 the improved situation in the important income categories then initiated a recovery of private consumption as well. The main reason for the strong investment growth was the explosion of company profits, which was initially due to import substitution following depreciation and the decline in real wages and only later also to the expansion of export earnings.

On the expenditure side of GDP, around half of the overall economic growth in 2000 is accounted for by the increase in private consumption, while around one third is due to investment growth. The expansion of net exports was determined primarily by the sharp rise in exports, while imports remained largely stable. Nonetheless, the strong boost exports gave to GDP growth was almost completely neutralised by the restrictive fiscal policy.

On the income side of GDP, aggregated profits again rose substantially, even though enterprises that are losing money are included in this total. Loss-making enterprises still make up almost 40% of the industrial sector, though the share again decreased slightly. The total income of private households increased in real terms at a much slower rate (over 9%) than wages (+24%) and pensions (+26%) (cf. figure 1). The rapid increase in real wages has by now eaten up some 50% of the cost advantage gained by enterprises after the 1998 crisis. The residual income of private households – in particular income from business activities and assets and especially profits from dividends<sup>2</sup> – has thus decreased again.

<sup>2</sup> A number of concerns must be mentioned regarding the data on profits provided in the Russian statistics. On the one hand, there is probably considerable upward distortion, given that the figures include a substantial number of claims that are *de facto* irrecoverable. On the other hand, there is probably also downward distortion, because it is well known that Russian companies do their utmost to conceal profits in order to avoid taxation.

Figure 2  
Sectoral Shares in Overall Profits and Investments\*



\* Based on data for the first half of 2000. More recent data are not yet available.

\*\* Data on profits in agriculture are not yet available. It has been assumed that, as in 1999, the profits amount to practically zero.

Sources: Goskomstat; Institutes' calculations.

## Structural adjustment, prices and employment

A comparison of the structure of profits and investments (cf. figure 2) allows a number of interesting insights.<sup>3</sup> First, it should be pointed out that the majority of profits – over 70% – were earned in industry,

<sup>3</sup> Of course the total dimensions of profits and investments must not necessarily be identical. However, in this case the two variables actually have very similar magnitudes, that is, profits only slightly exceed investments.

while housing and agriculture made no profits or even suffered losses.<sup>4</sup> While industry also accounts for the largest share of overall investment, this share by no means corresponds to its proportion of overall profits. The difference represents profits earned in industry that are not invested in industry. By contrast, investments are made in housing, agriculture, and transport and communications, in particular, which are not matched by profits earned. In other words, industry is more or

<sup>4</sup> Up-to-date figures are not yet available for the agricultural sector. However, it can be assumed with reasonable certainty that there has been no change on last year when profits were practically zero.

Table 2

## Industrial Output Growth by Sector

real change on previous year in %

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	
											I to III	Jan. to Oct.
Industry, total <sup>1</sup>	0	-8	-18	-14	-21	-3	-4	2	-5.2	8.1	9.7	9.8
Electricity	2	0	-5	-5	-9	-3	-2	-2	-2.5	0.2	2.1	2.4
Fuel	-3	-6	-7	-12	-11	-2	-3	0	-2.5	2.4	4.8	4.9
Iron and steel	-2	-7	-16	-17	-17	9	-4	1	-8.1	14.4	19.0	17.9
Non-ferrous metallurgy	-2	-9	-25	-14	-9	1	-5	5	-5.0	8.5	11.2	11.5
Chemicals and petrochemicals	-2	-6	-22	-22	-29	7	-11	2	-7.5	21.7	15.5	15.0
Engineering and metal-processing	1	-10	-15	-16	-38	-8	-11	4	-7.5	15.9	16.0	17.5
Wood, wood-processing, cellulose and paper	-1	-9	-15	-19	-31	-5	-22	1	-0.4	17.2	13.7	13.2
Building materials	-1	-2	-20	-16	-29	-8	-25	-4	-5.8	7.7	9.5	9.4
Light industry	0	-9	-30	-23	-47	-31	-28	-2	-11.5	20.1	29.2	28.6
Food	0	-10	-16	-9	-22	-9	-9	-1	-1.9	7.5	9.2	9.1
Grain mills and animal feed	-	-	-	-	-	-	-	-	-	-0.3	-3.8	-

<sup>1</sup> From 1994: including small and medium-sized enterprises. The figures for the individual sectors include only large and medium-sized enterprises in all years.  
Source: Goskomstat.

less co-financing these sectors. This state of affairs is all the more remarkable given that there is a huge share of loss-making companies in the industrial sector. Profits gained in the areas of non-ferrous metallurgy, fuel, and iron and steel, in particular, are not used for reinvestment in these sectors but made available or surrendered for investment in other sectors of the economy. Another net recipient in this sense is the food industry.

The flow of funds described here may be the result of market economic mechanisms, as is supposed in the case of the food industry, but it could also be due to state intervention. The latter almost certainly applies to the housing and agricultural sectors. Data on the financing structure of investment are only available for the economy as a whole and not disaggregated by economic sector. Only a total of 4% of investments are financed by means of bank loans. The public budgets account for the largest share (42% of external funds), while various investment funds (20%) and (public) extra-budgetary funds (8%) play a much less significant part.<sup>5</sup> It appears that the least profitable sectors (housing and agriculture), especially, receive investment funds via the public budgets to an extent that far exceeds the average for the economy as a whole.

<sup>5</sup> 'Other' unspecified credit sources provide another 21% of external funds.

At almost 10%, the rate of output growth in industry – by far the largest sector of the economy – was even stronger than in 1999. All the important branches of industry showed an upward trend, many of them achieving two-digit growth rates (cf. table 2). Of course the significance of high growth rates in one branch of industry for the whole economy must be relativised when this branch accounts for only a small part of industrial output. This applies, for example, to light industry, which may have grown by almost 30%, but accounts for less than 2% of total output.

If in addition to the growth rate of a particular branch of industry we also consider its relative weight, we can rank the branches' contributions to total industrial growth, as presented in figure 3. The comparison reveals that the engineering and metal-processing sector still makes by far the largest contribution to total industrial growth, followed by iron and steel, food, non-ferrous metallurgy, fuel, chemicals, wood and paper, light industry, building materials and electricity. There has been little change in the ranking order compared with the previous period.

As regards developments within the individual branches of industry, only a few points can be emphasised here. Notable in the energy sector is the renewed substantial increase in nuclear electricity production of almost 9% (representing a share of over 15%). In the

iron and steel sector the significant increase in the production of steel pipes (+61%) is conspicuous. In the chemical and petrochemical industry there has been substantial expansion in the production of tyres for agricultural vehicles (+22%). This increase goes hand in hand with growth in the engineering sector, where there is continued extremely strong growth in the output of agricultural machinery (+54%). There was less rapid expansion in the other areas of engineering, though most still achieved two-digit growth rates. The only significant exception was the automobile industry, where the increase was relatively low at 4% and where the production of private cars grew at the slowest rate – under 2%. The overall economic recovery was evidenced in the food industry by the fact that it not only affected basic foodstuffs in 2000, as was the case in 1999, but also higher quality foods (such as fresh meat and cured meats).

These examples again reflect the nature of the current upturn. On the one hand, it is based on the operation of market mechanisms, as can be assumed in the case of increased production of higher quality foodstuffs. On the other, the effects of direct state intervention are also clearly visible, as must be assumed for the increase in the production of agricultural machinery.<sup>6</sup> The same may apply to the strong increase of production in the 'military-industrial complex'.

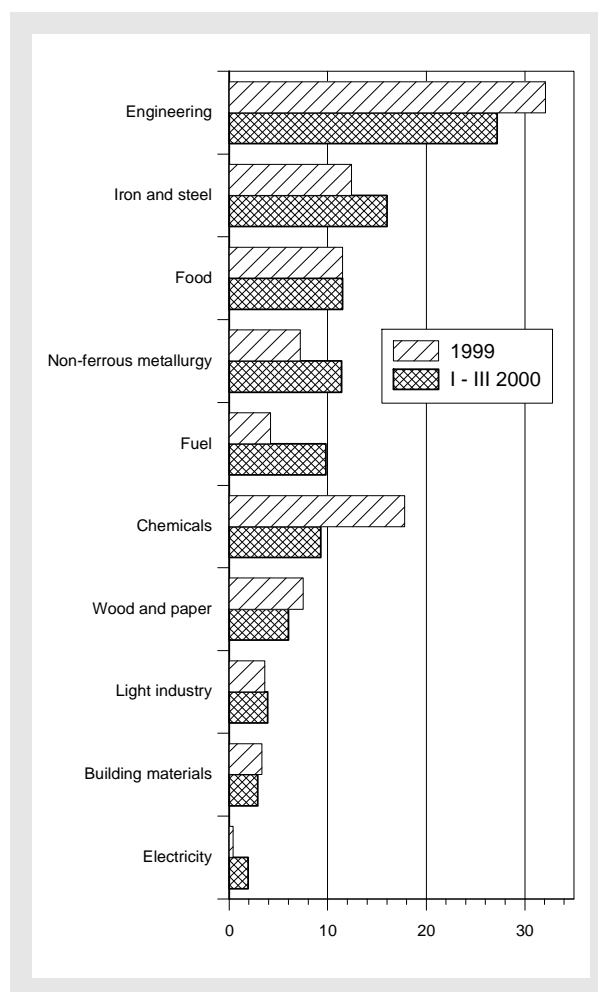
As pointed out above, Russian exports only began to grow towards the end of 1999. Of course the increase was due in large part to the higher world market prices for energy sources. However, it must be added that there were also some cases of strong export growth in volume terms, especially in the area of raw materials.<sup>7</sup> In the few cases where imports have already begun to grow, the area most affected is consumer goods. In the machinery and equipment sector, by contrast, there were still declines of over 3% during the observation period. However, the category of machinery and equipment includes motor vehicles, where imports increased substantially (private vehicles: +14%; commercial vehicles: +31%). This means that other machinery imports, and thus especially investment goods, have still not shown any sign of recovery.

Prices rose at a much slower rate in 2000 than in 1999 (cf. tables 3 and 4), though significant changes in relative prices can still be observed. These changes are completely justified where they represent adjustments

<sup>6</sup> Only recently Prime Minister Kasyanov made reference once again to the massive interest subsidies granted to the agricultural sector. Cf. interview in *Der Spiegel*, No. 48 of 27 November 2000, p. 249. According to provisional data, at least half of the investments in agriculture are to be financed in 2001 through reduced-rate loans at negative real interest rates. Cf. *Izvestija* of 6 December 2000.

<sup>7</sup> For example, ores: +55%, hard coal: +52%, cellulose: +36%.

Figure 3  
Contribution of Branches  
to Total Industrial Growth  
in % points\*



\* The sum of the contributions gives the growth rate of industry as a whole (change on corresponding period of previous year).

\*\* The sum of these shares is 100%.

Sources: Goskomstat; Institutes' calculations.

to account for relative scarcities, as in the case of the price increases for energy sources. The current average consumer price inflation rate of 20% is reconcilable with substantial energy price increases; a lower average rate would only be possible if at the same time there were an absolute reduction in the prices for other categories of goods and services. However, such a development would lead to considerable and unnecessary friction. In this sense, therefore, the current inflation rate can be considered entirely appropriate. Moreover, the consumer price increases are sufficiently moderate to avoid the price advantages of Russian consumer goods producers over foreign competitors being perceptibly reduced, in

Table 3  
Monthly Inflation Rates, 1994 to 2000

	Consumer prices							Industrial producer prices						
	1994	1995	1996	1997	1998	1999	2000	1994	1995	1996	1997	1998	1999	2000
January	17.9	17.8	4.1	2.3	1.5	8.5	2.3	19.0	21.5	3.2	1.1	0.9	6.8	4.0
February	10.7	11.0	2.8	1.5	0.9	4.1	1.0	15.1	16.9	2.7	1.6	0.5	5.5	3.7
March	7.4	8.9	2.8	1.4	0.6	2.8	0.6	10.2	10.8	2.6	1.3	-0.1	3.9	2.6
April	8.5	8.5	2.2	1.0	0.4	3.0	0.9	10.6	14.8	2.4	0.8	0.0	3.6	1.6
May	7.0	7.9	1.6	0.9	0.5	2.2	1.8	6.6	8.9	1.1	0.5	-0.9	3.5	1.7
June	6.0	6.7	1.2	1.1	0.1	1.9	2.6	8.4	6.1	1.6	0.8	0.0	3.7	2.3
July	5.3	5.4	0.7	0.9	0.2	2.8	1.8	7.8	6.7	1.2	0.2	-0.8	3.1	3.4
August	4.7	4.6	-0.2	-0.1	3.7	1.2	1.0	5.8	6.7	2.1	0.5	-1.2	4.6	1.7
September	7.9	4.4	0.3	-0.3	38.4	1.5	1.3	7.3	5.7	1.7	0.1	7.4	5.9	1.9
October	15.0	4.7	1.2	0.2	4.5	1.4	2.1	11.0	4.6	2.8	0.1	5.9	5.5	2.7
November	14.6	4.5	1.9	0.6	5.7	1.2	1.5	12.6	2.9	0.9	0.2	5.1	3.9	1.2
December	16.5	3.2	1.4	1.0	11.6	1.3	1.6	12.9	1.9	0.8	0.0	4.8	2.2	1.0

Source: Goskomstat.

Table 4  
Consumer and Industrial Producer Prices, 1991 to 2000  
% change on previous year<sup>1</sup>

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 <sup>2</sup>	
										I to III	Jan. to Oct.
Consumer prices	160	2 510	840	215	131	22	11	84	36.5	14.1	16.5
Food	171	2 570	838	233	123	18	9	96	35.9	11.6	14.0
Alcohol	52	2 370	655	131	127	53	18	51	43.2	22.1	22.7
Other consumer goods	211	2 570	642	169	116	18	8	100	39.2	13.3	15.4
Services	79	2 120	2 310	522	232	48	23	18	34.0	26.5	29.5
Industrial producer prices	240	3 280	895	233	175	26	7	23	67.3	25.4	28.8
Electricity	110	5 410	1 258	229	199	35	9	3	14.4	37.0	37.0
Fuel	130	9 170	634	201	187	40	19	1	134.9	38.8	50.7
Iron and steel	240	3 520	1 086	242	185	16	1	12	89.9	33.3	26.2
Non-ferrous metallurgy	230	5 120	558	296	121	12	3	76	115.8	9.8	14.8
Chemicals	170	3 790	848	262	168	18	5	26	43.8	20.8	22.7
Petrochemicals	150	5 250	672	260	167	24	11	17	66.5	22.1	41.9
Engineering and metal-processing <sup>3</sup>	210	2 620	949	230	178	24	9	29	49.6	24.8	26.6
Wood, wood-processing, cellulose and paper	240	1 920	889	271	174	12	8	43	67.7	18.8	21.0
Building materials	210	2 710	1 145	212	171	34	9	13	37.3	27.3	30.4
Light industry	370	1 160	381	241	163	20	10	44	56.0	16.5	19.5
Food	310	2 630	971	208	156	22	11	53	62.6	12.5	14.5

1 December to December of previous year. — 2 Compared with December 1999. — 3 Only engineering.  
Source: Goskomstat.

Table 5  
Labour Market, 1992 to 2000<sup>1</sup>

	Labour force	Employed	Unemployed		Registered unemployed		Share of registered unemployed in total unemployment
	in mill.	in mill.	in mill.	rate in %	in mill.	rate in %	in %
1992	76.0	72.1	3.9	5.1	0.6	0.8	14.9
1993	75.4	70.9	4.5	6.0	0.8	1.1	19.4
1994	74.2	68.5	5.7	7.7	1.6	2.2	28.7
1995	73.0	66.4	6.5	8.9	2.3	3.2	34.7
1996	73.2	66.0	7.3	10.0	2.5	3.4	37.2
1997	72.8	64.6	8.1	11.1	2.0	2.7	24.8
1998	72.2	63.6	8.6	11.9	1.9	2.6	22.1
1999	72.9	64.0	8.9	12.2	1.3	1.8	14.6
January 2000	72.5	63.8	8.7	12.0	1.2	1.7	13.8
February 2000	72.1	63.5	8.6	11.9	1.2	1.7	14.0
March 2000	72.1	63.9	8.2	11.4	1.2	1.7	14.6
April 2000	72.2	64.4	7.8	10.8	1.2	1.7	15.4
May 2000	72.2	64.8	7.4	10.2	1.1	1.5	14.9
June 2000	72.3	65.0	7.3	10.1	1.0	1.4	13.7
July 2000	72.3	65.1	7.2	10.0	1.0	1.4	13.9
August 2000	72.3	65.2	7.1	9.8	1.0	1.4	14.1
September 2000	72.3	65.2	7.1	9.8	1.0	1.4	14.1
October 2000	72.3	65.1	7.2	10.0	1.0	1.4	13.9

<sup>1</sup> All figures refer to the end of the period.  
Source: Goskomstat.

the short term at least. There would be cause for concern, however, if the average increase in producer prices were to continue to significantly exceed average consumer price inflation.

Unemployment fell in 2000 (cf. table 5), amounting to 10% according to the most recent data. However, far from all of this decline is the result of rising employment; one-third can be attributed to a reduction in the number of gainfully employed persons who also dropped out of the unemployment statistics. The employed labour force increased by less than 2%; thus, by far the largest share of GDP growth is due to improved manpower utilisation, i.e. to higher labour productivity.

## Government budgets

The situation of the Federal budget has changed dramatically. There was a significant budget surplus of almost 4% of GDP in the first half of 2000 (cf. table 6). Federal receipts increased significantly, from 13.5% in 1999 of GDP to 17.2% in the first half of 2000. The indicators available for the first 10 months of the year are approximate figures for revenues, expenditures and the

budget deficit. However, these data show that the Federation budget surplus contracted again in the second half of the year. Revenues fell to 16% of GDP between January and October 2000, and the budget surplus dropped to 2.3%.<sup>8</sup>

In the past, the instability of the public budgets was widely said to derive from the poor quality of the institutional framework. In institutional economics a crucial role of institutions is seen in the reduction of uncertainties, where a distinction is made between the existence of regulations and their implementation or observance. Low transaction costs are assumed to depend on both conditions being met. Reduced transaction costs then lead via a higher volume of transactions to an increase in overall economic activity. Does the increased revenue in the Federal budget imply, then, that the institutions have improved and that transaction costs have decreased? The following circumstances must be taken into account:

First, corporate tax arrears against the Federal budget, which have often been taken as evidence for poor implementation of existing regulations, actually increased further.<sup>9</sup>

<sup>8</sup> Cf. Bank of Finland: *Russian & Baltic Economies. The Week in Review*, No. 45/2000.

Table 6

## Federal Budget

Selected public revenue and expenditure items

	1995	1996	1997	1998	1999	1st half of 2000	1995	1996	1997	1998	1999	1st half of 2000
	% of total revenue/expenditure						% of GDP					
Revenue, total	100	100	100	100	100	100	15.1	13.2	13.7	11.3	13.5	17.2
Tax revenue												
Corporation tax	17.9	11.5	10.4	11.5	13.2	15.3	2.7	1.5	1.4	1.3	1.8	2.6
Income tax	1.4	1.8	0.5	0.0	3.3	2.1	0.2	0.2	0.1	0.0	0.4	0.4
Excise duties	7.5	16.0	16.1	17.4	13.8	12.6	1.1	2.1	2.2	2.0	1.9	2.2
Value-added tax	30.9	35.9	37.4	34.6	36.1	34.7	4.7	4.7	5.1	3.9	4.9	6.0
Tax on foreign trade and foreign transactions	.	.	.	.	14.1	20.4	.	.	.	.	1.9	3.5
Use of natural resources	.	.	.	.	1.7	1.4	.	.	.	.	0.2	0.2
Foreign trade	.	.	.	5.1	5.7	3.1	.	.	.	0.6	0.8	0.5
Revenue												
from state assets	.	.	.	.	1.1	2.0	.	.	.	.	0.1	0.3
from privatisation	2.1	0.3	5.5	5.0	.	.	0.3	0.0	0.7	0.6	.	.
Earmarked funds	.	.	.	.	9.0	7.1	.	.	.	.	1.2	1.2
Other revenue	40.2	34.6	30.2	26.3	2.0	1.3	6.1	4.6	4.1	3.0	0.3	0.2
Expenditure, total	100	100	100	100	100	100	15.6	14.4	14.7	14.5	14.6	13.5
Economy	14.3	11.4	12.1	.	.	.	2.2	1.6	1.8	.	.	.
Industry, energy, construction	.	.	.	2.9	2.5	2.0	.	.	.	0.4	0.4	0.3
Agriculture, fisheries	.	.	.	0.8	1.4	1.2	.	.	.	0.1	0.2	0.2
Transport, communications	.	.	.	.	0.2	0.2	.	.	.	.	0.0	0.0
Social and cultural purposes	8.2	8.9	16.6	14.7	12.8	14.6	1.3	1.3	2.4	2.1	1.9	2.0
Defence	20.6	20.6	21.9	14.6	17.5	20.7	3.2	3.0	3.2	2.1	2.6	2.8
Administration and legal organs	10.2	10.9	14.9	10.4	10.6	13.6	1.6	1.6	2.2	1.5	1.5	1.8
Debt servicing	.	.	.	27.4	24.5	21.4	.	.	.	4.0	3.6	2.9
Environmental protection	.	.	.	.	0.4	0.4	.	.	.	.	0.1	0.1
Fiscal transfers	.	.	.	.	9.3	11.9	.	.	.	.	1.4	1.6
Earmarked funds	.	.	.	.	8.3	8.0	.	.	.	.	1.2	1.1
Other expenditure	46.7	48.1	34.6	29.2	20.9	13.9	7.3	7.0	5.1	4.2	3.1	1.9
Balance as % of expenditure/ GDP	-3.4	-8.4	-7.3	-22.2	-8.0	28.1	-0.5	-1.2	-1.1	-3.2	-1.2	3.8

Sources: Goskomstat; Rosstat; Institutes' calculations.

Second, the higher Federal budget revenues must be seen in relation to the general economic upturn. Thus, both corporate tax and V.A.T. revenues increased substantially (cf. table 6). The higher enterprise profits on which these increases are based can at best be only partially explained by the introduction and implementation of efficient regulations.

Third, the increased revenue from taxation of foreign trade was based largely on the rise in world market prices for energy sources. This revenue accounted for around one fifth of the Federation's total income. A fis-

cal burden of this dimension creates a further incentive for enterprises to evade tax.<sup>10</sup>

Fourth, corporate tax, income tax, V.A.T. and excise duties are all components of a system where the Federation not only determines the rate of tax, but also the distribution of tax revenue between the federal level and subordinate local authorities. All of the legal amendments introduced in the course of the year seek to increase the federal share, while the income in the consolidated budget actually decreased slightly on 1999 (cf. table 7).

<sup>9</sup> The arrears amounted to 268.8 billion rouble on 1 September 1999 and had risen to 332.5 billion rouble by 1 September 2000. This corresponds to a nominal rate of increase of around 24%. The real rate of increase was around 5%.

<sup>10</sup> A recent Russian government tax report states that enterprises are currently managing to significantly reduce their tax bills, in particular by means of transfer pricing. Cf. *The Moscow Times* of 29 November 2000.

Table 7

## Consolidated Budget

Selected public revenue and expenditure items

	1995	1996	1997	1998	1999	1st half of 2000	1995	1996	1997	1998	1999	1st half of 2000
	% of total revenue/expenditure						% of GDP					
Revenue, total	100	100	100	100	100	100	26.1	24.8	27.3	25.5	26.3	25.7
Tax revenue												
Corporation tax	27.0	17.3	14.7	14.5	18.4	23.3	7.0	4.3	4.0	3.7	4.8	6.0
Income tax	8.4	10.1	10.6	10.4	9.8	9.3	2.2	2.5	2.9	2.7	2.6	2.4
Excise duties	5.6	9.6	9.6	10.5	9.1	10.5	1.5	2.4	2.6	2.7	2.4	2.7
Value-added tax	22.0	25.8	25.7	24.8	24.0	27.5	5.7	6.4	7.0	6.3	6.3	7.1
Foreign trade	4.6	3.0	1.6	2.7	2.9	2.1	1.2	0.7	0.4	0.7	0.8	0.5
Revenue from state assets	.	.	1.3	2.0	1.9	3.1	.	.	0.4	0.5	0.5	0.8
Revenue from privatisation	.	.	3.3	2.5	.	.	.	.	0.9	0.6	.	.
Earmarked funds	32.3	34.2	25.5	25.9	26.0	14.7	8.4	8.5	7.0	6.6	6.8	3.8
Other revenue												
Expenditure, total	100	100	100	100	100	100	29.4	28.9	32.3	31.2	27.5	25.5
Economy												
Industry, energy, construction	7.4	6.0	6.0	3.1	2.5	2.1	2.2	1.7	1.9	1.0	0.7	0.5
Agriculture, fisheries	4.2	3.9	3.7	2.9	2.9	2.9	1.2	1.1	1.2	0.9	0.8	0.7
Transport, communications	2.7	.	2.8	2.3	2.1	1.9	0.8	.	0.9	0.7	0.6	0.5
Social and cultural purposes	26.0	28.9	32.2	29.2	29.2	30.4	7.7	8.4	10.4	9.1	8.0	7.8
Education	11.6	.	.	.	.	.	3.4	.	.	.	.	.
Health	8.3	.	.	.	.	.	2.4	.	.	.	.	.
Social insurance	4.2	.	.	.	.	.	1.2	.	.	.	.	.
Defence	9.8	9.8	9.7	7.7	9.3	10.9	2.9	2.8	3.1	2.4	2.6	2.8
Administration and legal organs	7.7	.	10.5	9.1	9.6	11.4	2.3	.	3.4	2.8	2.7	2.9
Foreign trade	4.4	4.1	.	.	.	.	1.3	1.2	.	.	.	.
Debt servicing	5.1	6.6	4.9	17.7	13.0	14.3	1.5	1.9	1.6	5.5	3.6	3.7
Environmental protection	.	.	0.5	0.4	0.4	0.4	.	.	0.2	0.1	0.1	0.1
Earmarked funds	.	.	.	5.2	7.4	8.2	.	.	.	1.6	2.0	2.1
Other expenditure	8.6	40.9	29.7	22.5	23.6	17.5	2.5	11.8	9.6	7.0	6.5	4.5
Balance as % of expenditure/GDP	-11.2	-14.4	-15.2	-18.4	-4.3	0.7	-3.3	-4.2	-4.9	-5.8	-1.2	0.2

Sources: Goskomstat; Russian Ministry of Finance; DIW et al., various publications.

Thus, the improved financial situation of the Federation can hardly be seen to be the result of institutional progress. In fact it is also due to transfers within the fiscal and quasi-fiscal sector and to recentralisation of public revenue.<sup>11</sup>

This recentralisation has a major impact on the nature and functionality of fiscal federalism. In theory, the distribution of public tasks across various public levels is legitimised in particular by differences in regional preferences and information. Some of the few public goods for which general provision by a central government makes sense are national defence, foreign

policy and also a standardised legal system. On the other hand, the provision of regional public goods through subordinate local authorities can increase efficiency compared with universal provision by central organs.<sup>12</sup>

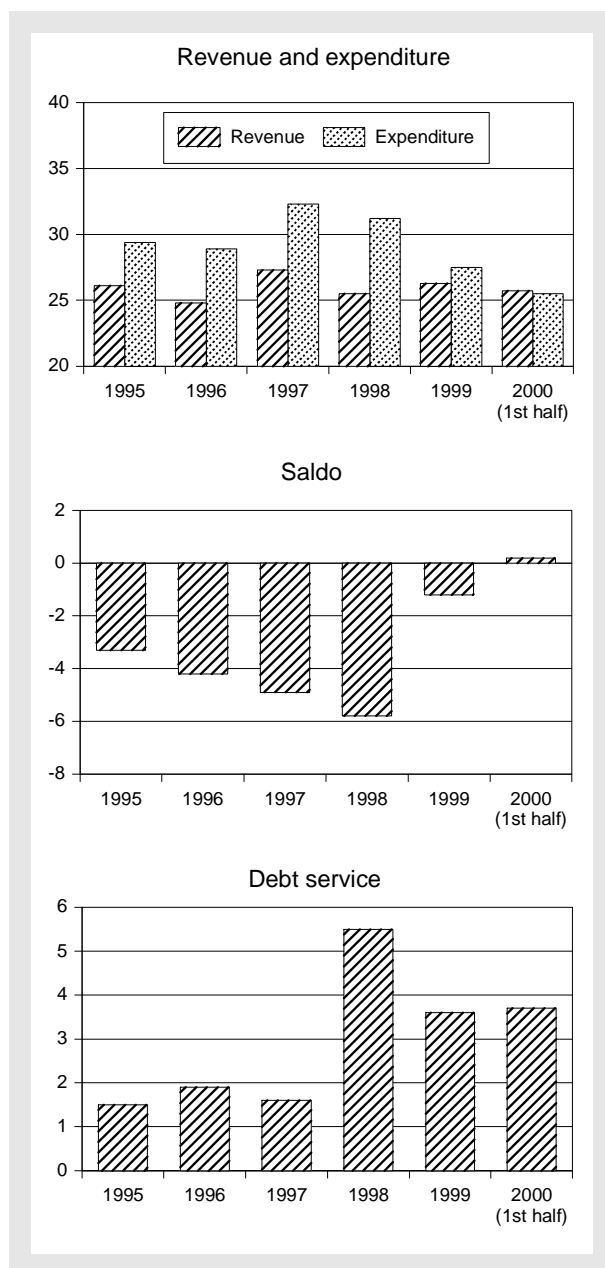
The Russian variety of federalism incorporates elements of the competitive model of federalism, where the individual regions compete with each other.<sup>13</sup> This applies both to the taxation of economic activities and to

<sup>11</sup> The grouping in Summer 2000 of the 89 federal regions into seven districts, each administered by a representative appointed by the president, was one expression of the trend towards recentralisation.

<sup>12</sup> Cf., especially, W.E. Oates: *Fiscal Federalism*, New York, 1972.

<sup>13</sup> M. Schrooten, B. Seidel: *Fiscal Federalism and Financial Resources for Regional Development – Co-operative and Competitive Models: The International Experience – An Example for Russia?* DIW Discussion Paper No. 220, 2000.

Figure 4  
**Consolidated Budget**  
 as % of GDP



Sources: Goskomstat; Rosstat; Institutes' calculations.

the supply of regional public goods. Moreover, the centre and the regions are clearly engaged at present in an unequal contest for public revenue. Because the centre is the party with legislative competence, it is at a distinct advantage in this battle for revenue. In fact the 'official' financial situation of the Russian Federation's regions is becoming increasingly precarious. The increases in rev-

enue at Federation level are matched by significant losses at the level of the subordinate local authorities. The income of the 89 local authorities fell to 10.1% of GDP (including inter-governmental fiscal transfers) in the first half of 2000, compared with 14.1% in 1999. In order to reduce their exclusive dependence on local taxes, the regions receive a fiscal transfer, although its volume amounts to only around 1.5% of GDP.<sup>14</sup> The aim of the system of inter-governmental transfers is to provide the regions with a minimum endowment of funds.

While the regional authorities still had direct control over half of the total volume of tax and contributions in 1999, this share fell to around one third in the first half of 2000. At the same time, the redistribution of tax revenue in favour of the federal level was not accompanied by increased transfers. As a result, the budgets of the regional authorities showed a substantial deficit in the first half of 2000 (3.6% of GDP, taking the fiscal transfers into account), having balanced out for years. The deficit might have been substantially higher had the regional authorities had more than limited access to the capital market.

The consolidated budget's slight surplus of 0.2% of GDP is thus due to the combination of a surplus in the Federation budget and deficits in the budgets of the regional authorities (cf. figure 4). Russian fiscal policy is currently restrictive. This is made particularly evident by the (consolidated) primary balance.<sup>15</sup> The primary budget showed a surplus of 3.9% of GDP in the first half of 2000, where debt servicing was lower than in 1999. The Federation level, which is the largest Russian debtor on the international and national capital markets, even showed a primary surplus of 6.9% of GDP.

Given these indicators, the Russian government can no longer use tax-collection problems as an argument in favour of delayed payment, debt restructuring or non-payment on the international financial market. However, the international and national creditors, if they are willing to make concessions, may rightly demand an improvement of the institutions in the Russian Federation, for the functionality and efficiency of such institutions is essential for long-term recovery.<sup>16</sup>

<sup>14</sup> This volume is low compared with Germany. However, in making such a comparison it must be noted that in Russia the creation of equal or equivalent living conditions in the different regions is not a primary constitutional aim. Rather the federalism in operation there - in full accordance with the theory - serves to unite heterogeneous constituents in a single state.

<sup>15</sup> Primary balance = revenue minus expenditure, excluding interest payments.

<sup>16</sup> C. Buch, R. P. Heinrich, L. Lusinyan, M. Schrooten: *Russia's Debt Crisis and the Unofficial Economy*. DIW Discussion Paper No. 208, 2000, and Kiel Working Paper No. 978, 2000.

The restrictive fiscal policy stance is to be eased slightly according to the budget plans for 2001.<sup>17</sup> The federal draft budget, which has not yet been passed, anticipates revenue amounting to 15.4% of GDP next year.<sup>18</sup> If the budget balances out overall, the planned primary-budget surplus will amount to 3.1% of GDP.

## Outline of the tax reform

Reform of tax legislation has long been discussed in the Russian Federation, because the code created in the course of the transformation at best satisfies only the elementary requirements for a modern tax system. The current situation is still characterised by a lack of transparency, discretionary tax concessions and impromptu changes in fiscal law. Modern tax legislation, by contrast, requires not only the operation of the rule of law, but also transparent regulations, simplicity, administrative efficiency and the capacity to generate revenue, while at the same time being conducive to economic growth, investment and environmental protection.

The tax reform, which came into force on 1 January 2001, is principally concerned with restructuring tax rates, but also with redefining the tax base. The reform affects personal income tax, V.A.T. and excise duties, in particular, and will also introduce changes concerning social insurance contributions. The definitive – and thus long-term – distribution of tax revenue to the various federal levels is again excluded from this tax reform, as is corporation tax, for which the maximum rate of 30% still applies.<sup>19</sup> If the tax burden on enterprises is felt to be overwhelming, this is due, on the one hand, to firms' limited possibilities for writing off operating costs and, on the other, to the additional taxes and contributions levied by the regional authorities, including the municipalities.

The most radical amendment to the Russian tax code concerns personal income tax. Income tax had previously been progressive, ranging from an entry rate of 12% to a top rate of 30%. But despite its progressive structure, the income tax collected from natural persons made up only a small part of Russia's total tax revenue. Although all personal income is subject to income tax, it has thus far primarily been levied on wages reported by enterprises. The inefficient administration of the tax system gave freelance workers and the self-employed lit-

tle incentive to report their actual incomes and pay the corresponding taxes. Under the new system a flat tax rate of 13% will be imposed on all income, regardless of the amount. The declared aim of this reform is to make tax evasion or non-declaration of income seem unattractive in view of the low tax rate. Whether the aim of voluntary declaration of income can be achieved with a low tax rate alone remains to be seen, not least because there is little doubt that the government intends to return to a progressive system within a few years.

Social insurance contributions will also be reformed. Up to now all earned income was subject to a total contribution rate of 39.5% to the various social insurance funds. This 'unified social tax' was replaced on 1 January 2001 by a regressive system. The entry rate is now 35.6%, while the lowest rate for an annual income exceeding 600,000 rouble will be 2%. The reform will not only reduce the social insurance contribution rate, but also merge the existing social insurance funds into one system with the aim of increased transparency and improved efficiency.

The amendments concerning V.A.T. are much less radical. The main changes relate to the abolition of numerous exemptions and the gradual abolition of V.A.T. on foreign transactions.<sup>20</sup> However, the general V.A.T. rate of 20% will remain unchanged, with the reduced rate of 10% levied on selected foodstuffs and children's clothing. The main thrust of the reform of excise duties is to increase taxes in this area. Alcohol tax is defined in complicated terms, whereby different rates apply depending on the beverage and its alcohol content.

All in all, the tax reform disappoints expectations. On the one hand, the existing regulations on enterprise taxation remain in force. The opportunity to create additional incentives for investment, for example through improved depreciation allowances, was not seized. On the other hand, the controversial uniform income-tax rate of 13% will not necessarily increase the incentive to pay up. Those who have evaded tax to date still have little incentive to move from the shadow economy into the official economy and declare their actual income, especially as an increase in the tax rate is already expected (cf. table 8).

## Monetary policy and the banking sector

The situation in the Russian financial sector is characterised by two opposing trends. On the one hand, a considerable degree of stability has been achieved at the

<sup>17</sup> This policy was formulated on the basis of a predicted growth rate of 4%, an inflation rate of 12%, an average exchange rate of 30 rouble/US-\$ and an oil price of US-\$ 20 per barrel.

<sup>18</sup> Bank of Finland: *Russian & Baltic Economies. The Week in Review*, No. 41/2000.

<sup>19</sup> Special regulations exist for banks and insurance companies.

<sup>20</sup> International Monetary Fund (IMF), *Staff Report for the 2000 Article IV Consultations*, Washington, D.C. ([www.imf.org](http://www.imf.org)).

Table 8

## Significant Amendments to the Tax Code as of 1 January 2001

Tax	Basis of assessment and tax rate
Personal income tax	Flat personal income tax rate of 13%
Social tax	This tax will replace contributions to the pension, social insurance and sickness insurance funds. Standard rates for employers: <ul style="list-style-type: none"> <li>– 35.6% for an annual income under 100,000 rouble</li> <li>– 20% for incomes between 100,000 and 300,000 rouble</li> <li>– 10% for incomes between 300,000 and 600,000 rouble</li> <li>– 5% for incomes over 600,000 rouble; this rate will be reduced to 2% as of January 2002</li> <li>– abolition of the 1% employee contribution to the pension fund</li> </ul>
V.A.T.	<ul style="list-style-type: none"> <li>– standard V.A.T. is 20%</li> <li>– V.A.T. on basic foodstuffs and children's clothing is 10%</li> <li>– 0% on export goods</li> <li>– 0% on goods delivered to the CIS; however, oil and gas exports to the CIS are subject to V.A.T.</li> </ul>
Excise duties	<ul style="list-style-type: none"> <li>– 8 to 88 rouble per litre of pure alcohol; vodka is subject to the maximum rate</li> <li>– 1 to 3.30 rouble per litre of beer</li> <li>– 35 to 55 rouble per 1,000 cigarettes</li> <li>– 405 rouble per kg pipe tobacco</li> <li>– 166 rouble per kg smoking tobacco</li> <li>– 10 rouble per cigar</li> <li>– 75 rouble per 1 000 cigarillos or filter-tipped cigarettes</li> <li>– 66 rouble per tonne gas/gas condensate</li> <li>– 1 350 to 1 850 rouble per tonne petrol (depending on octane number)</li> <li>– 550 rouble per tonne diesel fuel</li> </ul>

Source: Sobranie Zakonodatel'stva Rossijskoj Federacii, No. 32/2000.

macroeconomic level. Following the high price increases resulting from the depreciation of the rouble in 1998, annual inflation was around 20% in 2000. The rouble/US-\$ exchange rate remained largely constant throughout the year, while the rouble actually gained in nominal terms against the euro. On these indicators, Russia's economic policy can even be described as relatively successful. The situation at the microeconomic level is less positive, however. At the end of the day, the long-term success of macroeconomic stabilisation also depends on the progress made in this area, especially as regards the reform of the banking system.

The positive fiscal trend, which removed the pressure on the central bank to monetise budget deficits, was decisive for monetary stabilisation. Net lending to the government decreased in nominal terms in the first half of 2000.<sup>21</sup> This decrease was largely due to an increase in government deposits with the central bank,

<sup>21</sup> Cf. International Monetary Fund (IMF), loc. cit.

which trebled in the first three quarters of 2000.<sup>22</sup> All in all, net lending to the government as a share of the monetary base, which had risen sharply after the crisis, decreased in the first half of the year from 95% to 43% (cf. table 9). At the same time, the demand for money and thus the real money supply increased due to the economic recovery.

However, the central bank still lacks market-based instruments to control monetary policy. Even though the central bank maintained a positive real refinancing rate since the beginning of 1999 (cf. figure 5), this rate is actually irrelevant as regards refinancing the banks. Liquidity in the banking sector is in fact primarily controlled via changes in the minimum reserve rates;<sup>23</sup> moreover, the central bank has increasingly provided a deposit facility of its own. All in all, gross lending to banks remained stable in the first half of the year. Net

<sup>22</sup> [http://www.cbr.ru/eng/dp/denvl\\_00\\_engl.htm](http://www.cbr.ru/eng/dp/denvl_00_engl.htm) of 16 November 2000.

lending decreased further due to an increase in bank deposits with the central bank (cf. table 9).

The lack of market-based instruments for controlling monetary policy is due in part to the fact that the domestic securities market has effectively collapsed, so that the central bank cannot resort to open market operations. However, in large part the lack also reflects the profound problems of the Russian banking sector, which became particularly evident during the 1998 crisis. High foreign-currency liabilities accompanied by large, but effectively worthless, claims on the Russian government led to the insolvency of many banks. There is no long-term solution to the problems in sight, even if some attempts at reform have been made. But without reform the central bank is constantly at risk of having to provide liquidity to banks that are effectively bankrupt.

Another factor limiting the room for monetary policy manoeuvre is the tacit goal of preventing another real appreciation of the rouble. While the substantial current account surpluses of recent months have largely fed capital exports by the private sector, around one third of the surpluses were destined for building up the central bank's currency reserves. These more or less reached their pre-crisis level in mid-2000 and have continued to grow since. Thus, the net currency reserves made a positive contribution to the monetary base for the first time since the crisis struck (cf. table 9). However, since the central bank has only limited possibilities for sterilising

Table 9  
Change in Monetary Base, 1997 to 2000  
Contributions in %

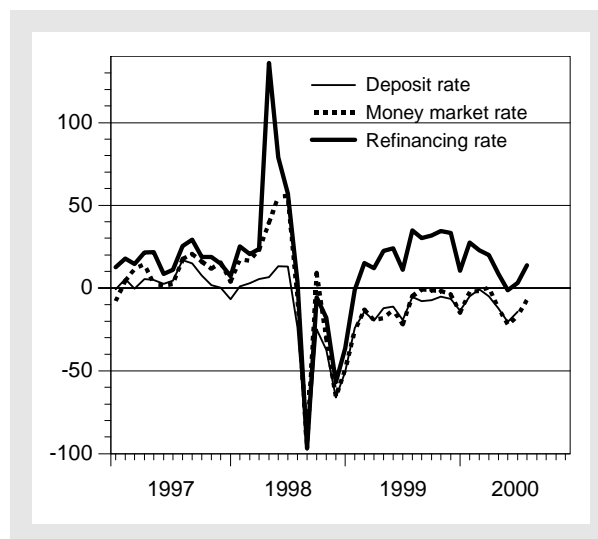
	1997	1998	1999	2000 <sup>1</sup>
Foreign-currency reserves (net)	13.6	-97.0	-23.6	51.5
Domestic assets (net)	86.4	197.0	123.6	48.5
loans to government (net)	116.5	131.3	95.3	43.0
loans to banks (net)	-13.0	-11.3	-14.2	-31.1
other (net)	-17.1	77.0	42.4	36.5
Memo item:				
International currency reserves (US-\$ billions)	17.8	12.2	12.6	21.2
Monetary base (rouble billions)	164.5	210.4	324.3	397.2

<sup>1</sup> June.

Sources: IMF, loc. cit., 2000; Institutes' calculations.

<sup>23</sup> As of January 2000, the central bank has increased the minimum reserve requirement from 8.5% to 10% for corporate deposits and from 5.5% to 7% for private accounts ([http://www.cbr.ru/eng/dp/res\\_int\\_intr\\_engl.htm](http://www.cbr.ru/eng/dp/res_int_intr_engl.htm) of 16 November 2000).

Figure 5  
Real Interest Rates,<sup>1</sup> 1997 to 2000  
% per annum



<sup>1</sup> Deflated by the consumer price index (annualised monthly inflation rate). Deposit rate = interest rate for private bank accounts with a maturity of less than one year. Refinancing and money market rates: average values.  
Sources: International Monetary Fund (IMF): International Financial Statistics on CD-ROM, Washington, D.C., 2000; Institutes' calculations.

the inflow of currency reserves and thus preventing uncontrolled money supply growth, a policy of this kind will only increase the inflation pressure. While the latter has so far been held in check by an increase in demand for money and thus an increase in the real money supply (cf. figure 6), the situation could be reversed if economic growth were to flag or if the real interest rates on domestic deposits (which are still negative) were to play a more significant part in Russian investors' investment decisions.

All in all, the Russian banking sector has made practically no contribution to the economic recovery. Basically, during the last two years the restructuring of the banks' balances consisted in reducing loans to the government while increasing foreign assets and reserve holdings.<sup>24</sup> The share of the overall balance made up of claims on the private sector fell from almost 40% at the end of 1997 to 34% in the middle of 2000 (cf. table 10).<sup>25</sup> The real volume of loans fell by 12% in the first half of 2000 alone (cf. figure 6).

Up to now, the economic upturn has been financed mainly through profits from the enterprise sector, and

<sup>24</sup> The increase in foreign claims in part also reflects a valuation effect.

<sup>25</sup> Many of these claims are denominated in US dollars and have thus appreciated due to the depreciation of the rouble. This must also be taken into account when looking at the decline in loans for financing investments.

Table 10

## Structure of Russian Commercial Banks' Balance Sheets, 1994 to 2000

Shares in %

	1994	1995	1996	1997	1998	1999	2000 <sup>1</sup>
<b>Assets</b>							
Reserves	11.7	10.7	9.5	11.8	7.3	10.3	15.5
Foreign claims	23.9	13.5	14.6	11.8	23.5	23.9	22.2
Claims on government	5.2	18.3	30.3	31.5	27.8	28.2	24.7
Claims on public enterprises	23.4	18.2	13.9	5.4	3.5	3.0	3.1
Claims on private sector	35.9	39.1	31.6	38.3	37.1	33.7	33.5
Claims on financial institutions	0.0	0.2	0.0	1.3	0.8	0.8	1.0
<b>Liabilities</b>							
Sight deposits	15.8	20.3	17.5	26.3	16.0	16.1	17.7
Time and foreign currency deposits	29.7	36.4	33.1	25.7	30.4	29.5	31.2
of which: foreign currency deposits	18.1	16.1	14.0	13.0	20.5	18.7	19.4
Money market instruments	1.7	3.5	6.1	6.9	4.6	7.0	6.1
Restricted deposits	0.0	0.0	0.0	1.0	2.4	0.7	1.8
Foreign liabilities	7.0	8.8	11.8	16.9	21.8	14.4	11.1
Government deposits	3.4	2.8	2.3	3.0	2.2	1.8	3.7
Central bank loans	8.3	2.3	1.4	1.4	7.7	12.9	10.7
Capital	12.7	19.5	24.9	23.3	16.9	18.9	18.1
Other assets (net)	21.4	6.5	2.8	-4.4	-2.1	-1.2	-0.3
<b>Memo item:</b>							
Net foreign assets	16.9	4.7	2.8	-5.1	1.8	9.6	11.1

1 July.

Sources: IMF, loc. cit., 2000; Institutes' calculations.

initially there was thus less need for an efficient system of financial intermediation. However, investment financing of this kind reaches its limits as soon as current and future profit opportunities begin to diverge in the enterprise sector, or as soon as private sector savings are increasingly needed to finance investment. Comprehensive reforms are thus necessary to give the Russian banking sector a long-term role in the intermediation of funds. These would include closing non-profitable banks, opening up to external competition, implementing a strategy to reform the savings bank (Sberbank) system and withdrawal of the state from the commercial banking sector. Even though a series of laws have been passed to this end and the central bank intends to divest itself of those commercial banking activities it is still involved in, little visible progress has been made. On the contrary, plans to maintain or even increase state control over the banking system through so-called development banks are still popular.

### Exchange-rate policy and the balance of payments trend

The Russian central bank is clearly pursuing the aim of preventing a real appreciation of the rouble. Although the bank has officially had no exchange-rate goal since

the speculative attack in 1998, by intervening in the foreign exchange market it managed to keep the nominal exchange rate against the US dollar stable from April to September 1999. In the first quarter of 2000 the bank accepted a monthly depreciation of between 1% and 2%. Since then the exchange rate has been practically unchanged. The result is that the real effective exchange rate remained more or less stable throughout the year (cf. figure 7).

One of the positive aspects of the post-crisis economic recovery is the development of the current account balance, due mainly to the real depreciation of the rouble and the increase in world market prices for oil and gas. The trade surplus amounted to over US-\$ 25 billion in the first half of 2000 (cf. table 11) and was thus twice as high as in the first half of 1999.<sup>26</sup> It rose to more than US-\$ 60 billion for the whole year 2000.<sup>27</sup>

The fact that the current account moved into surplus after the crisis was initially due almost exclusively to import substitution. Imports then stabilised in the first half of 2000 at the low level reached in the first half of 1999. At the same time exports more than doubled, and the current account surplus rose accordingly. The export boom mainly reflects the higher oil price. How-

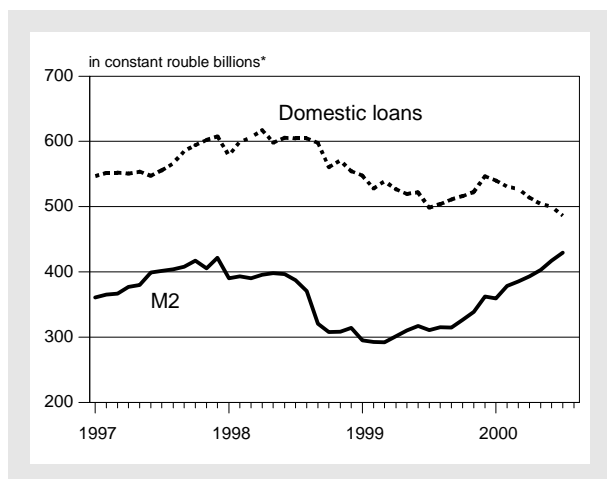
<sup>26</sup> Cf. [http://www.cbr.ru/eng/dp/P\\_balance99.htm](http://www.cbr.ru/eng/dp/P_balance99.htm) and [http://www.cbr.ru/eng/dp/P\\_balance00.htm](http://www.cbr.ru/eng/dp/P_balance00.htm) of 16 November 2000.

<sup>27</sup> Goskomstat (based on Russian central bank statistics).

ever, exports also benefited in quantitative terms from the depreciation of the rouble, especially in the area of raw materials, though these exports are now increasingly coming up against capacity limits.

Against the background of the tense situation on the world energy markets, at their summit meeting at the end of October 2000 the EU and Russia discussed a new strategic energy partnership. A working group is to analyse the possibilities for expanding EU energy imports from Russia and will ascertain the need for investments in infrastructure.<sup>28</sup> So far the principal projects concern the expansion of the transport facilities for natural gas. The Russian Gazprom company has agreed on a joint project with Gaz de France amounting to US-\$ 1 to 2 billion, which also provides for the construction of a pipeline from Russia to western Europe, passing through Belarus, Poland and Slovakia. This route would by-pass Ukraine, which has always been the most important (though from the Russian point of view not always reliable) transit country. It is not known under which conditions Belarus would agree to the transit. Thus, it remains to be seen whether agreement can be reached between Russia, as a gas producer, and Belarus, as an important transit country, as well as the west European buyers.

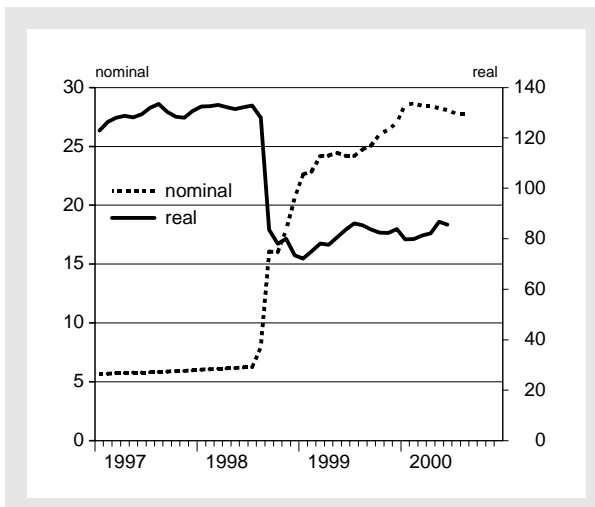
Figure 6  
**Money Supply and Loans**  
 1997 to 2000



\* Deflated by consumer prices  
 Sources: International Monetary Fund (IMF): International Financial Statistics, Washington, D.C., 2000; Institutes' calculations.

<sup>28</sup> The EU currently imports around 34% of its total natural gas and around 13% of its total oil needs from Russia. German imports of natural gas and oil from Russia amount to around 44% and 21% respectively. Cf. 'Russia's Energy Sector in the Wake of the Financial Crisis'. Hella Engerer, Petra Opitz and Christian von Hirschhausen. In: *Economic Bulletin*, No. 7/1999.

Figure 7  
**Rouble Exchange Rate Against the US Dollar**  
 1997-2000



The real exchange rate is calculated on the basis of consumer prices. An increase corresponds to a real appreciation of the rouble.  
 Sources: International Monetary Fund (IMF): International Financial Statistics, Washington, D.C., 2000; Institutes' calculations.

The capital account deficit increased in the first half of 2000 compared with the same period the previous year. Net capital exports increased from US-\$ 6.3 billion to over US-\$ 9 billion. The lower increase in Russian outstanding arrears with foreign creditors (around US-\$ 2.2 billion) had a negative effect. Inflows of foreign direct investments, which were low to begin with, decreased slightly. Inward portfolio investments also decreased further, amounting to only a fraction of the pre-crisis level.

The positive economic trend raised hopes that the exodus of capital would contract and that foreign investors might even return to Russia. These hopes have at best been only partially fulfilled. Measured in terms of the statistically non-classifiable transactions, which show a capital outflow of US-\$ 4.5 billion in the first half of 2000, compared to US-\$ 1.7 billion in the first half of 1999, the problem of capital flight has in fact worsened. However, the absolute figures only give an indication of the trend, not the actual magnitude of capital flight, which is thought to be much higher. The various measures implemented to try to regulate the flows of capital have not proved very effective.<sup>29</sup> Moreover, there is little to suggest so far that Russia is becoming more attrac-

<sup>29</sup> The restrictions on the exchange of frozen assets in so-called 'S-accounts' and on the repatriation of profits from the sale of public debt notes, for example, are still in force. Cf. International Monetary Fund (IMF), loc. cit.

Table 11

## Balance of Payments, I/1999 to II/2000

US-\$ millions

	1999					2000		
	I	II	III	IV	Year	I	II	1st half
Current account balance	4 457	4 206	5 801	10 838	25 301	12 159	10 804	22 964
Balance of trade	6 454	6 881	9 525	13 361	36 220	14 440	14 350	28 789
Exports	15 550	16 999	19 011	24 285	75 845	24 294	24 752	49 045
Imports	-9 097	-10 118	-9 486	-10 923	-39 625	-9 854	-10 402	-20 256
Balance of non-factor services	-859	-918	-995	-1 130	-3 902	-1 439	-1 945	-3 384
Exports	1 774	2 276	2 595	2 399	9 044	1 796	2 329	4 126
Imports	-2 634	-3 194	-3 590	-3 529	-12 946	-3 235	-4 275	-7 510
Factor income	-1 089	-1 835	-2 936	-1 699	-7 559	-890	-1 681	-2 571
Earned income	57	59	49	56	221	52	42	95
Capital yields	-1 146	-1 894	-2 985	-1 755	-7 780	-943	-1 723	-2 666
Capital yields received	2 175	610	310	361	3 456	2 403	598	3 001
Capital yields paid out	-3 322	-2 504	-3 294	-2 116	-11 236	-3 346	-2 321	-5 667
Current transfers	-48	78	206	306	541	49	80	129
Capital transfers	-30	-95	-81	-122	-328	4	-39	-36
Balance on capital account	-3 944	-2 855	-4 102	-6 547	-17 448	-9 217	-9 197	-18 414
Direct investment balance	227	188	63	687	1 164	188	315	503
Direct investment abroad	-415	-563	-597	-570	-2 145	-380	-202	-582
Direct investment in Russia	642	751	659	1 257	3 309	569	517	1 085
Portfolio investment balance	67	-620	-41	-440	-1 034	623	-1 629	-1 006
Assets	-23	-202	306	172	254	37	9	47
Liabilities	90	-418	-347	-612	-1 287	585	-1 638	-1 053
Other capital transactions	-5 311	-705	-5 201	-4 409	-15 625	-7 019	-1 612	-8 631
Assets	-6 306	-317	-4 899	-3 571	-15 093	-6 459	-1 206	-7 664
Change in cash holdings	186	1 025	-473	68	806	-33	430	397
Current accounts and deposits	-1 095	-1 535	-473	-786	-3 889	-1 476	-595	-2 071
Commercial loans	-2 032	788	-2 570	-1 961	-5 773	-1 106	12	-1 094
Other loans	1 800	2 187	139	731	4 857	1 622	985	2 606
Overdue payments	-4 073	-1 312	-231	-188	-5 805	-3 808	-690	-4 498
Outstanding export payments and advances extended on imports	-960	-1 504	-1 342	-1 245	-5 051	-994	-1 087	-2 081
Other claims	-132	34	50	-191	-240	-664	-260	-924
Liabilities	995	-388	-301	-838	-532	-560	-407	-967
Change in cash holdings	-2	1	-7	11	3	23	42	65
Current accounts and deposits	-258	644	-378	153	162	148	-348	-200
Commercial loans	104	77	48	-224	5	0	0	0
Other loans	-1 318	-2 134	2 250	-1 333	-2 535	-1 083	-1 378	-2 462
Overdue payments	2 437	1 198	-2 200	601	2 036	296	1 190	1 487
Other liabilities	33	-174	-14	-46	-201	56	88	144
Reserve assets	969	-1 611	1 091	-2 227	-1 778	-3 102	-6 219	-9 321
Adjustment*	104	-107	-14	-158	-176	92	-52	41
Errors and correction items (net)	-484	-1 255	-1 617	-4 169	-7 525	-2 946	-1 568	-4 514

\* The adjustment was introduced for the purpose of reconciling the balance of payments data prepared in accordance with the 5th edition of the IMF Balance of Payments Manual with the reserve assets data calculated in accordance with national guidelines. The method used to calculate reserve assets differs from that proposed in the manual in the following respect: short-term foreign currency deposits in resident banks were included in the reserve assets up to the 3rd quarter of 1999; from then onwards, the reserve assets are adjusted by the equivalent value of foreign currency deposits held by resident banks with the Russian central bank (excluding foreign currency which the central bank provides for servicing the state's foreign debts).

tive as a location for foreign direct investment. On the other hand, Russia's domestic investors have clearly gained confidence in the country's economy. While in 1999 probably almost half of domestic savings flowed abroad by legal or illegal means, provisional figures suggest that over two thirds of domestic savings were invested in the Russian economy in the year 2000.<sup>30, 31</sup>

<sup>30</sup> In the first half of 1998, in other words immediately before the balance of payments crisis arose, over 80% of domestic savings were exported.

In addition to the Russian banking sector's chronic weakness, the reticence of foreign investors may also be due to the fact that the rescheduling negotiations with

<sup>31</sup> According to preliminary IMF figures for the entire year 2000, savings accounted for 28.4% of GDP, or around US-\$ 65 billion. If the transactions which are not statistically classifiable are taken as the gauge for capital flight, legal and illegal net capital exports amounted to US-\$ 20.7 billion. Legally registered net capital exports amounted to US-\$ 18.5 billion. In 1999 savings amounted to around US-\$ 49 billion, and net capital exports to US-\$ 23.6 billion (including capital flight) or US-\$ 16.6 billion (official figure).

the Paris Club of public creditors have not yet been concluded. The relatively high surpluses in the Russian public budget further reduced the creditors' willingness to compromise.<sup>32</sup> Russia, for its part, contributed to no small degree to the uncertainty of foreign investors by the way it handled the debt crisis.<sup>33</sup> Institutional reform. An improved institutional framework is considered one of the main tasks of Russian reform policy. The hypothesis commonly expressed in recent years was that institutional deficiencies were decisive in impeding economic growth in Russia. Ad hoc measures were still the order of the day even after the financial crisis in 1998.<sup>34</sup> Thus, it was practically impossible for the economic actors to develop reasonably stable expectations regarding future political and economic trends. It may seem extraordinary, therefore, that the Russian economy is actually recovering. The following explanations might account for the apparent paradox: It is conceivable that institutions play a less important role in transformation processes – and especially as regards investment activities – than assumed.<sup>35</sup> It is also possible that while institutional inadequacies exist, the economic actors expect better conditions in the foreseeable future and are thus investing now. However, the most probable explanation is that the institutional weaknesses were overcompensated in the short term by the effects of depreciation, the fall in real wages and the rise in oil prices, and that a profound institutional reform is needed for a long-term recovery.

Foreign investors, in particular, still clearly view the institutional environment as unsatisfactory. Foreign investment, which had grown to US-\$ 12.2 billion (gross) in 1997 and fell due to the financial crisis (first half of 1998: US-\$ 7.7 billion; second half of 1998: US-\$ 4.1 billion), remained stuck over the following two years at around US-\$ 9.5 billion. The continued high level of capital flight is another indication of institutional deficits.

<sup>32</sup> *Daily News and Views – New European Markets, Middle East and South Africa*. Goldman Sachs Economics, Moscow, November 2000.

<sup>33</sup> The most recent Russian proposal for solving the debt crisis suggests transforming part of the debt into shares in Russian enterprises. However, the proposal's prospects of success have to be viewed sceptically, not least because it has clearly met with considerable resistance even within the Russian government.

<sup>34</sup> Cf. 'The Russian Economy. Crisis Reveals Economic Policy Errors', *Economic Bulletin* No. 7/1998; 'The Economic Situation in Russia. Debt Forgiveness Instead of Reforms?', *Economic Bulletin* No. 6/1999.

<sup>35</sup> This is also discussed in the relevant literature. Cf., for example, O. Havrylyshyn, R. van Rooden: *Institutions Matter in Transition, but so Do Policies*, IMF Working Paper (WP/00/70). Janine Aron provides a critical overview of the most important research looking at the link between institutions and growth: 'Growth and Institutions: A Review of Evidence', *The World Bank Observer*, Vol. 15, No. 1, 2000, pp. 99-135.

The new Russian government has laid out its ideas concerning future reforms in an economic modernisation plan for the period 2000-2001 and in a development strategy for the period up to 2010. The important issues in the two programmes include the protection of property rights and the general improvement of the legal parameters and economic administration, easier access to the market, improved competition (including deregulation), reforms in the financial sector and far-reaching fiscal reform. While the tax reform – as discussed above – has already been launched, concrete proposals have yet to be elaborated in the other areas. However, it remains to be seen whether this will actually succeed in the near future in the case of controversial plans such as demonopolisation and the clarification of private land property rights.<sup>36</sup> Moreover, it is only when the proposals exist in concrete form that it will become clear whether the individual reform measures are mutually compatible. Finally, it is also uncertain whether the state will really restrict its role to creating and implementing market-economic rules, or whether, and if so to what extent, it will involve itself selectively and directly in economic affairs. All in all the programmes offer economic actors at least broad guidelines as to future reform. However, expectations can only be stabilised if the government views its intentions as binding commitments and demonstrates efforts to implement the reforms. Ultimately this would also reinforce its own credibility.

One example of government inconsistency is the privatisation of public enterprises. In contrast to the declaration in the modernisation plan that a large share of the enterprises still owned by the state would be rapidly privatised,<sup>37</sup> the year 2000 saw more of the delays and suspended proceedings already encountered in previous years. For example, the sale of shares in the Gazprom gas monopoly and in the Slavneft' oil enterprise was postponed, while the sale of shares in the Rosneft' oil company was halted. The official justification for these decisions was that the selling price would have been too low.<sup>38</sup> A total of 919 objects, including operating units

<sup>36</sup> The enactment of the law on land ownership is still subject to delays. Thus, in recent years individual regions have passed their own regulations on land law and have carried out auctions. The city of Moscow sold its first piece of land to a private investor in October 2000. However, land ownership legislation that applies to the whole Federation is required in order to increase legal security. Progress is expected through the law on mortgages. The Duma agreed in autumn 2000 on the first reading to abolish the existing ban on mortgages for agricultural land. Cf. Bank of Finland. *The Week in Review*, No. 40/2000, p. 1; RFE/RL of 23 October 2000.

<sup>37</sup> This aim was reinforced in autumn 2000 when the government announced its intention to sell around 3,000 public enterprises within the next three years. Cf., for example, *Russia Today* of 30 October 2000.

Table 12

## Number of Converted and Privatised Enterprises (Objects), 1992 to 2000

	1992	1993	1994	1995	1996	1997	1998	1999	1st half of 2000	Total
Total	46 815	42 924	21 905	10 152	4 997	2 743	2 129	1 536	919	134 120
of which previously owned by:										
Municipalities	–	26 340	11 108	6 960	3 354	1 821	1 544	1 134	–	–
Regions	–	9 521	5 112	1 317	715	548	321	298	–	–
Federation	–	7 063	5 685	1 875	928	374	264	104	–	–

Source: Goskomstat.

and buildings, were privatised in the first half of 2000,<sup>39</sup> yielding income totalling 6.4 billion rouble (cf. tables 12 and 13). Proceeds from privatisation for the entire year 2000 will be significantly higher than those for 1999 (12.1 billion rouble),<sup>40</sup> with preliminary estimates exceeding 30 billion rouble. Auctions clearly now more commonly take place under market conditions – in contrast to previous years, when insiders were able to buy companies at a price that only slightly exceeded the opening price.<sup>41</sup> Fair conditions are an important requirement if foreign investors are also to become more involved in the privatisation process. However, the government must first actually implement its privatisation aims and not postpone or entirely halt privatisations

which have been announced. This applies all the more since there is no guarantee that the enterprises or enterprise units still owned by the state are efficiently managed. Proposals were frequently made in the past as to how the management of public enterprises could be improved, and some of these were implemented. Nonetheless, it is clear that a real improvement in efficiency was not achieved. This is also unlikely in the future, given that the modernisation plan only contains vague references to reforming the management and administration of public enterprises.

One of the main aims of the modernisation plan is the creation of a good climate for investment. Bureaucratic obstacles are to be reduced, fair competitive conditions created for investors, subsidies to inefficient enterprises abolished and the state's influence on the economy diminished. It remains to be seen, however, to what extent the state really will redefine its role. It was announced in autumn 2000 that the reform of so-called natural monopolies (e.g. in the gas and electricity sector, railways<sup>42</sup> and telecommunications) would only take place under the strict control of the state. In addition, the deconcentration of the Gazprom gas enterprise, which has repeatedly been demanded by the IMF, and the liberalisation of the gas market were postponed.<sup>43</sup> It is extremely difficult for independent gas producers to gain access to the pipeline system. The situation is similar in the oil sector. While there were large-scale liberalisation, deregulation and privatisation of the producer companies in this sector in the past, the Transneft' and Transnefteprodukt transport companies, in which the state owns 75% and 100% of the shares, respectively,<sup>44</sup> still control the majority of oil exports.<sup>45</sup> Discussions were held in autumn 2000 on the possibility of auction-

<sup>38</sup> The reason for the halt on the sale of Rosneft' is not only the low selling price, but also the government's plan to entrust the oil company with representing its interests in production-sharing agreements. The sale of Rosneft' shares had already been planned in 1998, but proved impossible at that point in time owing to a lack of bids.

<sup>39</sup> Around 134,000 companies have been sold since privatisation commenced. This corresponds to around 60% of the public enterprises that once existed. Cf. *Russia Today* of 30 October 2000.

<sup>40</sup> Federal income alone amounted to 37.5 billion rouble at the end of October 2000. Cf. RFE/RL of 10 November 2000.

<sup>41</sup> In the summer of 2000 the chief public prosecutor contested the legality of the transfer of shares in the Norilsk-Nickel company to the Onexim bank, which had taken place in the mid-1990s under the so-called 'loans for shares' scheme, because the selling price was too low. Since no settlement was reached out of court, the next step should really be a legal inquiry. If the sale is actually classified as illegal, further revisions of privatisations under the 'loans for shares' scheme might follow. However, it cannot be ruled out that the legal proceedings will be suspended because under the current restructuring of Norilsk-Nickel the company is ultimately to be liquidated and its assets transferred to a subsidiary. It should be pointed out that criticisms have been made in the course of the restructuring process that the minority shareholders, who enjoy only unsatisfactory legal protection, may be disadvantaged. On the 'loans for shares' scheme, cf. 'The Economic Situation in Russia. New Course for Stabilisation Policy?', *Economic Bulletin* No. 2/1996. On the restructuring of Norilsk-Nickel, cf. *The Moscow Times* of 5 October 2000.

<sup>42</sup> A plan for reforming the railway system is to be elaborated by 1 April 2001. Cf. *The Moscow Times* of 10 November 2000.

Table 13

## Income from Privatisation, 1993 to 2000

in billions of rouble

	1993	1994	1995	1996	1997	1998	1999	1st half of 2000
Total	0.36	0.98	3.57	2.81	24.7	17.5	12.1	6.4
of which:								
Federation	0.07	0.12	1.14	0.90	18.0	15.0	8.5	4.1
Regions	0.10	0.18	0.52	0.42	3.3	0.9	1.9	1.2
Municipalities	0.13	0.40	0.96	0.91	0.7	1.0	0.9	0.5
Other	0.06	0.29	0.95	0.58	2.7	0.6	0.8	0.6

Source: Goskomstat.

ing off transit rights for some gas and oil exports. It remains to be seen whether a partial auction will significantly diminish the monopoly position of Gazprom, Transneft' and Transnefteprodukt, and really improve the position of independent producers.

Some important conditions which would encourage foreign investors to increase their interest in Russia are still lacking. For example, an amendment to the production-sharing law with a view to increasing foreign involvement in the exploitation of new oil finds has not yet been made.<sup>45</sup> Although further deposits have been approved for joint extraction and a special agency is to be founded to improve market access for foreign companies, the conclusion of production-sharing contracts is being impeded, for example, by bureaucratic obstacles. The involvement of foreign investors in the Russian energy sector has declined overall: foreign investments in this sector amounted to around US-\$ 300 million in the first half of 2000, which corresponds to a fifth of the figure for the first half of 1999.<sup>47</sup> The decline in investments in the rather attractive energy sector is a specific indication that foreign investors still consider the insti-

tutional environment to be unsafe. This could change in the long term if legal security is indeed increased for investors, for example under the joint energy project between Russia and western Europe.

Financing of investment is hampered by institutional deficits in the financial sector. According to the modernisation plan, banking supervision, deposit insurance and regulations on bankrupt credit institutions are to be improved.<sup>48</sup> There are also plans to expand the range of available financial instruments and, in particular, to promote long-term forms of financing. Discussions were held in autumn 2000 on the leasing law passed in 1998. The background to the debate are regu-

<sup>43</sup> Concentration in the gas sector in fact seems to have increased recently. The Russian cartel authority agreed in autumn 2000 to Gazprom becoming majority shareholder in Sibur, a company mainly concerned with further processing of natural gas. By contrast, the modernisation plan intends to demonopolise the gas sector and also regulate gas prices. The domestic price for gas is currently only around 15% of the world market price. In addition, under the modernisation plan the natural gas share of the primary energy supply is to be reduced in the future. This would be a new departure for energy policy, which to date has been geared towards increasing the share of natural gas used for domestic purposes. Cf. *The Moscow Times* of 18 October and of 24 October 2000.

<sup>44</sup> The Ministry for Privatisation proposed selling shares in the transport companies in 2001, but the proposal is not supported either by the companies or the Ministry of Energy. Cf. *The Moscow Times* of 21 October 2000.

<sup>45</sup> Up to now, the individual oil companies have been allocated export volumes for transit through the Transneft' pipeline network, while transport costs were increased in the past. Thus, the oil companies are looking for alternative export possibilities (e.g. shipping). However, in order to safeguard domestic supplies, manufacturers of oil products were obliged in autumn 2000 to sell a large share of their products on the domestic market. In addition, export duties on diesel and petrol were increased to 32 euro/t (from 25 euro/t). The export tax on crude oil was raised in November from 27 euro/t to 34 euro/t. All in all, measures such as higher export duties and limits on export volumes have only limited effects, and illegal exports cannot be prevented. Cf. *vvd-Russland* of 18 October 2000, p. 2, of 12 September 2000, p. 1, and of 31 August 2000, p. 1; *Russian Economic Trends*, Monthly Update, 11 October 2000, p. 12; *The Moscow Times* of 4 November 2000.

<sup>46</sup> 21 projects have been approved under production-sharing agreements to date, but operations have only begun on three of these. Cf. Bank of Finland: *Russian & Baltic Economies. The Week in Review*, No. 44/2000, p. 1.

<sup>47</sup> Figures on foreign investments in the individual branches of the energy sector are not available.

<sup>48</sup> On the law on bankruptcy of credit organisations cf. 'The Economic Situation in Russia. Debt Forgiveness instead of Reforms', *Economic Bulletin*, No. 6/1999. Amendments to the insolvency law for enterprises were discussed in spring 2000, but no decision was reached. Cf. Bank of Finland: *Russian and Baltic Economies. The Week in Review*, Nos. 15/2000 and 18/2000.

lations under the leasing law that are incompatible with stipulations contained in the Civil Code and, for example, with the depreciation allowances contained in the new tax code. The resulting legal insecurity for both lessors and lessees is preventing the development of the leasing market, which has been insignificant to date.<sup>49</sup> Moreover, the existing licensing practices make it difficult for foreign leasing companies to enter the market. Foreign firms avoid cross-border leasing operations if they are worried about difficulties with the payment of instalments or possible reclamation of property. On the Russian side, the problems that still exist on the leasing market mainly affect small and medium-sized enterprises, which have difficulty obtaining long-term bank loans and for whom leasing would be an alternative form of long-term financing.<sup>50</sup>

Whilst Russia has made some progress with institutional reform in recent years, there are still institutional weaknesses, which may not be immediately evident but continue to have a negative effect on the investment climate. This has already been seen in the other transformation economies (e.g. the Czech Republic), where high investment rates initially raised hopes of long-term economic recovery, but where declines in investment and growth followed, not least because the institutional problems had not been solved.

## Summary

The accelerated growth of the Russian economy in 2000 – with rates of around 7% for GDP and around 20% for capital investment – stands up very well in international comparison. And in other respects, too, the situation looks favourable at first sight. Inflation is within acceptable parameters, the advantages gained through the depreciation of the rouble are likely to persist for some time, the budget deficit has been transformed into a surplus, and the exchange rate is stable.

The upturn may seem surprising, given that essential reform issues remain unresolved. However, the institutional deficits have been more than offset by cost and revenue advantages in the enterprise sector. The cost

advantage was gained through the drastic reduction in real wages after the 1998 crisis, while the sharp increases in world market prices for oil and the depreciation of the rouble had positive effects on revenues. The result was that enterprise profits rose substantially, indeed to such an extent that funds were available both for increased investment and for a continued high exodus of capital.

Apart from the problem of capital flight, the current upturn thus leaves much to be desired because it was bought at the price of a further reduction in the standard of living, which – along with the windfall profits from the oil-price rise and depreciation-linked import substitution – concealed the institutional weaknesses. In addition, on closer examination the budget surplus proves to be largely the result of a transfer of state revenue from the budgets of the regional authorities to the (central) Federation budget.

More worrying even than this is the fact that the current economic growth seems to be on a course that cannot be sustained. The recent real-wage growth of well over 20% cannot remain compatible with overall economic growth of 7% and investment growth of 20% for very long. If there is no adjustment, above all in the form of more moderate wage growth, the incompatibility in real economic terms will sooner or later be corrected in a quasi-automatic way. This correction would most probably take the form of a return to sharp inflation if the current rapid growth in the money supply were no longer to be offset by increased demand for money. Renewed negative repercussions for the real economy could not then be avoided.

If, however, policy-makers have the will and the strength to introduce adjustments and reforms, then continued high growth rates of 5% or more – alongside falling inflation and strong investment growth – are certainly possible in 2001 and 2002. If adjustments are not made, then the probability of a renewed real economic backlash will increase. While this could be softened by continued high energy prices, which would also ostensibly justify the lack of political action, it would not reduce the damage that will be suffered by the Russian economy if no change in course is made.

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<sup>49</sup> Leasing activities have clearly not expanded significantly in recent times. In the first half of 2000 enterprises concluded contracts amounting to 0.4 billion rouble with leasing companies. The share of investments in equity capital accounted for by expenditure on leasing amounted, as in the first half of 1999, to only 0.1%. The volume of leasing is estimated to amount to around US-\$ 500-700 million (1994: US-\$ 3 million). Overall, leasing activities in Russia are much less frequent than in other transformation economies. Cf. *The Moscow Times* of 5 October 2000.

<sup>50</sup> There are around 900,000 small firms in Russia, which employ around 9% of the working population.