

The Economic Situation in Russia

Debt forgiveness instead of reforms?

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The renewed loan package recently agreed with the International Monetary Fund (IMF), and the rise in the price of crude oil on the world market have given the Russian government a temporary breathing space. It should take advantage of this in order, first, to meet the conditions – which are much more binding in nature – for actual disbursement of the loan as quickly as possible, and, second, to change the economic policy parameters in such a way as to make continued capital flight from Russia unattractive and to make real investment in Russia attractive.

Output, investments and prices

Macroeconomic trends continue to reflect the repercussions of the financial and currency crisis of last summer. In 1998 GDP was 4.6% below the previous year's level (cf. table 1).¹ This deterioration had commenced as early as May of 1998, and it subsequently accelerated into the late autumn. From then on the pace of contraction slowed somewhat. There are no signs, however, that this marks a fundamental change for the better. Rather, the provisional data available for first quarter of 1999 suggest a continuation of the economic decline (estimated contraction of GDP: 7%).²

Private consumption clearly mirrors the trend prior to and following the outbreak of the crisis. In the first half of 1998 private consumption, as measured by real changes in retail trade turnover, fell by a comparatively moderate 1.0%.³ July and August of 1998 saw strong real growth of private consumption, especially in the

form of purchases of consumer durables (+4.8% between the second and third quarter of 1998). This trend came to a sudden halt in the wake of the subsequent sharp rise in prices. In the last quarter of 1998 purchases of consumer durables contracted sharply, the real volume falling by 21.3% compared with the last quarter of the previous year, and by 9.6% on the third quarter of 1998. Even so, the decline in retail trade turnover lagged significantly behind that of the real money income at the disposal of private households (-18.2% for 1998 as a whole).

The decline in real gross fixed capital formation accelerated once again in 1998. The progressive deterioration continued up until the final quarter (8.4% below the fourth quarter of 1997) and into the first quarter of the current year. The sustained decline in investment activity since the start of the decade has meant that work has been suspended on 57% of investment projects and building sites. The machine park is declining in size and becoming increasingly obsolete. Statistical information on these trends is available for construction machinery. The stock of such machinery declined by more than 20% in 1998 compared with the previous year; the maximum working life had been exceeded in the case of almost 40% of such machines. The Russian government has clearly abandoned hope that investment activity might recover on the basis of free-market entrepreneurship. Rather, it is seeking to bring about a turnaround with the help of direct government intervention in bank lending.⁴

The available data on government consumption (see the section on public finances) clearly show that it has not served to stimulate demand, but rather has exerted a marked contractionary effect on GDP. Fragmentary data on the expenditure side of GDP indicate that inventories, too, exerted a restrictive effect. They declined by more than half; in spite of their limited share of total Russian output, they thus contributed more than one percentage point of the negative rate of GDP growth. The opposite was true of foreign trade. Although both exports and imports fell (see the section on the balance of payments), the contraction of imports was far greater than that of exports, leading to a more than a doubling of net exports, and thus initially preventing a far sharper decline in GDP.

¹ Unless indicated otherwise, the figures given are taken from publications by the State Committee for Statistics (Goskomstat). The question-mark over the reliability of the statistics needs to be constantly kept in mind. In the light of the important role played by unofficial economic activity, and the extent of barter trade in which prices are not in accordance with market prices, it is advisable to consider the statements made as representing general trends.

² Estimate by the Russian economics ministry; cf. *Moscow Times*, 26 March 1999.

³ The figures for private consumption in 1998 have been revised downwards in recent Goskomstat publications. Previously, considerable growth of private consumption had been recorded for the period under consideration.

⁴ A 'Russian Development Bank', currently being set up on the basis of the former Promstroibank, is to be used for this purpose; cf., for instance, *Moscow Times*, 16 March 1999.

Table 1

Selected Economic Indicators

Change on previous year or shares in %

	1990	1991	1992	1993	1994	1995	1996	1997	1998 1st half	1998	1999 1st quarter
GDP ¹	-3.0	-5.0	-14.5	-8.7	-12.7	-4.2	-4.9	0.8	-0.5	-4.6	.
Industrial output ¹	-0.1	-8.0	-18.0	-14.1	-20.9	-3.3	-4.0	2.0	0.1	-5.2	-2.0
Agricultural output ¹	-3.6	-5.0	-9.0	-4.0	-12.0	-8.0	-5.1	1.3	0.1	-12.3	-5.4
Fixed capital formation ¹	0.1	-15.0	-40.0	-12.0	-24.0	-10.0	-18.1	-5.0	-6.0	-6.7	-10.7
Volume of goods transport ²	.	-7.4	-23.6	-5.0	-24.3	-10.2	-17.7	-9.8	.	-5.3	.
Volume of goods transport ³	.	-7.4	-13.9	-11.5	-14.2	-1.0	-4.6	-3.4	-3.8	-3.5	0.3
Retail trade turnover ¹	12.0	-3.2	-3.0	1.9	0.1	-7.0	-4.1	4.7	-1.0	-4.5	-15.8
Market services for final consumers ¹	10.2	-17.0	-18.0	-30.0	-38.0	-18.0	-5.8	3.3	0.4	-2.4	.
Nominal monetary income of private households	18.0	120	750	1030	360	158	46.1	22.7	-1.3	3.8	.
Real monetary income of private households ⁴	.	7.5	-50.5	11.2	13.0	-15.0	-0.8	6.3	-11.2	-18.2	-27.0
Nominal wages and salaries	15.0	81.0	994	878	276	114	57.3	20.2	13.2	10.1	18.6
Real wages	.	-3.0	-33.0	0.4	-8.0	-28.0	6.4	4.7	4.5	-13.8	-41.5
Consumer prices ⁵	6.0	160	2510	840	215	131	21.8	11.0	4.1	84.4	81.1
Industrial producer prices ⁵	4.0	240	.	895	233	175	25.6	7.5	0.5	23.2	88.0
Unemployment rate ⁶	.	.	4.7	5.5	7.4	8.8	9.3	11.3	11.5	11.8	12.4

1 Real. — 2 Calculated on the basis of tonnes. — 3 Calculated on the basis of tonne-kilometres. — 4 1991 to 1993: December to December of the previous year: annual average. — 5 1990: Annual average; 1991 to 1998: December to December of the previous year respectively June 1998 to December 1997. — 6 At the end of the period; on ILO definitions.

Source: Goskomstat.

The origin side of GDP reveals that not a single sector of the economy managed to escape the crisis. Industrial output fell by 5.2% in 1998. Although the double-digit decline in the immediate wake of the events of the summer of 1998 was followed by a slight recovery, which was maintained in the first quarter of 1999, in annual average terms the process of industrial contraction continued (-2.0% on the previous year). The downward trend also continued in the transport sector. The crisis was exacerbated by extraordinarily poor results in agriculture. Drought and flooding led to a fall of 23.5% in non-animal agricultural output; the grain harvest was down by as much as 46% on the previous year. Animal production stagnated (-0.9%). Animal stocks at the end of 1998 were down on the levels twelve months earlier; in the case of cattle by 9%.

In 1998 every single industrial branch suffered a loss of output (cf. table 2). The decline in output in the engineering and metal-working sector, given its quantitative importance (20%) for industrial output, contributed most to the overall loss of industrial output; three times as much as any other branch. Many segments of the engineering industry suffered double-digit percentage

output losses in 1998.⁵ More than 80% of the categories of consumer durables covered by the statistics exhibited double-digit percentage output losses; only in a very few cases was output growth recorded, one example being colour televisions.

The important energy sector was characterised by a slight decline in crude oil output (-1.0%), a more serious fall in oil refining output (-7.4%), and a marginal increase in natural gas production (+0.8%). Gas now accounts for more than 50% of total primary energy production. Yet even the prospects for this industry seem bleak given a decline in natural gas drillings of 40%.

In the light of the massive depreciation of the rouble, the food industry can lay claim to particular interest, as its products, above all others, could be expected to bene-

⁵ Even the output of personal computers fell by 40%. An expansionary trend was observed only in certain segments whose products may be deployed in order to improve efficiency, such as cash tills (+21.8%) and electricity meters (+39.8%). These few exceptions are insignificant compared with the decline in important industries, such as private cars (-15%), tractors and agricultural machinery (-9.3%) and combine harvesters (-55.1%).

Table 2

Industrial Output by Branch, 1990 to 1998

Real change on same period the previous year in %

	1990	1991	1992	1993	1994	1995	1996	1997	1998 1st half	1998
Industry, total ¹	0	-8	-18	-14	-21	-3	-4	2	0.1	-5.2
Electricity industry	2	0	-5	-5	-9	-3	-2	-2	-0.3	-2.5
Fuel industry	-3	-6	-7	-12	-11	-2	-3	0	-1.8	-2.5
Iron and steel industry	-2	-7	-16	-17	-17	9	-4	1	-2.1	-8.1
Non-ferrous metallurgy	-2	-9	-25	-14	-9	1	-5	5	2.0	-5.0
Chemical and petrochemical industry	-2	-6	-22	-22	-29	7	-11	2	-3.5	-7.5
Engineering and metal-processing	1	-10	-15	-16	-38	-8	-11	4	1.0	-7.5
Wood, wood processing, cellulose and paper industry	-1	-9	-15	-19	-31	-5	-22	1	3.4	-0.4
Building materials industry	-1	-2	-20	-16	-29	-8	-25	-4	-0.5	-5.8
Light industry	0	-9	-30	-23	-47	-31	-28	-2	0.0	-11.5
Food industry	0	-10	-16	-9	-22	-9	-9	-1	3.7	-1.9

¹ Since 1994: including small firms and joint ventures. The data for the various branches refer only to large and medium-sized firms in all years.
Source: Goskomstat.

fit from additional demand following the rise in the price of imports. And indeed, such import substitution occurred, although only in certain areas. While in 1998 overall food output fell by 1.9%, production of pasta goods, for instance, expanded strongly (+21.4%), with the growth trend continuing to strengthen (December 1998 compared with December 1997: +58.4%). The re-orientation in favour of domestic goods was also reflected in imports as a proportion of total retail trade sales: by the fourth quarter of 1998 the figure had fallen to 37%, from 48% in the first quarter.⁶

Only a few segments of the chemical and petrochemical industry escaped the sharp output decline in the sector as a whole. One exception was the substantial growth of car tyre production (-4.5%). The fact that the iron and steel industry at times recorded successes on export markets, a trend recently seriously retarded by counter-action, particularly by the USA, was insufficient to prevent this branch suffering the most serious loss of output (-8.1%) of all the major branches. Only in light industry was the decline in output greater (-11.5%), but this is no longer really significant, because light industry, now accounting for just 1.8% of overall industrial output, is now virtually of negligible importance. Non-ferrous metals, also an important sector, likewise reported a sharp drop in output; an expansionary trend was experienced only by aluminium and copper production. Both products are largely destined for export markets.

⁶ The peak value had been 49% in 1997; in 1992 the figure had been just 23%.

Regarding the marked decline in output in the construction materials industry, it is to be noted that a number of building materials likely to be used particularly in private housing construction continued to record positive growth. The output of radiators (+14.7%), baths (+12.1%), linoleum (+6.3%) and sanitation ceramics (+10.1%) all expanded strongly. This is in accordance with the official data on private housing construction. Completed buildings in this segment (measured in terms of surface area) rose significantly (+5.0%), representing a substantial proportion of total housing construction (40%). Output in the wood and wood processing industry declined only marginally (-0.4%). The cellulose and paper industry experienced strong growth (+7.5%), with a particularly strong rise in the output of newspaper (+17%), here too, with a substantial export component.⁷

The fall in output in the transport sector (-3.5% in tonne-kilometres) affected virtually all segments, with the sole exception of pipeline transport, where output rose by 2.3%. All the other areas of the transport sector suffered serious output losses; the least pronounced were in rail transport (-7.3%) – the only segment in which the decline was in single figures – the most serious in marine transport (-30%). One striking phenomenon was the decline in imports by rail (-9.1%) and the rapid acceleration of this decline (December 1998 on December 1997: -31.2%).

⁷ Also striking is the sharp increase in exports (*sic!*) of grain, by more than 20%.

Table 3

Monthly Price Inflation, 1994 to 1999

Change on previous month in %

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

Source: Goskomstat.

Prior to the outbreak of the crisis, the prices of consumer goods were rising at an annual rate of only around 5%. Industrial producer prices were actually falling (cf. tables 3 and 4). In the wake of the devaluation of the rouble, the consumer-good price level initially rose sharply, peaking in September 1998 at almost 40% on the August figure. Although monthly inflation rates have since declined, the average rate for the first quarter of 1999 was still in excess of 80% on an annual basis, although the underlying monthly inflation rates were declining (January: 8.5%, February: 4.1%, March: 2.8%).

Increasing government intervention in the price mechanism reduces the value of the inflation figures given as an indicator. This is one factor behind a further rise in the uncertainty already resulting from the important role played by barter trade, in which the reported prices do not equate with market prices. One effect of government intervention is to create substantial regional price differentials. The sum of money required to purchase a basket of basic foodstuffs, for example, ranged from 347 to 833 rouble. The government has announced that it intends to impose stricter controls on food prices.

The labour market

According to official figures, calculated using the ILO method,⁸ around 8.6 million people were unemployed in

⁸ The International Labour Organisation (ILO) calculates unemployment as the difference between employment and the active population.

December 1998; the unemployment rate was 11.8% (December 1997: 11.3%). The unemployment rate has since risen further, reaching 12.4% in the first three months of 1999. However, the real volume and dimensions of unemployment cannot be determined beyond doubt, given the importance of unregistered employment and the inadequate statistical coverage of the labour market situation.⁹ According to some estimates, in 1997 unemployment was already at around 11 million, i.e. around 15% of the economically active population.

According to the official statistics, the number of persons in employment fell again slightly in 1998 on the previous year, to 6.4 million persons in December; this represents a decline of 400,000 on December 1997. The financial crisis that began in August 1998 did not exert an incisive influence on employment trends until the end of the year. In large and medium-sized companies and in the public sector, where the two-thirds of the workforce is active, unemployment in November 1998 was 3.7% lower than a year earlier. The number of second jobs increased by 83.8%, representing 2% of total employment (in each case calculated as full-time equivalents).

The most serious job losses in relative terms were recorded in crude oil production (-17.2%), oil refining (-12.4%), coal mining (-12.7%), and in light industry (-11%); in each case the figures are from November 1997

⁹ The labour market data are determined once a year using surveys; they are intermittently estimated using other statistical methods. The results of the last survey, conducted in October 1998, were published in March 1999.

Table 4

Development of Prices, 1991 to 1998

Change on previous year in %

	1991	1992	1993	1994	1995	1996	1997	1998	1998					
									July	Aug.	Sept.	Oct.	Nov.	Dec.
Consumer prices	160	2510	840	2115	131	22	11	84.4	0.2	3.7	38.4	4.5	5.7	11.6
Food	171	2570	838	233	123	18	9	96.0	-0.1	2.4	39.5	3.9	7.6	17.1
Alcohol	52	2370	655	131	127	53	18	.	.	.	.	.	.	.
Other consumer goods	211	2570	642	169	116	18	8	99.5	0.1	7.1	54.3	7.4	4.3	6.3
Services	79	2120	2310	522	232	48	23	18.3	1.2	1.2	3.4	1.6	1.3	1.8
Industrial														
producer prices	240	3280	895	233	175	26	7	23.2	-0.8	.	7.5	5.9	5.1	4.8
Electricity	110	5410	1258	229	199	35	9	.	0.1	.	1.2	.	-0.9	-0.5
Fossil fuel energy	130	9170	634	201	187	40	19	.	-4.9	.	1.9	.	7.3	4.2
Iron and steel industry	240	3520	1086	242	185	16	1	.	1.0	.	2.4	.	1.9	3.2
Non-ferrous metals	230	5120	558	296	121	12	3	.	-1.4	.	19.2	.	9.8	5.2
Chemical industry	170	3790	848	262	168	18	5	.	0.6	.	8.3	.	4.5	3.9
Petrochemical industry	150	5250	672	260	167	24	11	.	-0.1	.	3.4	.	4.4	3.0
Engineering and metal-processing	210	2620	949	230	178	24	9	.	-0.1	.	8.6	.	5.9	4.1
Wood, wood processing, cellulose and paper industry	240	1920	889	271	174	12	8	.	0.0	.	6.1	.	8.3	8.8
Building materials industry	210	2710	1145	212	171	34	9	.	0.3	.	3.6	.	1.0	1.6
Light industry	370	1160	381	241	163	20	10	.	-0.2	.	10.5	.	8.2	7.3
Food industry	310	2630	971	208	156	22	11	.	-0.2	.	21.1	.	7.6	11.3

Source: Goskomstat.

to November 1998. In the extractive industries this represented an adjustment to the prior sustained fall in the price of crude oil on the world market, and thus of profits. In light industry employment adjusted to the continued decline in output, which by 1998 had fallen to just 11% of its 1998 level. On the other hand, additional labour was recruited in the following sectors: electricity generation (+ 2.1%), the health service (+ 1.6%), education (+ 0.9%), culture and art (+ 2.3%), and the public administration (+ 3.1%); clearly, most new jobs were created in the public sector.

In contrast to the increase in the total number of unemployed persons, the number of people registered as unemployed with the employment offices declined from 2.0 million in December 1997 to 1.9 million in December 1998. Thus the jobless rate for the officially registered unemployed declined from 2.8 to 2.7%. Comparing this rate with that calculated using the ILO method, it is readily apparent that relatively few unemployed people register with the employment offices. The main reason for the small number of registrations is the low level of benefits and the widely held view amongst those affected that the employment office cannot be expected to provide effective help with job search. This is underlined by the number of vacancies registered with the employment offices: against the background of sustained economic contraction, in December 1998 there

were on average 6.6 registered unemployed persons for each vacancy, compared with 6.0 a year earlier.

Alongside unemployment that is not registered with the authorities, hidden employment within enterprises remained at a high level. In 1998, as in previous years, firms avoided redundancies by ordering compulsory holidays and short-time working. Between January and September an average of around 9% of employees were affected by these measures, with a substantially higher figure reported in some branches. In industry they affected around 42% of employees, in transport 35% and in construction 29%. For the first three quarters of 1998, the loss of working time this entailed was equal to hidden unemployment averaging 1.1 million workers (1997: 1.3 million); this, in turn, represented 1.5% of total employment. In the wake of the economic crisis, it is almost certain that increasing use was made of short-time working and compulsory holidays in the fourth quarter.

Private household income

The outbreak of the financial and balance-of-payments crisis exacerbated the negative trends already observed for real money income since the start of last year. By

August 1998 real money income had already fallen around one-tenth below the level of the corresponding month in 1997. From September the year-on decline jumped up to around 25%. Comparing annual average figures, real money income fell by 18.2%.¹⁰ The decline in real wages, however, did not begin until August, when inflation accelerated. In September real wages fell by 30% on the same month the previous year; for the year as a whole the decline amounted to 13.8%. Despite a substantial decline beginning in September 1998, the real value of the average pension fell by only 4.8% on the previous year's level. This was due to the pension increases at the start of the year. Wages rose as a share of total money income to 42.4% (+3.1 percentage points); social transfers, on the other hand, fell by 1.6 percentage points to 13.3%. Income derived from self-employment, property and other sources fell overall by 1.5 percentage points to 44.3%. Self-employed income (entrepreneurial activity) was recorded separately in the statistics for the first time. Its share of total money income rose from 13% last year to 16.5%. Hence, other income was reduced as a share of the total by around 5 percentage points to 22.3%.

Considerable uncertainty remains concerning the actual level of disposable income. This relates both to the income from dependent employment and that from entrepreneurial activity, primarily because income from the black economy, including wages, can only be estimated very roughly. On top of this comes the fact that wages continue to be paid partly in kind, and the volume of outstanding wage payments is substantial. In Russian statistics wage arrears are counted as wage income. Given that such arrears grew substantially faster than wages (57% compared with 14%) between December 1997 and December 1998, by the latter date they must have represented around 150% of the average monthly wage. As a result, the decline in real, actually disposable wage income was significantly more serious than the above-mentioned figure of 13.8%. In December 1998 government budgets accounted for 26% of outstanding wage payments, more than double the figure in December 1997 (10%). On average the wages owed by regional government amounted to more than two months' wages at the start of 1999.¹¹ The number of firms owing their workers outstanding wages covered by the statistics also doubled compared with December 1997. Overall, the financial and currency crisis almost certainly led not only to a decline in real wages, but also to a redistribution of wage income between the various branches.

¹⁰ Cf. *Russian Economic Trends*, Monthly Update, February 1999.

¹¹ Cf. *Izvestiya*, 12 March 1999.

Under an amendment to criminal law that came into force in March 1999, failure to pay more than two months' wages – or pensions, grants and other statutory income claims – by the head of a company, office, or other organisation responsible, irrespective of its ownership form, can lead to criminal proceedings. Penalties include fines, a ban on performing certain activities, and prison sentences of up to two years (in particularly serious cases up to a maximum of seven years). It would be surprising, however, if this new provision were actually rigorously enforced in practice.

Income disparities narrowed marginally in 1998.¹² The relationship between the highest and the lowest income decile amounted to 13.4 (1997: 13.5). Wage differentiation, on the other hand, increased between January and November compared with the previous year, thanks to different rates of wage growth in various branches. As in the past, the highest wages were paid in the natural gas industry and other energy industries, in the banking sector and the public administration, the lowest wages in agriculture and forestry. The average wages in agriculture and forestry, education and in culture and art fell below the minimum subsistence level for a single person of working age in November 1998. The minimum wage of 83 rouble, which has remained unchanged since the start of 1997, represented 6% of the average wage and around 10% of minimum subsistence level in December 1998.

The situation for pensioners initially improved at the start of the year, thanks to pension increases. In August 1998 the real average pension was 14.5% above its level 12 months earlier, and represented 127% of minimum subsistence income for a single person of pensionable age. However, unchanged nominal pensions and sharp price increases in the fourth quarter meant that by December 1998 the real average pension had fallen to around 60% of its value at the end of the previous year. By December 1998 the average pension had fallen to just 80% of minimum subsistence level.

From the start of 1998 the proportion of the population whose money income was below minimum subsistence level (poverty rate) rose, initially slowly. In the wake of the financial crisis, the proportion living in poverty exploded from September onwards, the poverty rate reaching 27.3% in December (December 1997: 18.3%).

Consumer spending rose as a proportion of total money expenditure from 67.9% in 1997 to 78.5% in 1998, a trend that reflected declining real incomes and increasing poverty, and also panic buying in the run-up to the currency crisis and a flight into real assets. Conversely, the savings-to-income ratio declined from 25%

¹² This does not allow for the impact of unpaid wages, however.

in 1997 to 15.3%. As in the previous year a large proportion of savings, around 80%, were held in foreign currency.

Government finances

The state of government finances has become increasingly precarious. Although the signs are that the deficit in the Federation budget for 1998 as a whole will be smaller than in the previous year, the credibility of the state as a debtor has been shattered to such an extent that for the foreseeable future it will have great difficulty in obtaining finance on either the domestic or the international capital market. If the central bank sticks to the course that it has largely maintained so far, and refuses to monetise the financial liabilities of central government, government finance would face a hard budget constraint for the first time since the start of transition. On the other hand, this would also markedly increase adjustment pressure on the economy as a whole. In particular, the Federation would no longer be able to tolerate companies refusing to pay their taxes, and it would ultimately force improvements in regulatory conditions. If, on the other hand, the central bank is deflected from its course, the experiences of the early years of transition will be repeated, and an inflationary spiral will be set in motion.

In 1998 the Federation budget deficit, as measured using the IMF's methodology, amounted to 5% of GDP.¹³ The figures calculated on this basis continue to differ from those provided by the Russian ministry of finance, which puts the Federation budget deficit at just 3.2% of GDP.¹⁴ The main reason for these differences is the different way in which incoming payment obligations and financial claims are treated. The Russian finance ministry evidently treats 'payments' in the form of bills and privatisation receipts as income, whereas payments obligations entered into by the Federation are not counted.

The decline in government revenue continued in 1998. According to figures published by Goskomstat, receipts by the consolidated budget amounted to just 21.7% of GDP (January to November 1998), another marked fall on the previous year's level (cf. table 5).¹⁵

Revenue from taxes on profits was affected particularly badly by the decline in profits; here the previous year's level was not even reached in nominal terms. As a result, indirect taxation is playing an increasingly important role in budgetary finance. However, this trend does not reflect any amendment of the taxation law. Rather, it must be assumed that the decline in receipts from taxes on profits primarily reflects the desolate state of the business sector. Firms continued to exploit the failure to enforce existing taxation law, and increased their debts against the public sector. At the end of November tax arrears exceeded the total revenue of the Federation budget. This means that if taxes were paid according to the law, government budgets would be earning a substantial surplus. The privatisation receipts recorded by the finance ministry on the income side in the first 11 months of 1998 amounted to less than 0.5% of GDP. Not until the sale of public shares in the natural gas company, Gazprom, to the German company, Ruhrgas AG, in December did government finances benefit to a significant extent from privatisation.

The curbing of the deficit primarily reflected further cuts in spending. According to Goskomstat figures, total spending between January and November 1998 amounted to just 25.2% of GDP. Given that spending had already been falling for an extended period, the fact that scope still remains for further cuts seems surprising. Yet the cuts in spending do not mean that the government has reduced the spectrum of public tasks; it is merely failing to meet its payments obligations. Neither the responsibilities nor the powers of the state are clearly defined. The Russian state is accumulating debt vis-à-vis not only domestic, but also international creditors. In both cases it is seeking to establish a relatively strong bargaining position.

Even prior to the passing of the federal budget for 1999, it was clear that the calculations had been made on the basis of unrealistic parameters. The assumptions made in formulating the budget plan included an annual inflation rate of 30% and an exchange rate of 21 rouble per US dollar.¹⁶ According to the budget law government receipts are to amount to 11.7% of GDP, spending to 14.2%. Planned spending on debt servicing exceed the planned deficit, in accordance with the primary fiscal surplus called for by the IMF. In addition, government receipts as a share of GDP have been almost certainly set at too high a level. Substantial changes in taxation laws are planned, all of which serve to reduce tax rates. Currently a cut in the rate of value added tax from 20 to 15% is planned to come into effect on 1 July; a fur-

¹³ Cf. *Russian Economic Trends*, no. 4/1998, p. 24.

¹⁴ Cf. Bank of Finland, *Russian and Baltic Economies – The Week in Review*, 19 February 1999.

¹⁵ Contrary to usual practice, Goskomstat has not published GDP data for the period January to November 1998. The figure used here is based on data published by the Institute for the Economy in transition, *Russian Economy – Trends and Perspectives*, Moscow 1999, p. 5.

¹⁶ Cf. RFE-RL, 23 March 1999.

Table 5
The Consolidated Budget 1992 to 1998
 Selected Revenue and Expenditure Items (%)

	as a % of total revenue/expenditure							as a % of GDP						
	1992 ¹	1993	1994	1995	1996	1997	1998 ²	1992 ¹	1993	1994	1995	1996	1997	1998 ²
Revenue, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	28.0	29.0	29.0	26.1	24.8	23.5	21.7
Income tax	29.4	33.8	27.5	27.0	17.3	15.8	15.0	8.2	9.8	8.0	7.0	4.3	3.7	3.3
Excise duties	8.1	8.8	9.9	8.4	10.1	11.6	11.0	2.3	2.6	2.9	2.2	2.5	2.7	2.4
Value added tax	4.0	3.6	4.2	5.6	9.6	10.3	10.5	1.1	1.0	1.2	1.5	2.4	2.4	2.3
Customs duties etc.	37.5	22.5	21.0	22.0	25.8	26.5	23.9	10.5	6.5	6.1	5.7	6.4	6.2	5.2
Revenue	8.8	4.7	10.8	4.6	3.0	1.1	2.2	2.5	1.4	3.1	1.2	0.7	0.3	0.5
from states assets	.	.	.	.	.	2.0	2.1	.	.	.	.	.	0.5	0.5
from the sale of state assets	.	.	.	.	.	1.8	0.6	.	.	.	.	.	0.4	0.1
Other revenue	12.2	26.6	26.6	32.3	34.2	30.9	34.7	3.4	7.7	7.7	8.4	8.5	7.3	7.5
Expenditure, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	31.4	33.6	38.5	29.4	28.9	28.6	25.3
Economy	34.5	28.1	27.0	.	.	.	.	10.8	9.4	10.4	.	.	.	.
Industry, energy, construction	.	.	.	7.4	6.0	4.6	2.6	.	.	.	2.2	1.7	1.3	0.7
Agriculture, fisheries	.	.	.	4.2	3.9	3.4	2.3	.	.	.	1.2	1.1	3.4	0.6
Transport, communication	.	.	.	2.7	.	2.8	2.4	.	.	.	0.8	.	0.8	0.6
Social-cultural purposes	23.2	24.9	23.5	26.0	28.9	34.0	31.4	7.3	8.4	9.0	7.7	8.4	9.7	7.9
Education	.	.	.	11.6	.	.	.	.	.	.	3.4	.	.	.
Health	.	.	.	8.3	.	.	.	.	.	.	2.4	.	.	.
Social security	.	.	.	4.2	.	.	.	.	.	.	1.2	.	.	.
Defence	14.3	12.5	11.9	9.8	9.8	10.2	7.5	4.5	4.2	4.6	2.9	2.8	2.9	1.9
Administration and legal organs	5.9	7.3	7.9	7.7	.	10.3	9.4	1.8	2.4	3.0	2.3	.	2.9	2.4
External trade	7.0	4.8	2.1	4.4	4.1	.	.	2.2	1.6	0.8	1.3	1.2	.	.
Debt servicing	.	.	.	5.1	6.6	6.2	15.5	.	.	.	1.5	1.9	1.8	3.9
Environmental protection	.	.	.	.	.	0.5	0.4	.	.	.	.	.	0.2	0.1
Other spending	15.2	22.5	27.5	8.6	40.9	28.0	28.5	4.8	7.6	10.6	2.5	11.8	5.6	7.2
Balance as a % of expenditure/GDP	-10.8	-13.8	-24.5	-11.2	-14.4	-18.0	-14.0	-3.4	-4.6	-9.4	-3.3	-4.2	-5.1	-3.5

1 In 1992 extra-budgetary activities were very substantial in quantitative terms. — 2 January to November 1998.

Sources: Wochenbericht des DIW, no 18/98; Goskomstat; calculations by the Institutes.

ther reduction to 10% has been mooted for 1 January 2000. The IMF has clearly spoken out against cuts in VAT rates. The rate of tax on profits is also to be reduced by five percentage points. Although these changes have already been allowed for in the budget plan, it must be questioned whether the expectations of an improved willingness to pay taxes and of the recovery in economic activity, and thus of tax revenues, will be fulfilled. Moreover, as inflation rises once more, revenue losses are to be expected in real terms; in particular, the revenue from value added tax, which is currently the most important source of revenue, but which enters the budget only after a time lag, is particularly susceptible to devaluation through inflation. The deficit of 2.5% of GDP envisaged in the budget law is to be met partially through international borrowing, partially on the domestic financial markets. However, the reputation of Russia on both the international and the domestic financial markets has been badly damaged. This has increased the pressure on the Russian central bank to monetise the financial liabilities of the Russian Federation.

Monetary and exchange-rate policy

The scope for monetary policy action has been severely curtailed as a result of the sustained economic and financial crisis. Although the abandonment of the exchange-rate target means that the central bank has obtained an additional degree of freedom, faced with a banking system that is de facto insolvent,¹⁷ it is extremely difficult to provide the economy with central bank money in accordance with market requirements.

The rates of money supply growth have been comparatively moderate since the outbreak of the currency crisis (cf. table 6). Although all the money supply aggregates rose significantly faster in the second half of 1998 than in the first half of the year, with a particularly sharp rise in domestic central bank assets in September and October, since then the trend has been downward. The decline in foreign-currency reserves held by the central bank has exerted a restrictive influence. At the end of March 1999 the central bank's gross reserves were just US-\$ 10.9 billion, and thus less than half their peak value in mid-1997. Net reserves of foreign currency have been negative since the outbreak of the currency crisis.

¹⁷ This conclusion is unaltered by the fact that smaller regional banks have been less badly affected by the crisis and that the state-owned Sberbank reported a profit in 1998. It is unlikely that the value of government securities held by the Sberbank has been appropriately adjusted. Moreover, high interest payments on GKO in the first half of the year are probably responsible for the positive result.

Measured in terms of the producer price index, the real monetary base remained broadly constant in 1998; measured in terms of the consumer price index it fell sharply. In the first two months of 1999 the rate of money supply growth was extremely slow, the monetary base expanding by between 1 and 2% per month.

Overall, in the course of 1998 the structure of central bank assets continued to shift towards claims on the government. Given the fact that the central bank is still officially not permitted to finance the state budget directly, the rise in these claims consists largely of purchases of government bonds on the secondary market. At the same time, the central bank has once again lent more to commercial banks, although such lending constitutes only a small proportion of the total. To some extent, lending to commercial banks consists of so-called stabilisation loans granted for a maximum of one year. Accurate data on the volume, recipients, and terms of these loans are not available. In some cases, for example in the case of Promstroibank, equity capital shares have been offered as security for the loans, so that the central bank has de facto taken a stake in commercial banks.

The picture is less clear regarding the growth of the more broadly defined aggregate, M2. Focusing initially only on the rouble money supply, M2 grew by 7% in 1998. If accounts denominated in foreign currency are included, the rate of growth increases to 21%, which is primarily a reflection of a change in the exchange rate. Thus, overall the growth of M2 was in line with that of the monetary base. However, this trend conceals relatively sharp fluctuations in the money multiplier, which became even more serious in the immediate wake of the currency crisis, only to subside once more in the fourth quarter of 1998. This trend reflects corresponding changes in both the reserves held by commercial banks and the cash balances of the non-bank sector.

One striking phenomenon is the strong growth of lending by the banking system in the second half of 1998, compared with the first half of the year. However, this reflects not an increasing willingness to grant new loans, but rather the effect of the change in the exchange rate. Prior to the outbreak of the currency crisis, around 45% of domestic loans were denominated in foreign currency.¹⁸ The revaluation requirement due to the depreciation of the rouble, alone, would have been far in excess of the nominal increase in the value of credit. To a substantial extent the loans made in foreign currency, in particular, are likely to have been non-performing following the depreciation. It seems that the valuation adjustments to allow for this have not yet appeared in the accounts.

¹⁸ Central Bank of the Russian Federation, Bulletin of Banking Statistics, no. 8/1998.

Table 6

Money Supply and Credit Aggregates, 1992 to 1998

Real change in %, based on the end of period figures

	1992	1993	1994	1995	1996	1997	1998 ¹		1998 ¹
	2nd half						1st half	2nd half	
Cash	267	691	169	126	29	26	-1	36	31
Monetary base	.	648	186	118	26	27	-1	22	21
M2 (rouble)	290	409	200	126	34	28	-2	9	7
M2 ²	.	.	217	113	30	30	-4	29	21
Bank loans ³	.	448	241	61	16	44	11	37	49
Net foreign currency reserves ⁴	428	112	-64	238	-78	118	-59	.	-270
Domestic central bank assets	331	787	412	71	61	16	9	61	69
Memo item:									
Producer prices	285	895	233	175	26	8	1	23	23
Consumer prices	213	840	215	131	22	11	4	77	84

1 Figures of the second half respectively for the whole year until November 1998, calculated on an annual basis (except monetary base). — 2 Incl. money supply of foreign currency holdings. — 3 Bank loans to firms and private households. — 4 In US-Dollar.

Sources: International Monetary Fund (IMF), International Financial Statistics, Washington D.C., October 1996; Government of the Russian Federation, Russian Economic Trends, Monthly Update, different issues, London and Moscow; Central Bank of the Russian Federation, Bulletin of Banking Statistics, Moscow 1996; calculations by the participating Institutes.

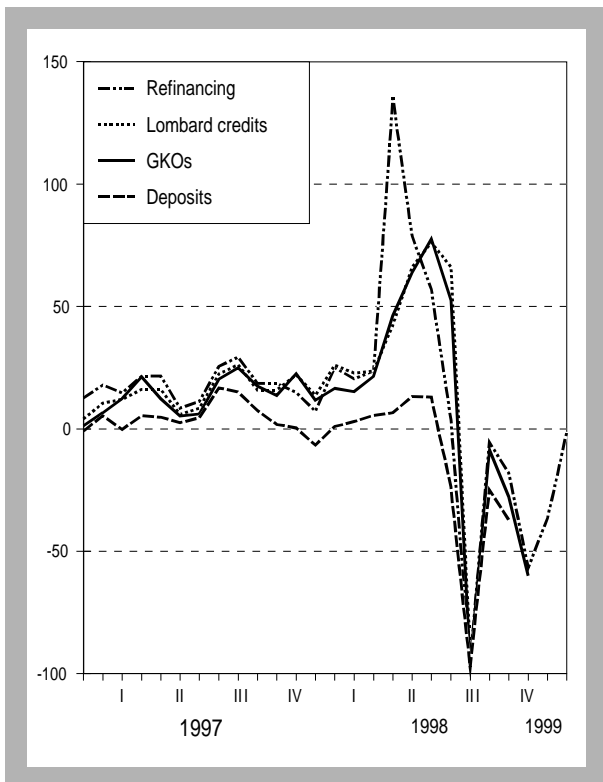
As far as the monetary policy instruments used by the central bank are concerned, there has been a marked shift away from market-oriented, and towards administrative instruments. A refinancing rate of 60% per annum has been in force since mid-1998; given the sharp rise in producer prices in the wake of currency depreciation, however, this interest rate was negative in real terms during the second half of the year (cf. figure 1). As a result the central bank was forced to resort to quantitative distribution procedures. In October and November, for which official figures are available, no more lending was granted using the Lombard facility. Alongside the stabilisation loans, the central bank uses its minimum reserve policy as a means of controlling the liquidity of the banking system. Following the cuts in the minimum reserve ratios introduced at the end of August 1998, from 8 – 11% to 5 – 7.5%, a uniform rate of 5% has applied since December. In mid-March the minimum reserve requirement on firms' accounts was raised once more to 7%. The scope for monetary policy decision-making in the future will depend to a considerable extent on the progress made in re-capitalising and restructuring the banking sector. So far, however, very little has been achieved in this area. Indeed, there is evidence that banks have sought, and are still seeking, to transfer their remaining assets to locations where they cannot be sequestered by their creditors. Following the presentation of a central bank plan to revitalise the

banking system in November 1998, an agency (ARKO) was set up at the start of 1999 to oversee restructuring. However, it was provided with only limited capital, sufficient, even on conservative estimates, to meet only part of the cost of restructuring the banking system.¹⁹ No further resources have been set aside for this purpose in the current budget. Moreover, uncertainty surrounds the tasks, structures and responsibilities of the agency, and the programme to restructure the banking sector still lacks a legal basis. Hence, it appears at present that the agency will not be able to play a significant role in restructuring the banking system.

The fact that at the start of March 1999 legislation finally came into force to regulate insolvencies in the banking sector (see the section on market reforms) could be seen as a positive step forward. There is now a procedure available to deal with bank insolvencies. It is ultimately a question of political will, however, whether the passing of the legislation will actually lead to increased use of insolvency procedures, and whether inefficient banks will be closed. In the months since the outbreak of the crisis, at least, there have been fewer cases in which

¹⁹ ARKO has equity capital totalling 10 billion rouble; Russian sources put the cost of refloating the banking sector at between 100 and 140 billion rouble. Yet even the interest costs of recapitalising Russian banks are likely to be closer to 200 billion rouble. On these calculations see C. Buch and R. Heinrich, *Handling Banking Crises – The Case of Russia*, Institut für Weltwirtschaft, Kiel.

Figure 1
Real Interest Rates¹, 1997 to 1999
 % per annum



1) Deflated using the consumer price index (monthly inflation rate on an annual basis). Deposit rate = interest rate on private bank account with a notice period of less than one year. Lombard and GKO interest rate: average values.
 Sources: Russian European Centre for Economic Policy. Russian Economic Trends. Monthly Update, March. Moscow 1999; International Monetary Fund (IMF): International Financial Statistics on CD-Rom. Washington, D.C., 1999; calculations by the Institutes.

the central bank has withdrawn banks' licences than during the first half of 1998.²⁰

Both the precarious state of government finances and the unsolved problems in the banking system increase the pressure on the central bank to expand the money supply and to monetise government liabilities. An amendment to the central bank act, which would limit the independence of the bank, and particularly its autonomy in setting interest rates, is currently being debated in the duma. Moreover, the credibility of the central bank has been seriously damaged by revelations in February 1999 about certain financial transactions; in past years the central bank has allowed its foreign-exchange reserves to be administered by an offshore bank that is evidently partially owned by Russian firms.

²⁰ In the first six months of 1998 an average of 21 licences were withdrawn per month; between July 1998 and January 1999 the figure was just over 14. Cf. <http://www.cbr.ru>.

It has been claimed that corruption now extends to the central bank.

The central bank's money supply target for 1999 is for monetary growth of between 18 and 26%. This would imply a substantial fall in the rate of monetary expansion compared with the second half of 1998, however. If the money supply were to remain on the trajectory observed in the second half of 1998, not least in the face of increasing political pressure, a rate of money supply growth in the region of 50-60% seems more likely. Given a further decline in GDP, and possibly a slight increase in the velocity of circulation of money, the inflation rate in 1999 would then be around 60 to 70%. The increasing use of price controls creates considerable uncertainty on price trends and the measurement of inflation, the macroeconomic effects of which are impossible to quantify.

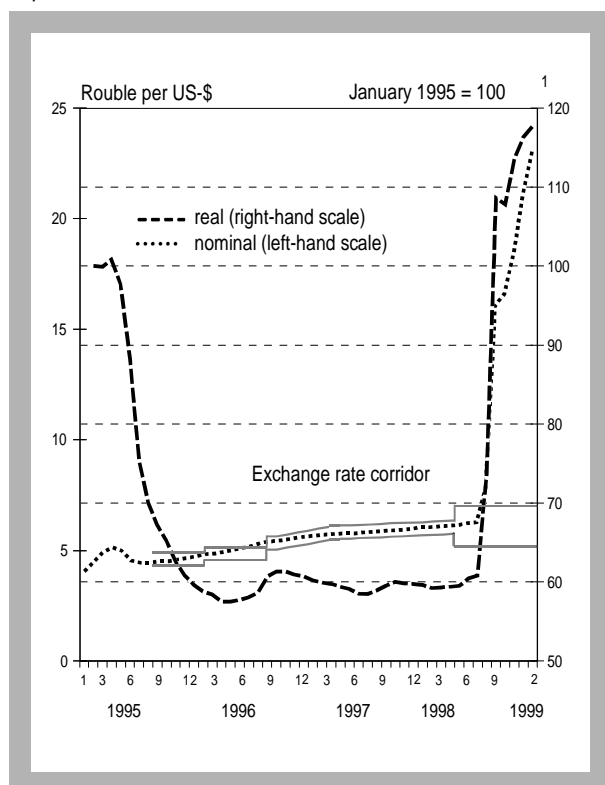
Since the exchange-rate target was abandoned in August 1998, the rouble has depreciated step-wise against the US dollar. Despite temporary stabilisation phases in September and October 1998, and at the start of 1999, overall the rouble has lost more than three quarters of its pre-crisis value. At the end of March 1999, one US dollar temporarily cost more than 27 rouble; in May 1998 it had been just over six rouble. The nominal depreciation has been accompanied by a depreciation in real terms, to a similar overall extent (cf. figure 2). For the first time following an extended phase between mid-1995 and mid-1998 in which the real and nominal exchange rate were maintained at relatively stable levels, the real depreciation that had occurred at the start of 1995 was more than offset. The substantial real depreciation has affected imports first and foremost; in the last four months of 1998 they were down by more than half compared with the corresponding period the previous year, against the background of a continued decline in exports (see the section on the balance of payments).

The central bank does not intend to pursue an exchange-rate target in 1999.²¹ This is contrary to the government's plans, however; in its budget proposal the government assumed an exchange rate that is already significantly stronger than the market rate. According to central bank plans, intervention in exchange-rate determination should conform to market principles; only in exceptional cases should administrative measures be used as a fall-back, and the creation of a black market is to be prevented. In the early months of the current year, exchange-rate trends have been comparatively calm. To a not insignificant extent, this is due to the restrictions on the convertibility of the rouble that were tightened following the currency crisis and have remained in

²¹ Cf. Central Bank of the Russian Federation, *The Objectives, Tasks and Instruments of the Exchange Rate Policy*, 17 March 1999.

force; indeed, they were tightened further at the start of the year (see the section on market reforms). Overall, the success of Russia's exchange-rate policy will be measured in terms of whether it prevents a renewed over-valuation of the rouble and enables the rate to be determined in accordance with market forces.

Figure 2
Russian Rouble/US-dollar Exchange Rate¹
 % per annum



1) Real exchange rate, index: January 1995 = 100. Following the currency conversion of 1.1.1998, 1000 old rouble are worth 1 new rouble.
 Sources: Russian European Centre for Economic Policy. Russian Economic Trends. Monthly Update, March. Moscow 1999; International Monetary Fund (IMF): International Financial Statistics on CD-Rom. Washington, D.C., 1999; calculations by the Institutes.

Balance of payments

Balance of payments trends in 1998 were largely determined by the impact of the currency crisis that occurred in August. In the run-up to the crisis, Russia's export surplus and capital imports had steadily declined, reflecting a loss of confidence by domestic and foreign investors. This negative trend in the balance of payments was reversed after the crisis; between September and December 1998 the foreign trade surplus, at US-\$

12.3 billion, was almost three times as high as in the corresponding period the previous year (US-\$ 4.4 billion). However, this improvement in the trade balance was due exclusively to a decline in imports, not least of food-stuffs. The value of exports measured in US-dollar fell by almost a quarter. Exports of crude oil and natural gas actually increased in volume terms, but this was more than offset by the decline in the price of oil and gas on the world market, by between around 30 and 40% in the corresponding period.

On the capital account the negative trends observed during the first half of 1998 accelerated in the third quarter (cf. table 7). The decisive factor here was a turnaround in portfolio-capital flows; in the third quarter there was actually a net outflow of capital. Although direct investment continued to increase, the expansion was far less substantial than last year. The fact that, during the first half of the year, private sector holdings of foreign exchange in cash²² had been reduced exerted a positive effect on the capital balance. Although in the wake of the crisis foreign-currency holdings increased once more in the third quarter, over the year as a whole private foreign-currency holdings fell, whereas they had continued to rise rather substantially in 1997.

Russian and international statistics are partially contradictory in terms of the impact of the crisis on borrowing from abroad. According to official Russian statistics, in the third quarter of 1998 foreign lending to Russia amounted to US-\$ 3.2 billion, compared with 1.8 billion in the previous quarter. The statistics published by the Bank for International Settlements, however, indicate a fall of US-\$ 2.5 billion in the claims held by foreign banks against Russia between the end of June and the end of September 1998. One possible reason for this discrepancy is that foreign creditors have adjusted the value of such claims in their balance sheets, but have not written off Russian liabilities.

Evidence of an increase in capital flight comes in the form of a slight rise in the value of the balancing item. It needs to be recognised, however, that capital flight was already a serious problem prior to crisis. Moreover, measures such as the obligation to convert on export earnings, which can be expected to have heightened the incentives to transfer capital abroad, did not take effect until October 1998 (see the section on market reforms).

The government has attempted to improve its financial position by changing customs duties. With effect from 1 March 1999, a duty of 5% was introduced on exports of metal goods. On the other hand, an export duty on sales of oil to the rest of the world, introduced in

²² This variable includes foreign exchange held by firms and banks and is therefore not comparable with the statistics on private household savings held in foreign currency.

January, was suspended in March 1999, after the price of crude oil on the world market had fallen below US-\$ 9.80 per barrel. A corresponding duty on exports of gas was abolished entirely. In order to prevent a further decline in the price of oil, restrictions on oil exports were also planned, in line with a decision by OPEC. In the wake of the recent rise in the price of oil, however, the export duty was re-imposed.

At the end of February guidelines were drawn up between Russia and the United States for an agreement on Russian steel exports, the aim of which was to prevent anti-dumping measures being imposed against the country. The guidelines set quotas and minimum prices for Russian steel exports to the USA. For 1999 steel exports of 0.75 million tons, 18% less than in 1998, are envisaged. Exports of steel goods account for around 8% of total Russian exports. It seems, however, that Russia has not yet finally decided whether to accept the agreement. Yet the government has scarcely any alternative to accepting the offer. The envisaged penal duties of between 70 and more than 200% would be tantamount to virtual exclusion from the US market.²³

Of central importance for Russia's external economic relations are the provisions governing the servicing of its debts to foreign creditors. In all, interest and principal payments by the Russian government totalling US-\$ 15 billion are due in 1999. Of this, three billion result from outstanding debt to members of the Paris Club assumed from the former Soviet Union, around one billion from debt held by private creditors belonging to the London Club, 4.4 billion from IMF loans, and 1.6 billion from Eurobonds. On top of this come payments on rouble bonds (including GKO) held by foreigners, and liabilities due for payment by private Russian debtors totalling around US-\$ 20 billion.

In December 1998 the state-owned Vneshekonombank, the main holder of debt accumulated in the Soviet period, failed to make interest payments totalling US-\$ 362 million to the creditors grouped in the London Club. In the wake of this failure, Russia's credit rating was once again reduced at the start of 1999. Nor have debt service payments on liabilities held by the Paris Club been made on time and in full in recent months. In contrast to debt held by the Paris and London Clubs, the Russian government has so far serviced its Eurobond debts on schedule, although a first failure to service Eurobonds – by the privately owned Uneximbank – did occur at the end of January.

So far all attempts to reach a comprehensive rescheduling agreement have failed. Nevertheless, the

²³ The US has so far refrained from imposing the penal duties, in order to avoid placing an excessive burden on the Russian steel industry during the current crisis.

government budget for the current year makes allowance for debt servicing payments of just US-\$ 9 billion, and, moreover, it expects additional capital inflows of US-\$ 7 billion. As far as the liabilities vis-à-vis the Paris Club are concerned, it appears that foreign creditors, and in particular the leading creditor country, Germany, are not prepared to accept general debt forgiveness. They are willing, however, to consider partial debt-servicing in the form of goods supplies. Russia has proposed setting off Russian foreign debt against Russia's claims against developing countries resulting from the Soviet period. Such claims are practically worthless, however.

Negotiations on how to deal with the GKO, almost half of which are held by foreigners, have been subjected to serious delays. At the end of 1998 the Russian government presented a proposal under which 70% of the nominal value of the debt was to be converted into bonds paying a variable rate of interest, and with a maturity period of between four and five years, and 20% into three-year zero bonds. Just 10% were to be paid out in cash. Foreign creditors can convert the zero bonds into shares in various Russian corporations. The Russian government has set creditors a deadline by which they can accept the offer. GKO holdings not converted by then are to be frozen for five years. Interest paid on these stocks will only be allowed to be used to purchase Russian government bonds at face value. By the deadline of the end of April, Russian investors had accepted the conditions set by the government for more than 95%, foreign investors for almost 90%, of their holdings of GKO.

Parallel to the negotiations with private creditors, those with multilateral lenders on the disbursement of existing loans and the provision of fresh money continued. At the end of February 1999 an agreement was reached with the World Bank on a US-\$ 400 million loan. Provided the conditions set are fulfilled, an initial tranche was to be paid out at the end of April 1999. At the end of April the IMF granted Russia a new standby loan of US-\$ 4.5 billion. In return, the Russian government committed itself to earning a primary-budget surplus of 2% of GDP and implementing structural reforms, particularly in the areas of taxation law and the banking sector. The new loan was to be used to service existing liabilities held by the IMF. Following the agreement with the IMF, Russia may also receive additional loans totalling US-\$ 3.5 billion from the World Bank and from Japan. All of these credits have been put on hold as a result of the change of government.

The agreement with the IMF has improved the chances of making progress in current negotiations with the Paris and London Clubs, which have also proved extremely laborious. The substantial increase in the burden of debt-servicing payments on the Russian govern-

Table 7

Balance of Payments,¹ 1995 to 1998

in US-\$ billions

	1995	1996	1997	1997					1998			
				I	II	III	I-III	IV	I	II	III	I-III
Balance of trade	20.8	23.1	17.6	6.0	3.6	3.5	13.1	4.4	1.2	1.1	4.4	6.6
Exports	82.7	90.6	88.9	21.2	20.7	21.7	63.6	25.4	18.5	18.2	17.8	54.5
Imports	-61.9	-67.5	-71.3	-15.1	-17.0	-18.3	-50.4	-21.0	-17.3	-17.1	-13.5	-47.9
Balance of non-factor services	-9.5	-5.9	-5.2	-1.0	-1.1	-1.4	-3.5	-1.5	-1.1	-1.4	-0.7	-3.3
Exports	10.5	13.0	13.9	2.9	3.4	4.3	10.6	3.5	2.9	3.3	3.7	9.9
Imports	-20.1	-18.8	-19.1	-3.9	-4.6	-5.7	-14.2	-5.0	-4.0	-4.7	-4.4	-13.2
Factor income	-3.4	-5.3	-8.5	-1.0	-2.4	-2.7	-6.1	-2.4	-1.3	-3.8	-3.4	-8.4
Earned income	-0.3	-0.4	-0.3	-0.1	-0.1	-0.1	-0.3	-0.1	-0.1	-0.1	-0.1	-0.3
Capital yields	-3.1	-4.9	-8.2	-0.9	-2.3	-2.6	-5.8	-2.3	-1.2	-3.7	-3.3	-8.1
Capital yields received	4.1	4.2	4.0	2.4	0.6	0.6	3.6	0.5	2.4	0.7	0.5	3.7
Capital yields paid out	-7.2	-9.2	-12.2	-3.3	-2.9	-3.2	-9.4	-2.8	-3.7	-4.5	-3.8	-11.8
Current transfers	0.1	0.2	-0.6	0.0	-0.2	-0.2	-0.4	-0.2	-0.4	-0.1	0.0	-0.6
Balance on current account	8.0	12.1	3.3	4.0	0.0	-0.9	3.1	0.4	-1.6	-4.2	0.2	-5.6
Capital transfers	-0.3	-0.5	-0.8	-0.1	-0.3	-0.2	-0.6	-0.2	-0.1	-0.2	-0.1	-0.4
Net direct investment	1.7	1.7	3.6	-0.1	1.0	1.4	2.3	1.4	0.3	0.1	0.3	0.7
Direct investment abroad	-0.3	-0.8	-2.6	-0.6	-0.6	-0.7	-1.9	-0.7	-0.4	-0.4	-0.1	-0.8
Direct investment in Russia	2.0	2.5	6.2	0.5	1.6	2.0	4.1	2.1	0.7	0.5	0.4	1.5
Net portfolio investment	-1.6	9.7	45.4	6.1	8.0	1.9	16.0	29.4	3.5	3.9	-0.4	7.0
Assets	-1.7	-0.2	-0.2	0.2	0.0	-0.3	-0.1	0.0	-0.1	-0.5	0.4	-0.3
Liabilities	0.1	9.9	45.6	5.9	8.1	2.2	16.2	29.4	3.6	4.4	-0.7	7.3
Other capital transactions	-11.9	-35.6	-18.5	-7.1	-0.7	-3.6	-11.4	-6.9	-1.4	0.8	-3.2	-3.8
Assets	5.0	-29.3	-26.9	1.2	-6.3	-10.0	-15.1	-11.6	-3.6	-2.1	-4.8	-10.5
Change in cash holdings	0.0	-8.9	-13.7	-2.7	-1.3	-3.7	-7.7	-5.8	0.4	1.5	-1.1	0.8
Current and deposit accounts	4.3	-1.0	1.0	1.4	-0.7	-1.0	-0.3	1.3	1.6	0.5	-0.1	2.0
Commercial and other loans	16.6	0.0	0.2	3.2	1.5	-1.3	3.4	-3.2	1.8	0.4	-0.5	1.7
Overdue payments	-10.6	-9.5	-3.0	1.8	-2.7	-1.0	-1.9	-1.1	-3.7	-2.8	-0.5	-7.0
Outstanding export earnings	-4.9	-9.8	-11.5	-2.8	-3.0	-2.8	-8.6	-2.8	-3.3	-1.7	-2.5	-7.4
Other claims	-0.6	-0.1	0.1	0.3	-0.1	-0.2	0.0	0.1	-0.2	-0.1	-0.3	-0.6
Liabilities	-16.9	-6.3	8.4	-8.3	5.6	6.4	3.7	4.7	2.2	2.9	1.6	6.7
Change in cash holdings	0.4	-0.2	0.0	-0.1	0.1	0.0	0.0	-0.1	0.0	0.1	0.0	0.1
Current and deposit accounts	2.5	1.5	-4.7	-7.4	0.5	0.9	-6.0	1.3	-1.0	0.4	-1.5	-2.1
Commercial and other loans	-20.7	-8.5	12.6	-0.3	4.7	4.7	9.1	3.5	3.4	1.8	3.2	8.3
Other liabilities	0.9	0.9	0.5	-0.5	0.3	0.7	0.5	0.0	-0.3	0.6	-0.2	0.2
Correction item	1.1	-1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance on capital account	-11.8	-25.7	30.5	-1.1	8.3	-0.3	6.9	23.8	2.4	5.0	-3.3	4.1
Statistical discrepancy	-8.0	-8.1	-7.1	-2.4	-1.0	-1.2	-4.6	-2.5	-2.2	-1.4	-1.7	-5.3
Balance of payments	-12.1	-22.2	25.9	0.3	7.0	-2.7	4.6	21.4	-1.5	-1.0	-4.9	-7.4
Financial balance	12.1	22.2	-25.9	-0.3	-7.0	2.7	-4.6	-21.4	1.5	1.0	4.9	7.4
Reserve assets	-10.4	2.8	-1.9	-1.3	-8.0	1.6	-7.7	5.8	0.9	0.7	3.5	5.1
IMF, World Bank, bilateral institutions	8.1	7.9	7.5	1.3	2.3	1.6	5.2	2.4	1.2	.	.	.
Special financing	14.4	11.5	-31.5	-0.1	-1.1	-0.5	-1.7	-29.6	-0.4	0.2	.	.
Rescheduling (net)	12.1	8.4	3.1	1.3	0.4	0.8	2.5	0.6	.	.	.	.
Overdue payments (net)	1.1	2.7	-24.0	1.0	1.1	1.1	3.2	-27.2	0.6	0.3	2.3	3.2
Loans to CIS countries	0.3	0.2	0.2	0.1	0.0	0.1	0.2	0.0	.	.	.	.

1) Columns may not sum to totals due to rounding.

Sources: Central Bank of the Russian Federation (CBR), Bulletin of banking Statistics, no. 8/1998; Balance of Payments of the Russian Federation. <http://www.cbr.ru>, March 1998; calculations by the Institutes.

ment, banks and firms following the devaluation of the rouble, against the background of a simultaneous deterioration in the economic situation, has dashed hopes that debts will be serviced on schedule. Consequently, it is vital that the negotiations currently underway are conducted in a constructive fashion, and that Russia refrains from implementing unilateral confiscatory measures. Otherwise it will be barred from gaining access to the international capital market in future.

Market reforms

The lack of an overall concept underpinning market reforms has become increasingly apparent since the outbreak of the financial crisis in August 1998. Initially, several economic policy programmes were drawn up to cope with the crisis, but none was implemented. Instead, ad hoc measures were used to deal with the most pressing problems. Although this did not lead to drastic intervention in the economy, for instance in the form of the nationalisation of enterprises, as had been feared, Russian policy-makers have given the appearance of focusing entirely on the short term, and have thus created additional uncertainty both at home and abroad.

Privatisation had already become bogged down in the first half of 1998. Following the events of August and the devaluation of the rouble, sales of large companies, in some cases to foreign investors, were postponed. Not until December were 2.5% of the shares in Gazprom sold to the German company, Ruhrgas, for US-\$ 660 million, only marginally above the minimum price that had been set. Privatisation receipts, which by the end of November 1998 had amounted to just 3.4 billion rouble, were stocked up by this means to 15.2 billion rouble for the year as a whole; even so they were down on 1997 (23.3 billion rouble). Measured in dollars, converted at the exchange-rate prevailing at year's end, the receipts represented just 55% of the sum originally planned, and only one-fifth of the last year's figure. In the course of 1999, the sale of shares, particularly in large companies, including Gazprom, Svyazinvest' and Aeroflot, is again supposed to generate 15 billion rouble. Strained government finances might induce the government to add additional companies to the privatisation list above and beyond the sales already planned. However, even in the face of cash-strapped budgets, the policy of proceeding very cautiously with privatising large companies in key sectors (including energy) is being maintained. In May the sale of a further 2.5% of shares in Gazprom planned for the first half of 1999 was postponed to the second half of the year. Moreover, a law has passed its first reading in the duma that would restrict the equity

stakes, and thus the influence, of foreign shareholders in 1 150 strategic companies to less than 25%.

On 1 March 1998 a law on insolvency came into force that marks an important precondition for increasing the degree of financial discipline on companies and forcing them to restructure. The obligation on the debtor to register as insolvent led to a doubling of insolvency applications in 1998 compared with the previous year. A special bankruptcy court is to be set up to improve the implementation of these regulations on insolvency, which is still inadequate.

The insolvency law does not apply to financial institutions. However, on 1 March 1999 special legal provisions came into force in the form of the law 'on the bankruptcy of credit organisations'. The provisions lay considerable emphasis on measures that aim to permit financial institutions to stay in business. Financial refloating measures, the imposition of a temporary external administration, and the reorganisation of financial institutions are all to be exhausted before the actual insolvency procedure is implemented. Within the framework of financial refloating, financial resources can be made available for a limited period, loan guarantees given, and payments delayed. The temporary administration, normally put in place by the central bank for a period of six months, in some cases up to a maximum of 18 months, is to supervise the asset transactions of the financial institution concerned and to work towards overcoming its financial crisis. To this end, reorganisation measures, including mergers, can be implemented. Only if these measures are unsuccessful, is the trading licence withdrawn and the insolvency procedure itself initiated. At this point financial institutions can no longer embark on the 'external leadership' reorganisation procedure envisaged for a period of up to 18 months for insolvent companies. Even so, the opportunities to postpone insolvency within the framework of the priority given to restructuring measures will draw out insolvency proceedings for financial institutions. Moreover, although the new law has defined the procedure to be followed for insolvency in the banking sector, it is unlikely that the legislation will be rigorously applied, either here or in the business sector at large, and that insolvency proceedings will be quickly brought to a conclusion.

Faced with the aftermath of the financial crisis, the government initially announced its intention to improve the conditions for attracting foreign capital. Particularly in the energy sector, a potentially interesting field for foreign investors, foreign investment in recent years has been very limited, in contrast to the situation in Azerbaijan and Kazakhstan. In addition to the statutory provisions on the Production Sharing Agreement (PSA), in February 1998 a list of extraction areas that were to be

reserved for joint mining and drilling activities was passed by the *duma*. Alongside the two agreements already reached – but not yet implemented, due, among other things, to legal uncertainties – a third PSA was reached with a French and Norwegian oil company. Before production can begin, however, a number of questions, relating to the terms for the use of pipelines, for instance, need to be addressed. Foreign oil companies are, in principle, subject to the export duty reintroduced at the start of this year;²⁴ in March the duty was suspended after the price of oil fell below US-\$ 9.8 per barrel, but has since been re-imposed. The compulsory sale of foreign exchange, which in January was raised from 50 to 75% of earnings, however, only applies to Russian companies. Moreover, since mid-March Russian companies that use at least 25% of their export earnings to service foreign debt are only obliged to convert 50%. Overall, the steps taken to clarify the situation concerning PSAs mark only a first step towards attracting foreign investments in the energy sector; given the instability of the overall framework, this measure alone cannot be expected to induce a significant inflow of direct investment.

A renewed attempt to pass a land ownership law, in order to remove the uncertainty surrounding the private acquisition of agricultural land, failed at the end of 1998. Auctions were nevertheless held at regional level, for instance in Saratov. Since the start of 1999 private ownership of real estate has been permitted in Moscow. Here, land is to be sold to investors to enable them to realise large-scale projects and for housing construction. Thus in terms of land rights, reforms at regional and local level have progressed faster than at Federation level. In other areas, however, the reverse is the case. During the last winter, for example, even more regions facing supply shortages imposed restrictions on the free-trade in food on their territories, in an attempt to restrain rising prices. This reveals that the trend for regions to take autonomous decisions on market reforms has continued. An additional problem is the uncertainty on which set of regulations, regional or federal, will remain in force.

In the autumn of 1998, numerous anti-crisis programmes were put forward, although none of them was implemented. It was announced that a new programme would be presented – one of the conditions for further lending by the IMF – at the end of the first quarter of 1999; a decision that was subsequently postponed, however. It will form part of the new package negotiated with the IMF.

²⁴ The duty amounts to 2.5 euro per tonne of crude oil at a world market price of between US-\$ 9.8 and 12.3 per barrel and 5 euro per tonne at a price above US-\$ 12.3.

Summary

Although the financial and currency crisis in Russia was exacerbated by global economic factors, such as the fall in energy prices and the Asian crisis, it was to a considerable extent caused by the economic policy mistakes committed by the government. In the wake of the crisis, the Russian rouble has so far lost around three-quarters of its value on the foreign exchange market. At the same time, total output has fallen sharply (-4.6%). The devaluation has, however, offered Russian companies a far better chance of successfully competing with imported goods on the domestic market. Some companies seem to be taking this opportunity. However, there is no sign that this trend is broadening out and assuming a more lasting character. Above all else, there is no evidence of a recovery of investment activity and an end to capital flight. By unilaterally suspending much of its debt-service payments, Russian economic policy makers have given themselves a breathing space. They are clearly hoping for a renewed and generous rescheduling package, further loans from the IMF, and substantial debt write-offs. Apart from this they have primarily focused on restoring or sharpening the redundant or blunted instruments of the pre-reform period. Against this background, GDP is expected to contract by between 4 and 5% in 1999. The inflation rate (December to December) will not fall below 60%.