

# Russia's Economy

## Steering a Risky Course

### Falling profits, accelerating growth of private consumption

While the world's large economies, especially the USA, Japan and Germany, are battling stagnation or recession, Russia is one of the few countries which was again able to boast strong economic growth last year. Russia can now look back on no less than three successful years for its economy. However, it is not clear whether and how long the current upswing will last. The DIW Berlin<sup>1</sup> believes that the Russian economy is still pursuing a course which is rife with danger. While the efforts towards institutional reform are highly welcome, a change in the direction of economic policy is also required if lasting growth is to be guaranteed. In particular, better conditions must be created so as to halt the decline in enterprise profits. Although growth already slowed perceptibly in some important sectors in 2001, which should be taken as cause for alarm, the current efforts towards altering the course of economic policy are inadequate.

### Marked slowdown in growth

At over 5%, Russian GDP growth in 2001 was already substantially weaker than in the previous, very successful, year (over 8%, cf. table 1). The slowdown was even more severe in some important economic sectors. Industrial output growth fell from 11.9% to only 4.9%. The slowdown in gross fixed capital formation, which fell from 17.7% to 8.7%, was also pronounced. The comparatively small decline in GDP growth can be explained on the output side by the extremely good grain harvest and lively construction activity, and on the consumer side by high and even accelerated private consumption growth.

The continued respectable upswing cannot yet be seen as essentially a result of the reforms introduced by President Putin, welcome as they are; rather it is a consequence of the developments that immediately followed the 1998 financial crisis. Following the drastic devaluation of the rouble at that time (it initially fell by 80%

against the US dollar), the Russian economy was subjected to a draconian cure in two senses. On the one hand, the volume of imports declined rapidly and substantially (by almost 50%), and demand shifted from the now higher priced imports to domestic producers (import substitution). On the other hand, there was a sharp reduction in real wages (initially by well over 30%), which was closely linked to the devaluation of the rouble. The result was a reduction in the burden of costs for enterprises. In addition, fortunately for Russia, the sharp increase in world market prices for energy sources led to a hefty rise in export earnings. Together, these developments initially resulted in a virtual explosion of profits in the enterprise sector, which very quickly led to two-figure growth rates in investments.

These three factors created a comfortable cushion for the Russian economy at the time, but this buffer has now been shrinking for at least two years. World market prices for energy, on which Russia has little influence, have fallen again to less than half their highest temporary level, and the decline has been very substantial recently. Real wages in Russia have been growing for two years at exorbitant rates of around 20%. In 2001, nominal wages actually rose by over 45%.

Given that the rouble exchange rate has remained practically stable, the additional nominal purchasing power largely takes effect on foreign markets as additional real purchasing power (real appreciation). It is thus not surprising that demand is increasingly shifting once again to imported goods, which are rapidly becoming more affordable. Import growth is consequently high (18%).<sup>2</sup> Export earnings (in US dollar), by contrast, actually declined (-2.6%). Considering that export earnings had risen by around 40% as recently as 2000, this development is the equivalent of a complete halt. The dynamics on the import side are practically the reverse.

Overall, these developments in 2001 led to a pronounced decline both in the trade and current account surplus and in real profits in the Russian enterprise sector. The latter contributed decisively to the sharp slowdown in growth in fixed capital formation.

As pointed out above, seen from the expenditure side of GDP, macroeconomic growth in 2001 was primarily based on the high and still accelerated growth of private consumption. Retail trade turnover increased by around 11% in real terms (following a 9% increase the previous year), and there was an above-average expansion in turnover for non-foodstuffs.<sup>3</sup> But the consumption boom

<sup>1</sup> The DIW Berlin is carrying out a Russian-German dialogue on economic policy in cooperation with the Higher School of Economics, Moscow, and within the framework of the German government's TRANSFORM programme. Parts of this report are based on the results of the dialogue.

<sup>2</sup> Imports from the West ('non-CIS') grew by a hefty 27%.

<sup>3</sup> This also applied to imports. According to provisional figures, food imports increased by 16% in 2001, compared with a 69% increase for non-food imports and a 73% increase for car imports. Cf. *Izvestiya* of 17 January 2002.

Table 1

## Selected Economic Indicators, 1990 to 2001

Change on previous year or % share

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
GDP <sup>1</sup>	-3.0	-5.0	-14.5	-8.7	-12.7	-4.2	-3.4	0.9	-4.9	3.2	8.3	5.0 <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	11.9	4.9
Construction <sup>1</sup>	-5.0	-2.0	-36.0	-8.0	-24.0	-6.0	-16.0	-6.0	-5.0	6.0	11.5	9.9
Agricultural output <sup>1</sup>	-3.6	-5.0	-9.0	-4.0	-12.0	-8.0	-5.1	1.5	-13.2	4.1	5.0	6.8
Gross fixed capital formation	0.1	-15.0	-40.0	-12.0	-24.0	-10.0	-18.1	-5.0	-12.0	5.3	17.7	8.7
Volume of goods transport <sup>2</sup>	-	-7.4	-23.6	-5.0	-24.3	-10.2	-17.7	-9.8	-5.3	5.3	6.3	-
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	4.8	3.1
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	8.7	10.8
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	5.7	-
Per capita nominal monetary income	18.0	120	750	1030	360	158	46.1	22.7	5.8	58.3	32.4	31.2
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	5.9
Nominal wages and salaries	15.0	81.0	994	878	276	114	57.3	20.2	10.6	43.4	46.0	45.5
Real wages and salaries	-	-3.0	-33.0	0.4	-8.0	-28.0	6.4	4.7	-13.4	-22.8	20.9	19.8
Real pensions	-	-	-48.1	30.7	-3.2	-19.5	8.7	-5.4	-4.8	-39.4	28.0	22.6
Consumer prices <sup>5</sup>	6.0	160	2 510	840	215	131	21.8	11.0	84.4	36.5	20.2	18.6
Industrial producer prices <sup>5</sup>	4.0	240	3 280	895	233	175	25.6	7.5	23.2	67.3	31.6	10.7
Merchandise exports (in US-\$)	-	-	-	11.3	13.2	20.1	9.3	-0.3	-15.9	1.3	39.5	-2.6 <sup>7</sup>
Merchandise imports (in US-\$)	-	-	-	3.1	14.0	20.6	12.9	7.0	-19.8	-31.7	13.5	17.8 <sup>7</sup>
Unemployment rate <sup>6</sup>	-	-	5.2	6.0	7.7	9.0	9.9	11.2	11.9	11.7	10.2	9.0

1 Real. — 2 Measured in tonnes. — 3 Measured in tonne-kilometres. — 4 1991 to 1993: December to December of previous year; from 1994 onwards: annual average. — 5 1990: annual average; from 1991 onwards: December to December of previous year. — 6 At end of period; on ILO definitions. — Provisional figure provided by the Russian Ministry for Economic Development and Trade, cited by Interfax on 28 January 2002. Source: Goskomstat.

was accompanied by a severe slowdown in the growth of fixed capital formation, and government expenditure even had a perceptibly restrictive effect (see section on budgetary position).

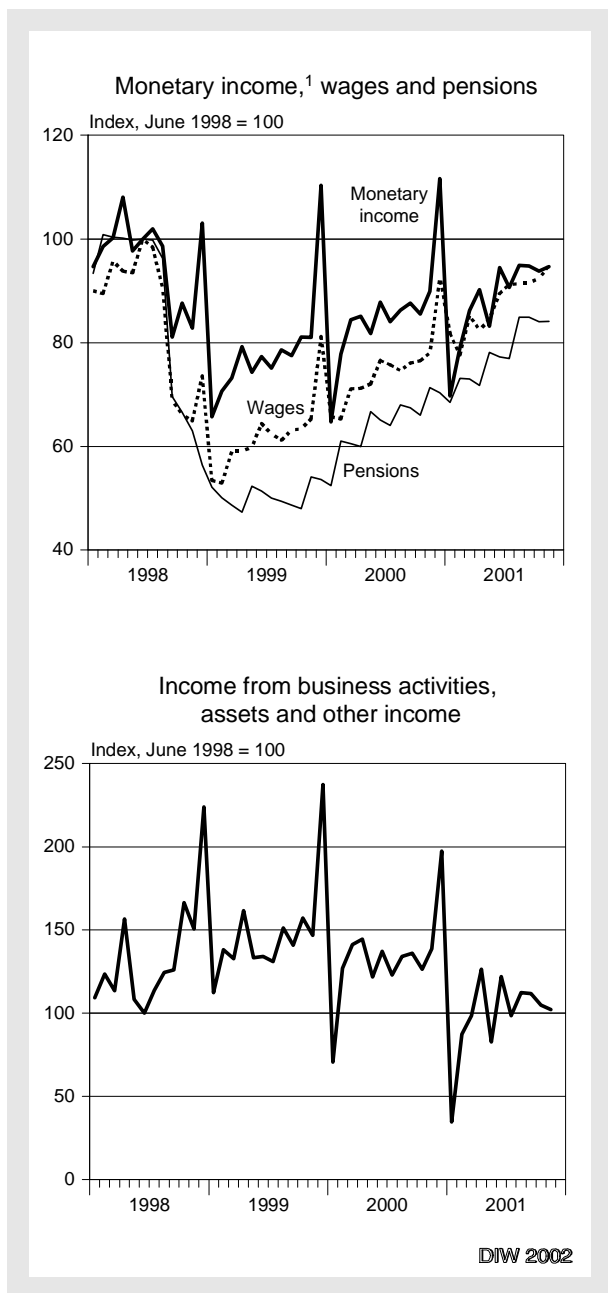
On the income side of GDP, aggregated enterprise profits fell sharply in 2001 (by more than 7% in real terms<sup>4</sup>), following a very strong increase only one year previously. The downward trend accelerated rapidly throughout 2001, and the disproportionate decline in industrial profits (by over 16%) was particularly con-

spicuous. The iron and steel, fuel and non-ferrous metallurgy industries (in other words, export-intensive sectors), in particular, were all affected by the fall in profits.

The disposable income of private households increased substantially again in real terms in 2001 – by around 6% (cf. figure 1). The increases in real wages (20%) and in real pensions (almost 23%) were well above average. Due to the rapid increase in real wages, the cost advantage gained by the enterprise sector as a result of the fall in real wages after the 1998 crisis has now been almost completely neutralised. By contrast, other private household income – in particular income from business activities and assets, especially distributed profits – declined sharply (by an annual average of around 22%).

<sup>4</sup> Cf. Vedomosti of 22 January 2002. The figures refer to net profits for the year (earnings minus losses). Data are only available for large and medium-sized enterprises. While there are many reasons to treat Russian profit statistics with considerable reticence, the DIW Berlin believes that they reflect the basic trends accurately.

Figure 1  
Real Income of Private Households,  
1998 to 2001



¹ Total monetary income of private households.  
Source: Goskomstat; DIW Berlin calculations.

## Structural adjustment, employment, prices

### Profits and investments

Recent comparisons of the structure of profits and investments show that while a substantial share of over-

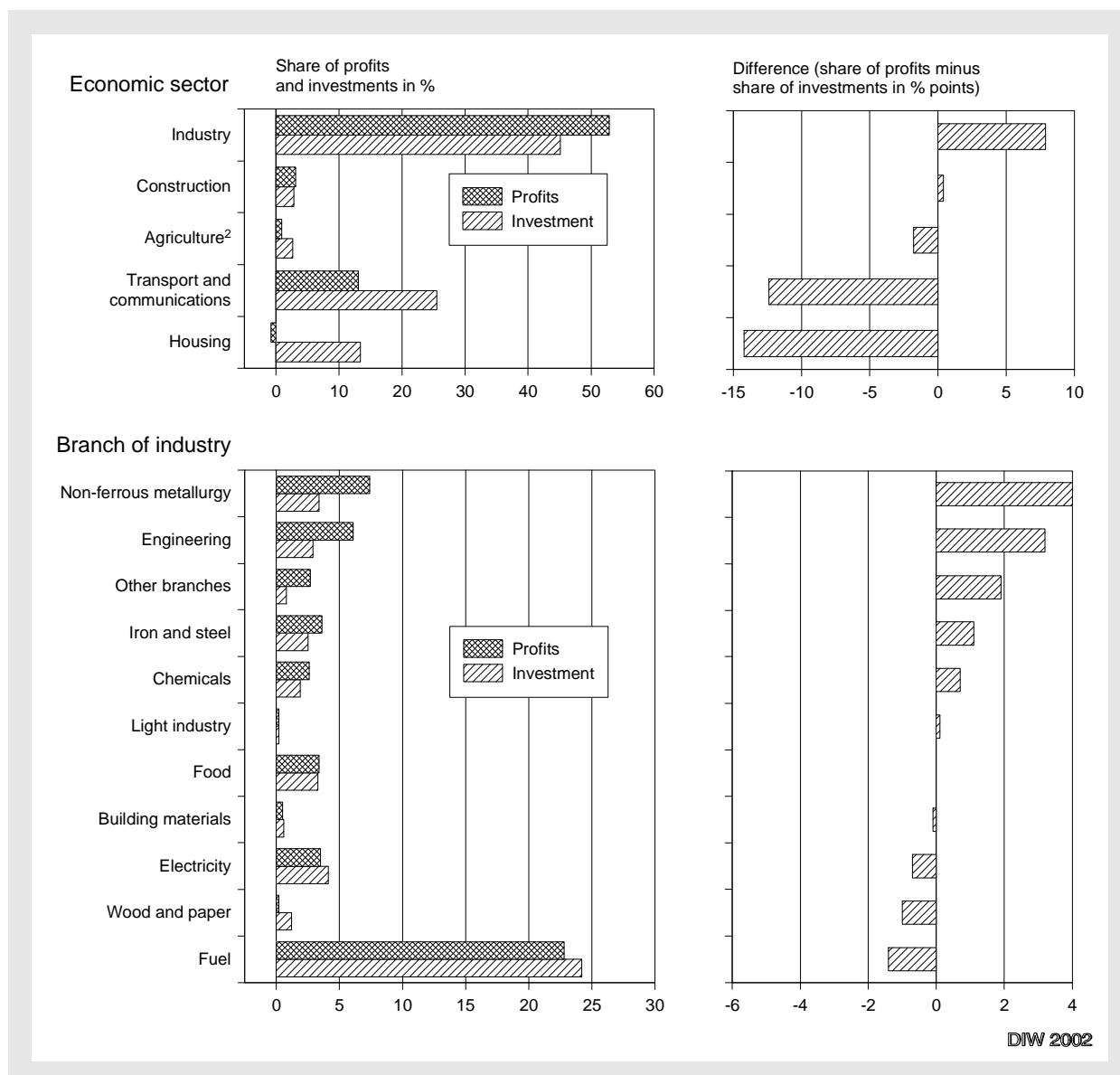
all investment went to the housing sector, this investment was not matched by any profits whatsoever (cf. figure 2). The housing sector reveals the largest gap in this respect. In other words, this sector depends most on resources from other branches of the economy. The main reasons for the losses are probably rents not covering costs and maintenance charges, as well as the inefficient provision of the relevant services. It is no coincidence that the reforms regarding the communal services and housing sector are among the most important and – because they imply price increases – the most controversial policy goals.

The problems seem to be different in the transport and communications sector. While this sector is also eating up net resources, the spending is probably due to investments – for example in the areas of pipeline construction and telecommunications – which are more closely linked to cost-oriented price formation and thus in the long term with profits.

Industry accounts for by far the highest shares of both overall profits and overall investments. The share of profits also exceeded that of investments in 2001, albeit to a much smaller degree than the previous year. While within industry, the fuel sectors still account for by far the largest share of both profits and investments, in 2001 the share of profits fell below the share of investments, unlike the previous year. Thus, in an almost complete reversal of the situation in 2000, the fuel industry has become the largest net recipient of resources within industry. This is primarily due to the fall in world market prices for energy sources. The difficulties became more severe during 2001. Most recently, the export duty on crude oil was reduced by a massive 70% to US-\$ 8 per tonne (as of 1 February 2002), a move explicitly justified by the fact that the fuel sector no longer has sufficient resources to finance the investments desired by the government. The resulting hole in the Federation budget is actually likely to exceed the sum of US-\$ 140 million a month quoted in Russia.

The repeated calls for functioning financial markets to handle financial intermediation between the different sectors of the economy are still justified: even today, less than 4% of overall investment is financed by bank loans, even though the volume of loans has recently increased substantially. Lately, financing via company bonds – starting at an equally low rate – has been growing in significance. In Russia, the transformation of savings (in this case, enterprise profits) into investments is primarily carried out via the public budgets – unless the profits are invested in the particular enterprise itself. Recently, investments have increasingly been made via direct company acquisitions, also across sectors.<sup>5</sup> Even in the area of agriculture, there have been numerous cases of industrial 'oligarchies' entering the sector.

Figure 2

Sectoral Shares in Overall Profits and Investments<sup>1</sup> in 2001

<sup>1</sup> Based on figures for the first half of 2001. More recent data are as yet unavailable. — <sup>2</sup> Figures for 2000.  
Sources: Goskomstat; DIW Berlin calculations.

## Production

Production growth in industry was more than 50% lower in 2001 than the previous year, and in some sectors of industry the decline took on dramatic dimensions. By weighting the growth rates for production in each sector of industry with the sector's share of total industry, we can create a ranking order of contributions

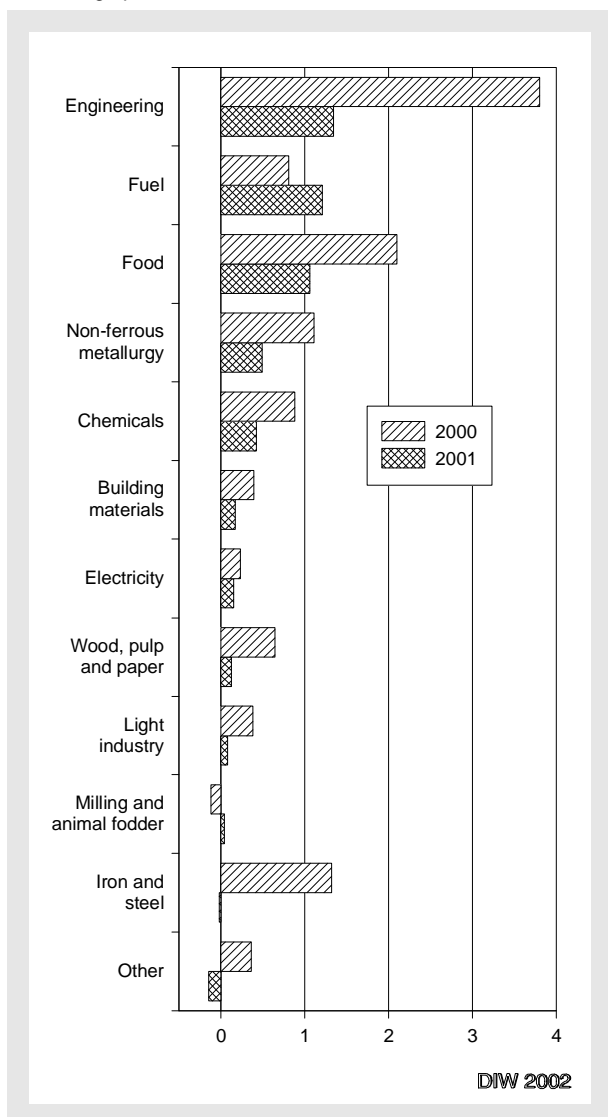
to total industrial growth (cf. figure 3). While the mechanical engineering and metal-processing sector, which is subject to strong competition from abroad,<sup>6</sup> still contributed most to industrial growth, it now only has a small edge on the other sectors. The largest change in the ranking order of contributions to growth was seen in the iron and steel industry, which fell from third place in 2000 to second-last place in 2001.

<sup>5</sup> Formation of conglomerates following the Korean model, known in Russia as 'chaebolisation'.

<sup>6</sup> Production of trucks, for example, declined by over 10%, while at the same time imports of trucks doubled.

Figure 3  
Contributions of Sectors to Total Industrial Growth, 2000 and 2001

Percentage points<sup>1</sup>



<sup>1</sup> The sum of the contributions to growth yielded an industrial growth rate of 4.9% in 2001 (11.9% in 2000).

Source: Goskomstat; DIW Berlin calculations.

### Labour market and prices

At first glance, the situation on the labour market appears to have improved. The unemployment rate amounted to 9% at the end of 2001, which was much lower than the previous year's figure. However, this decrease was not linked to an increase in employment: the number of employed remained unchanged at 65 million. The decline in the unemployment rate is due exclusively to the fall in the number of labour force members,

who at the same time dropped out of the unemployment statistics.

The increase in consumer prices by almost 19% in 2001 means that no notable progress was made in curbing inflation with respect to the previous year (cf. table 2). This is not necessarily worrying in itself, for there are still substantial changes in relative prices, which are undoubtedly required. These changes can thus take place without absolute price decreases – and thus more easily – if the average rate of increase of consumer prices leaves enough scope, in other words is not too low. The urgent need to cover costs in various services (especially public transport and housing and maintenance charges) will continue to make hefty price increases necessary. Naturally, such measures are controversial at the political level, and the first public transport price increase planned for this year was thus recently partially withdrawn.

All in all, the main worry as regards the continuing high level of inflation is the fact that it is taking place while the rouble exchange rate is essentially stable. The purchasing power of the rouble is thus increasing abroad, and demand is now increasingly shifting to imported goods. Going by the current declarations of intention, this problem is likely to worsen in 2002, for only a very slight further devaluation of the rouble is planned,<sup>7</sup> and the official forecasts regarding the rise in consumer prices, which are probably optimistic, already suggest a hefty 12% to 14% increase.<sup>8</sup> If world market prices for Russian export goods remain unchanged, then the trade surplus is likely to dwindle rapidly.

### Budgetary position dependent on oil price

Until the 1998 crisis, the catastrophic condition of the public budgets and the resulting rapid increase in the government's indebtedness on the international financial market contributed substantially to the destabilisation of the national economy. This situation changed completely after the crisis. The consolidated budget now boasts a substantial surplus for the second year in a row. In the first nine months of 2001, the surplus amounted to 3.4% of GDP (cf. table 3), but it decreased over the course of the year. At 6.7% of GDP, the primary balance<sup>9</sup> was comfortably positive. Thus, during the current phase of economic weakening the direction of Russian fiscal policy is extremely restrictive.

<sup>7</sup> To only 31.50 roubles to the US dollar according to Finance Minister Kudrin. Cf. <http://www.strana.ru> of 13 December 2001.

<sup>8</sup> Cf., for example, *The Moscow Times* of 22 January 2002.

<sup>9</sup> Revenue minus expenditure (not including interest payments).

Table 2

## Monthly Inflation Rates, 1994 to 2001

% change on previous month

	Consumer prices								Industrial producer prices							
	1994	1995	1996	1997	1998	1999	2000	2001	1994	1995	1996	1997	1998	1999	2000	2001
January	17.9	17.8	4.1	2.3	1.5	8.5	2.3	2.8	19.0	21.5	3.2	1.1	0.9	6.8	4.0	1.8
February	10.7	11.0	2.8	1.5	0.9	4.1	1.0	2.3	15.1	16.9	2.7	1.6	0.5	5.5	3.7	1.7
March	7.4	8.9	2.8	1.4	0.6	2.8	0.6	1.9	10.2	10.8	2.6	1.3	-0.1	3.9	2.6	1.1
April	8.5	8.5	2.2	1.0	0.4	3.0	0.9	1.8	10.6	14.8	2.4	0.8	0.0	3.6	1.6	0.9
May	7.0	7.9	1.6	0.9	0.5	2.2	1.8	1.8	6.6	8.9	1.1	0.5	-0.9	3.5	1.7	0.9
June	6.0	6.7	1.2	1.1	0.1	1.9	2.6	1.6	8.4	6.1	1.6	0.8	0.0	3.7	2.3	2.0
July	5.3	5.4	0.7	0.9	0.2	2.8	1.8	0.5	7.8	6.7	1.2	0.2	-0.8	3.1	3.4	0.9
August	4.7	4.6	-0.2	-0.1	3.7	1.2	1.0	0.0	5.8	6.7	2.1	0.5	-1.2	4.6	1.7	0.0
September	7.9	4.4	0.3	-0.3	38.4	1.5	1.3	0.6	7.3	5.7	1.7	0.1	7.4	5.9	1.9	-0.1
October	15.0	4.7	1.2	0.2	4.5	1.4	2.1	1.1	11.0	4.6	2.8	0.1	5.9	5.5	2.7	0.4
November	14.6	4.5	1.9	0.6	5.7	1.2	1.5	1.4	12.6	2.9	0.9	0.2	5.1	3.9	1.2	0.3
December	16.5	3.2	1.4	1.0	11.6	1.3	1.6	1.6	12.9	1.9	0.8	0.0	4.8	2.2	1.0	0.2

Source: Goskomstat.

Income linked to foreign trade increased substantially due to changes in tax and customs legislation ('raw materials tax'). It accounted for around 4% of GDP in the first three quarters of 2001 and flows exclusively into the federal budget. By contrast, the effect based on the introduction of a flat personal income tax rate of 13% is often over-estimated. The simultaneous introduction of a social tax clearly did not render the planned transfer of 'shadow economy' activities into the 'official economy' an attractive option.<sup>10</sup> In addition, 95% of taxpayers only paid the entry-level rate of 12% in the past, and were thus only slightly below the new tax rate to begin with.

The federal budget surplus amounted to 2.4% of GDP in 2001 (cf. table 4).<sup>11</sup> This surplus is partly used to build up foreign currency reserves ('stabilisation fund').<sup>12</sup> The government's declared aim is to redeem either part of the debt estimated for 2003 (currently US-\$

20 billion) in advance, or preferably all of it; then only US-\$ 16 billion would be owed in the form of euro bonds. Given the cross-default regulation for this type of loan, failure to service due debts would have catastrophic effects for the Russian Federation's reputation on the international financial markets, which is only recovering slowly as it is.<sup>13</sup>

The reduction of the maximum corporate tax rate from 35% to 24%, which took effect at the beginning of the year, has been retained.<sup>14</sup> Now, in principle, a federal tax of 7.5% is levied on enterprise profits, while another two percentage points flow into the local budgets.<sup>15</sup> The remainder goes to the regions. The regions are granted a degree of flexibility as regards the structure of their tax rates, which can amount to between 10.5 and 14.5 percentage points. At the same time as the reduction in the maximum corporate tax rate, however, numerous possibilities for special write-offs and other tax concessions were abolished. The consequences for the tax revenue remain to be seen.

<sup>10</sup> To quote Zubarov, the chairman of the state pension fund. Cited in Vedomosti of 17 December 2001.

<sup>11</sup> According to preliminary data from the Russian Ministry of Finance on the entire year, the primary surplus amounted to 4.9% of GDP. Cf. <http://www.opec.ru> of 22 January 2002.

<sup>12</sup> It is expected that foreign exchange receipts of up to US-\$ 3.5 billion will flow into the stabilisation fund. The purpose of the fund is not only to provide for due debts; the partial creaming off of the inflowing foreign exchange is also intended to have a stabilising effect on the money supply and exchange rate trends.

<sup>13</sup> Cf. C. Buch, R. P. Heinrich, L. Lusinyan, M. Schrooten: 'Russia's Debt Crisis and the Unofficial Economy', in: *DIW Discussion Paper*, no. 208 and Kiel Working Paper no. 978.

<sup>14</sup> *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 33/2001.

<sup>15</sup> Recently, a tax moratorium has been discussed, which would serve the purpose of guaranteeing the stability of the tax rates for a period of five years.

Table 3

**Consolidated Budget**

Selected public revenue and expenditure items

	1995	1996	1997	1998	1999	2000	I to III	1995	1996	1997	1998	1999	2000	I to III
	as % of total revenue/expenditure							as % of GDP						
Revenue, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	26.1	24.8	27.3	25.2	26.3	29.9	28.7
Tax revenue														
of which:														
corporation tax	27.0	17.3	14.7	14.5	18.2	19.2	20.2	7.0	4.3	4.0	3.6	4.8	5.7	5.8
income tax	8.4	10.1	10.6	10.4	9.7	8.4	9.3	2.2	2.5	2.9	2.6	2.5	2.5	2.7
excise duties	5.6	9.6	9.6	10.5	9.0	8.0	9.0	1.5	2.4	2.6	2.6	2.4	2.4	2.6
value-added tax	22.0	25.8	25.7	24.8	23.7	22.0	22.6	5.7	6.4	7.0	6.2	6.3	6.6	6.5
export tax etc.	.	.	.	.	7.1	11.0	13.2	.	.	.	.	1.9	3.3	3.8
Revenue														
from government assets	.	.	1.3	2.0	2.0	3.3	4.5	.	.	0.4	0.5	0.5	1.0	1.3
from privatisation	.	.	3.3	2.5	.	.	.	.	.	0.9	0.6	.	.	.
Foreign trade	4.6	3.0	1.6	2.7	3.0	1.8	1.5	1.2	0.7	0.4	0.7	0.8	0.5	0.4
Earmarked funds	.	.	7.7	6.6	8.8	10.8	5.7	.	.	2.1	1.7	2.3	3.2	1.6
Other revenue	32.3	34.2	25.5	25.9	25.6	26.6	14.1	8.4	8.5	7.0	6.5	4.9	4.7	4.0
Expenditure, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	29.4	28.9	32.3	30.9	27.3	26.9	25.3
Industry, energy, construction	7.4	6.0	6.0	3.1	2.5	3.1	5.7	2.2	1.7	1.9	1.0	0.7	0.8	1.4
Agriculture, fisheries	4.2	3.9	3.7	2.9	2.8	2.9	2.4	1.2	1.1	1.2	0.9	0.8	0.8	0.6
Transport, communications	2.7	.	2.8	2.3	2.1	2.1	3.7	0.8	.	0.9	0.7	0.6	0.6	0.9
Social and cultural purposes	26.0	28.9	32.2	29.2	29.2	28.5	30.1	7.7	8.4	10.4	9.0	8.0	7.7	7.6
of which:														
education	11.6	.	.	.	.	.	.	3.4	.	.	.	.	.	.
health	8.3	.	.	.	.	.	.	2.4	.	.	.	.	.	.
social security	4.2	.	.	.	.	.	.	1.2	.	.	.	.	.	.
Defence	9.8	9.8	9.7	7.7	9.2	10.2	10.2	2.9	2.8	3.1	2.4	2.5	2.7	2.6
Administration and legal organs	7.7	.	10.5	9.1	9.6	11.0	11.3	2.3	.	3.4	2.8	2.6	3.0	2.9
Foreign trade	4.4	4.1	.	.	.	.	.	1.3	1.2	.	.	.	.	.
Debt servicing	5.1	6.6	4.9	17.7	15.1	10.2	13.2	1.5	1.9	1.6	5.5	4.1	2.8	3.3
Environmental protection	.	.	0.5	0.4	0.4	0.4	0.5	.	.	0.2	0.1	0.1	0.1	0.1
Earmarked funds	.	.	.	5.2	8.0	11.9	6.1	.	.	.	1.6	2.2	3.2	1.6
Other expenditure	8.6	40.9	29.7	22.5	21.1	19.7	16.7	2.5	11.8	9.6	7.0	5.8	5.3	4.2
Balance as % of expenditure/GDP	-11.2	-14.4	-15.2	-18.4	-3.5	11.1	13.6	-3.3	-4.2	-4.9	-5.7	-1.0	3.0	3.4

Sources: Goskomstat; Russian Economic Trends; DIW Berlin calculations.

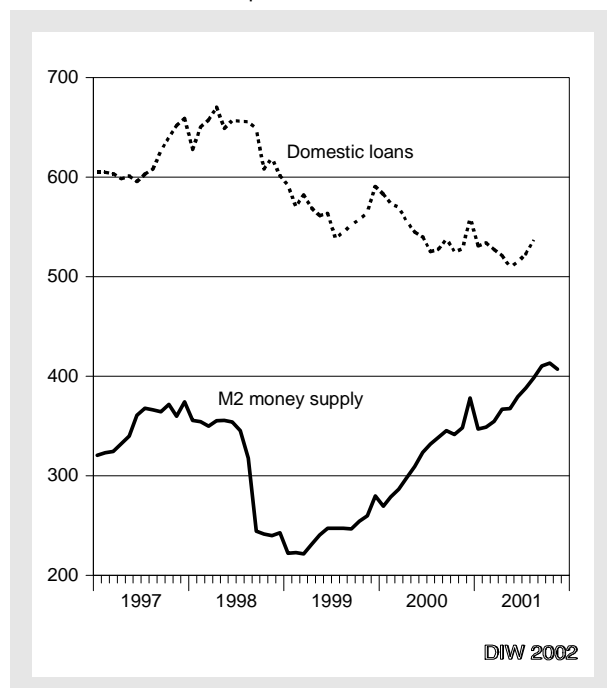
The constant revisions of the budget estimates for 2002 show clearly how dependent the budget position is on oil-price trends. Taxation of oil extraction is to be made temporarily dependent (from 2002 to 2004) on the trend for world market oil prices. From 2005 onwards, the rate is to amount to 16.5%.<sup>16</sup> This decision is closely related to the substantial reduction of oil export tax –

following a phase of repeated increases and decreases – to US-\$ 8 per tonne, which entered into force on 1 February 2002.<sup>17</sup> In addition, the tax on natural resources was standardised across the regions. The federal budget is expected to show a surplus again in 2002. Against the background of the oil-price trends, but also in view of the cooling down of the macroeconomic climate, the

<sup>16</sup> Bank of Finland, Russian & Baltic Economies (BOFIT), *The Week in Review*, no. 31/2001.

<sup>17</sup> This tax still amounted to euro 48 a year ago. The currency was changed to US dollars when the rate was reduced.

Figure 4  
**Money Supply and Loans, 1997 to 2001<sup>1</sup>**  
 In billion roubles at 1997 prices



<sup>1</sup> Deflated by the consumer price index.  
 Sources: International Monetary Fund (IMF): International Financial Statistics on CD-ROM, Washington, D.C., 2001; DIW Berlin calculations.

budget estimates entail considerable risks, however. In the event of income shortfalls, Russia's ability to service its debts would ultimately be jeopardised again.<sup>18</sup>

## Monetary stability despite lack of instruments?

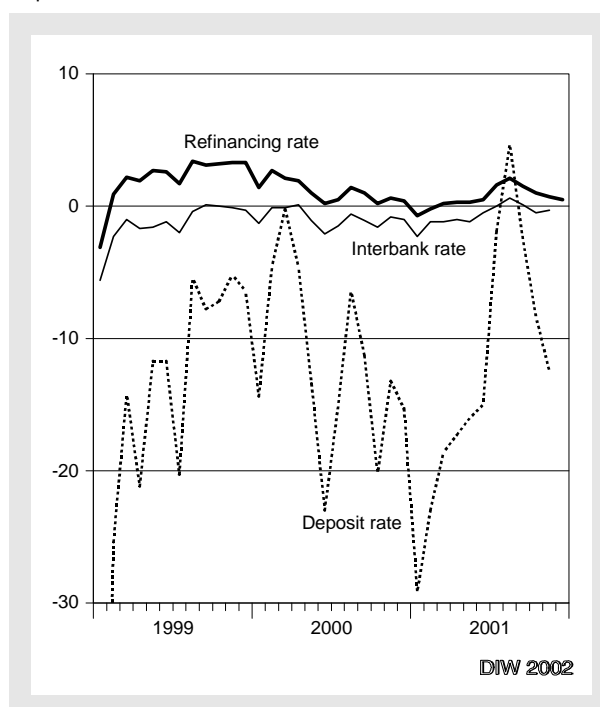
The insufficient monetisation of the Russian economy has been lamented for years. In actual fact, the degree of monetisation, measured as M2 money supply relative to GDP, has risen to around 17% since the financial crisis, against around 13% previously. However, in this respect the Russian economy is still lagging considerably behind the economies of the transformation countries which are seeking to join the European Union. The year 2001 saw a nominal expansion of around 40% (November figures) in the Russian Federation's M2 money supply compared with the previous year, while the stock of cash expanded by a hefty almost 50% during the same period. The money supply has also

<sup>18</sup> The draft budgets for 2002 assume economic growth of 4.3% and an average inflation rate of 12%.

expanded significantly in real terms since the financial crisis (cf. figure 4). The expansion of the money supply was driven by the influx of foreign currency, which led to a significant rise in net external assets. Domestic loans, by contrast, are on a declining trend. While loans to the private sector have expanded significantly, this effect is primarily due to the fact that the government has been increasingly building up deposits with the central bank (+40% in nominal terms). These reserves are also intended to form a cushion for future debt servicing.

A substantial influx of foreign currency, which was primarily due to the temporary oil-price boom, enabled the central bank to return de facto to its 'exchange rate anchor' policy with the help of currency market interventions. This step was also facilitated by the mandatory exchange rule for foreign currency earnings,<sup>19</sup> though this was temporarily relaxed, and by the formation of foreign exchange reserves and the creation of the stabilisation fund. Subsequently, the nominal devalua-

Figure 5  
**Real Interest Rates<sup>1</sup>, 1999 to 2001**  
 % 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., 2001; DIW Berlin calculations.

<sup>19</sup> See section on 'institutional development'.



Table 4

**Federal Budget**

Selected public revenue and expenditure items

	1995	1996	1997	1998	1999	2000	2001 I to III	1995	1996	1997	1998	1999	2000	2001 I to III
	as % of total revenue/expenditure							as % of GDP						
Revenue, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	15.1	13.2	13.7	11.1	13.3	16.2	16.9
Tax revenue														
of which:														
corporation tax	17.9	11.5	10.4	11.5	13.2	15.8	14.5	2.7	1.5	1.4	1.3	1.8	2.6	2.5
income tax	1.4	1.8	0.5	0.0	3.3	2.4	0.2	0.2	0.2	0.1	0.0	0.4	0.4	0.0
excise duties	7.5	16.0	16.1	17.4	13.8	11.6	12.8	1.1	2.1	2.2	1.9	1.8	1.9	2.2
value-added tax	30.9	35.9	37.4	34.6	36.1	33.0	38.2	4.7	4.7	5.1	3.8	4.8	5.4	6.5
export tax etc.	.	.	.	.	14.1	20.3	22.4	.	.	.	.	1.9	3.3	3.8
Use of natural resources	.	.	.	.	1.7	1.6	3.0	.	.	.	.	0.2	0.3	0.5
Foreign trade	.	.	.	5.1	5.7	3.2	2.6	.	.	.	0.6	0.8	0.5	0.4
Revenue														
from state assets	.	.	.	.	1.1	2.5	3.6	.	.	.	.	0.1	0.4	0.6
from privatisation	2.1	0.3	5.5	5.0	.	.	.	0.3	0.0	0.7	0.6	.	.	.
Earmarked funds	.	.	.	.	9.0	8.2	0.9	.	.	.	.	1.2	1.3	0.1
Other revenue	40.2	34.6	30.2	26.3	2.0	1.2	2.0	6.1	4.6	4.1	2.9	0.3	0.2	0.3
Expenditure, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	15.6	14.4	14.7	14.3	14.4	13.7	14.2
Economy	14.3	11.4	12.1	.	.	.	.	2.2	1.6	1.8	.	.	.	.
of which:														
industry, energy, construction	.	.	.	2.9	2.5	3.7	2.7	.	.	.	0.4	0.4	0.5	0.4
agriculture, fisheries	.	.	.	0.8	1.4	1.4	1.2	.	.	.	0.1	0.2	0.2	0.2
transport, communications	.	.	.	.	0.2	0.2	2.5	.	.	.	.	0.0	0.0	0.4
Social and cultural purposes	8.2	8.9	16.6	14.7	12.8	13.9	14.4	1.3	1.3	2.4	2.1	1.8	1.9	2.1
Defence	20.6	20.6	21.9	14.6	17.5	20.0	18.2	3.2	3.0	3.2	2.1	2.5	2.7	2.6
Administration and legal organs	10.2	10.9	14.9	10.4	10.6	13.7	12.5	1.6	1.6	2.2	1.5	1.5	1.9	1.8
Debt servicing	.	.	.	27.4	24.5	18.0	22.5	.	.	.	3.9	3.5	2.5	3.2
Environmental protection	.	.	.	.	0.4	0.4	0.3	.	.	.	.	0.1	0.1	0.0
Fiscal transfers	.	.	.	.	9.3	10.6	18.3	.	.	.	.	1.3	1.5	2.6
Earmarked funds	.	.	.	.	8.3	10.2	0.9	.	.	.	.	1.2	1.4	0.1
Other expenditure	46.7	48.1	34.6	29.2	20.9	18.1	7.4	7.3	7.0	5.1	4.2	3.0	2.5	1.0
Balance as % of expenditure/GDP	-3.4	-8.4	-7.3	-22.2	-8.0	18.2	19.2	-0.5	-1.2	-1.1	-3.2	-1.2	2.5	2.7

Sources: Goskomstat; Russian Economic Trends; DIW Berlin calculations.

tion of the rouble against the US dollar was only slight. Because Russia's inflation rates are much higher than those of its western trading partners, there has been a real appreciation against both the US dollar and the euro (cf. figure 6). This in turn has consequences for the real economy: the competitive advantage of Russian producers still persisting as a result of the financial crisis and the subsequent sharp devaluation is constantly dwindling.

### Financial sector remains fragile

The reform in the banking sector has also failed to make noteworthy progress since the financial crisis of 1998, which is hindering the development of the financial market. So far it has been possible to finance the upswing on the basis of profits withheld from the enterprise sector.

The banking sector is dominated by just a few commercial banks, some of which are government owned,

although the importance of foreign commercial banks has increased. The number of commercial banks in Russia has decreased since the financial crisis (1547 on 1 August 1998; 1281 on 1 July 2001). The smallest 1000 banks have a combined market share of only 0.6%. One distinctive feature of the crisis-rocked Russian banking sector is the fact that deposits in the 'state banks', such as the Sberbank, are informally ('implicitly') guaranteed by the government. Thus, as regards attracting savings, these banks have a significant competitive advantage over the others, including foreign commercial banks. From 2005 onwards, all banks will be required to have a minimum equity capital of euro 5 million. Numerous banks will then be forced to significantly stock up their equity capital; thus, from today's point of view, further consolidation of the commercial banking sector can be expected.

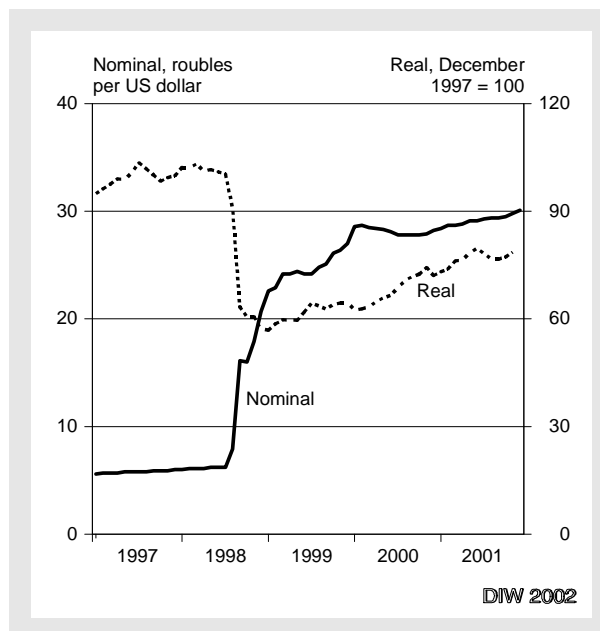
## Institutional development

Important steps have been taken in the effort to improve Russia's institutions. In the course of 2001, new regulations concerning the protection of property rights were defined and the legal framework was improved. In particular, new inheritance laws, new land ownership laws and laws seeking to reduce state interference and bureaucracy were passed.<sup>20</sup> However, above and beyond passing new laws, it is also important that the existing legislation is applied. There is uncertainty, in particular, as to whether the regions actually implement federal law. Only if there is wide-scale implementation can effective institutional progress be made.

### Property law

A decisive change to the property code was made on 1 March 2002 when the third part of the civil code came into force, creating extensive possibilities for inheritance for the first time.<sup>21</sup> The new land ownership law was already passed in autumn 2001.<sup>22</sup> The purchase, sale and rental etc. of industrial land is now permitted in principle.<sup>23</sup> While the new law only applies to around

Figure 6  
Rouble Exchange Rate<sup>1</sup> Against US Dollar, 1997 to 2001



<sup>1</sup> Real exchange rate 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 on CD-ROM, Washington, D.C., 2001; DIW Berlin calculations.

2% of all land in Russia, a signal has been sent out nonetheless: for the first time in around 80 years, private ownership of land is now permitted again in Russia. The fact that with the enactment of the new land ownership law numerous presidential decrees and government resolutions were abolished and that legal transparency is now likely to improve is also to be assessed positively. However, further legislation is needed before the new land ownership law can be implemented. The question of how to deal with land which has already been sold has yet to be clarified. Moreover, it is not certain to what extent the land law can be implemented at local authority level.<sup>24</sup>

The law on protection of enterprises in the event of public inspections, which entered into force in summer 2001, serves to strengthen the private sector with respect to the public sector.<sup>25</sup> For example, the law is intended to prevent regulatory authorities from exceed-

<sup>20</sup> Moreover, a comprehensive reform of the judicial system was launched, which provides, among other things, for changes to the law on the constitutional court, the judicial system and the code of criminal procedure.

<sup>21</sup> Cf. Grazhdansky kodeks Rossiyskoy Federatsii. Chast' Tret'ya, in: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 49/2001, p. 1041 ff.

<sup>22</sup> Cf. Zemel'nyy kodeks Rossiyskoy Federatsii. In: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 44/2001, p. 9175 ff.

<sup>23</sup> A regulation on land used for agricultural purposes is to follow in the coming months.

<sup>24</sup> The distribution of real estate to the Federation and subordinated local authorities was clarified in principle by the so-called allocation law, which was passed in summer 2001 and entered into force in January 2002. Cf. 'O razgranichenii gosudarstvennoy sobstvennosti na zemlyu', in: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 30/2001, p. 6009 ff.

Table 5

## Income from Privatisation, 1993 to 2001

Billion roubles

	1993	1994	1995	1996	1997	1998	1999	2000	2001 1st half
Total	0.36	0.98	3.57	2.81	24.7	17.5	12.1	41.2	2.8
of which:	0.36	0.98	3.57	2.81	24.7	17.5	12.1	41.2	2.8
federation	0.07	0.12	1.14	0.90	18.0	15.0	8.5	31.3	0.9
regions	0.10	0.18	0.52	0.42	3.3	0.9	1.9	5.3	0.8
municipalities	0.13	0.40	0.96	0.91	0.7	1.0	0.9	1.4	0.8
other	0.06	0.29	0.95	0.58	2.7	0.6	0.8	3.2	0.3

Source: Goskomstat.

ing their competence. Further measures to curb bureaucracy and to improve the investment climate include new legislation on the licensing and registration of enterprises.<sup>26</sup> The new legislation is expected to have a positive effect on the foundation of small businesses, for example. Their number has decreased further, according to the official statistics. In summer 2001, there were 842 200 registered small firms, around 30 000 fewer than one year previously.<sup>27</sup> Small businesses employ only around 10% of the working population. Given the still minor importance of small businesses, the measures taken to reduce bureaucratic interference and to facilitate market entry are a step in the right direction. The government has announced further supportive measures, such as financial aid and simplification of tax procedures.<sup>28</sup>

Amendments to the law on joint-stock companies entered into force on 1 January 2002.<sup>29</sup> The obligation to store and circulate information was tightened up. Share-

holders who together own 25% of the shares must now be granted access to the accounts. In addition, a time limit for dividend payments was introduced for cases where no deadlines have been set by the shareholders' meeting. Finally, the rights of shareholders regarding decisions concerning the issuing of shares have been strengthened and old shareholders are now better protected when new shares are issued. Capital increases by means of issuing new shares now require the agreement of three-quarters of the votes at the shareholders' meeting. All in all, these changes strengthen the rights of small shareholders, which have been only insufficiently protected to date.

Despite the voucher privatisation carried out between 1992 and 1994 and the sale of public enterprises which followed in the subsequent years, the state is still a major owner of productive assets. On 1 September 2001, the government owned shares in over 4300 joint-stock companies.<sup>30</sup> As in previous years, privatisation was accelerated again in the second half of last year. According to preliminary estimates, privatisation earnings in 2001 amounted to over 40 billion roubles.<sup>31</sup> In 2002, shares in 363 enterprises are to be privatised and privatisation earnings of up to 35 billion roubles are expected.<sup>32</sup> However, the fact that the new privatisation law (which was ratified by the Federation Council in

<sup>25</sup> Cf. Federal'nyy zakon 'O zashchite prav juridicheskikh lits i individual'nykh predprinimateley pri provedenii gosudarstvennogo kontrolya (nadzora)', in: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 33/2001, p. 7011 ff.

<sup>26</sup> Cf. Federal'nyy zakon 'O gosudarstvennoy registratsii juridicheskikh lits'. In: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 33/2001, pp. 6992 ff. Federal'nyy zakon 'O litsenzirovanii otel'nykh vidov deyatelnosti', in: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 33/2001, p. 6979 ff.

<sup>27</sup> Cf. Goskomstat: *Sotsial'no-ekonomicheskoye polozheniye Rossii, yanvar' – avgust 2001*, p. 129.

<sup>28</sup> However, the effect of the four federal programmes to support small businesses which were launched between 1994 and 2001 must so far be assessed as minor. These programmes had only a small volume of funds at their disposal. The most recent programme allocated only 90 million roubles for the promotion of small businesses, and press reports suggest that the amount actually paid out was much smaller.

<sup>29</sup> Cf. Federal'nyy zakon 'O vnesenii izmeneniy i dopolneniy v Federal'nyy zakon 'Ob aktsionernykh obshchestvakh', in: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 33/2001, pp. 6906 ff. Also cf. Bank of Finland, Russian & Baltic Economies (BOFIT), *The Week in Review*, no. 33/2001.

<sup>30</sup> Cf. *Argumenty i fakty*, no. 39/2001.

<sup>31</sup> Cf. *RFE/RL* of 11 December 2001.

<sup>32</sup> Cf. *Argumenty i fakty*, no. 39/2001.

December 2001 and will presumably enter into force in spring 2002) also makes the privatisation of enterprises in so-called strategic sectors (including the electricity and gas sector) dependent on the agreement of the government is to be interpreted negatively.

### Supply and transport monopolies

Demonopolisation is being carried out only hesitantly. The electricity sector is to be restructured and opened up to competition, with the first phase of the reform lasting until 2004. The competencies of the price-regulation authorities have already been changed. The ambit of the Federal Energy Committee, which is responsible for electricity prices, has been extended and a new federal price agency, which now determines electricity, gas and rail transport prices, for example, has been established.<sup>33</sup> These changes are also intended to curb autonomous price-setting by the regions. In January 2002, price increases of 16% for rail transport (to take effect on 15 February), of 20% for electricity (1 March) and of 20% for gas (15 March) were agreed; further price increases for electricity and gas are planned in the course of the year. While there are plans to introduce new household rates for electricity and heating, for example, and to abolish existing subsidies and pay transfers to low-income households,<sup>34</sup> the transition phase until the permanent introduction of the new price structures, which was initially intended to last three years, has been extended to 2010. Overall then, postponements of the necessary steps towards demonopolisation and price formation intended to cover costs have recently been slipping in. In addition, it is also doubtful again whether the regions will actually comply with the federal mandates.

### Reforms in other areas

There is still a considerable need for reform in the financial sector. The revision of the law on the securities market has not yet been completed. In the course of 2001, proposals for the reform of the banking sector were submitted by the central bank and the employers' and banking associations, among others. There was a lack of agreement on the pace of the reform and on how to deal

with banks that are still owned by the state and those that are not viable. Following lengthy discussions, at the end of the year the government accepted the central bank's proposal. However, the latter was able to push through only some of its proposals regarding the tightening up of the minimum capital requirements.

The problems in the financial sector will have a negative effect on the implementation of the pension reform, which entered into force at the beginning of 2002.<sup>35</sup> Individual retirement provision is to consist in future of a tax-funded basic pension and a wage-dependent pension funded by compulsory employer contributions plus a pension financed by personal savings. Thus, the aim is a mixture of a pay-as-you-go and a capital funding scheme. However, further legal conditions (including a law on pension funds) must still be created to accommodate the latter aspect.

The new labour code, which regulates the rights and duties of employees, employers and trade unions, entered into force on 1 February 2002.<sup>36</sup> The new code introduced a 40-hour week and the stipulation that the minimum wage must guarantee the minimum subsistence income. Employees are entitled to temporarily suspend work if – as has often happened in the past – their wages are not paid on time.

As regards external trade legislation, from summer 2001 onwards the mandatory exchange of 75% of export earnings in foreign currency was reduced to 50% and thus to the level which applied before the 1998 financial crisis.<sup>37</sup> This can be taken as a sign that foreign trade is being liberalised.

In the institutional sector, the government has numerous plans for the medium term. Private property rights are to be further strengthened, state bureaucracy is to be curbed and the investment climate is to be improved.<sup>38</sup> While these intentions are to be welcomed, what is most important is that the new measures are

<sup>33</sup> Cf. Ukaz Prezidenta Rossiyskoy Federatsii 'O vnesenii izmeneniya v Ukaz Prezidenta Rossiyskoy Federatsii' ot 29 noyabrya 1995 g., no. 1194, 'O Federal'noy energeticheskoy komissii Rossiyskoy Federatsii', in: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 37/2001, p. 7765 ff.

<sup>34</sup> Cf. Bank of Finland, Russian & Baltic Economies (BOFIT), *The Week in Review*, no. 31/2001.

<sup>35</sup> Federal'nyy zakon Rossiyskoy Federatsii 'O gosudarstvennom pensionnom obespechenii v Rossiyskoy Federatsii'; Federal'nyy zakon Rossiyskoy Federatsii 'O trudovyykh pensiyakh v Rossiyskoy Federatsii'; Federal'nyy zakon Rossiyskoy Federatsii 'Ob obyazatel'nom pensionnom strakhovanii v Rossiyskoy Federatsii', in: *Rossiyskaya gazeta* of 20 December 2001.

<sup>36</sup> Cf. 'Trudovoy kodeks Rossiyskoy Federatsii', in: *Rossiyskaya gazeta* of 31 December 2001.

<sup>37</sup> Cf. Federal'nyy zakon 'O vnesenii izmeneniy v nekotorye zakonodatel'nye akty Rossiyskoy Federatsii, zatragivayushchiye voprosy valyutnogo regulirovaniya', in: *Sobraniye zakonodatel'stva Rossiyskoy Federatsii*, no. 33/2001, p. 7005 f.

<sup>38</sup> As regards foreign investment, the regulations on production sharing, for example, are to be improved. In particular, special regulations for the regions are to be abolished and standard legislation introduced throughout the federation. On production sharing, cf. DIW Berlin, Institute for the World Economy at the University of Kiel: 'Russian economic recovery in jeopardy', in: *DIW Berlin Economic Bulletin*, vol. 38, no. 2, February 2001.

implemented consistently. Hesitant reform plans – such as those in the financial sector – should be reviewed.

## Conclusion

Russia's reform policy last year was characterised by vigorous efforts to create a more attractive investment climate for both domestic and foreign enterprises on the basis of extensive institutional changes. Further reform measures will either follow in the near future or are in the planning stages. All these endeavours are indeed urgently needed, for Russia's investment climate still leaves considerable room for improvement.

Nonetheless, the Russian economy showed strong growth last year, albeit at a much lower rate than the previous year. The slowdown in growth in the important area of fixed capital investment was even more precipitous. The DIW Berlin considers the recent decline in enterprise profits to be one of the critical aspects. These profits had exploded shortly after the financial crisis of 1998, but they decreased again, in absolute terms, last year. The same three factors as were responsible for the upward trend in enterprise profits following the crisis – the devaluation of the rouble, the decline in real wages and the oil-price increase – are now also causing the decline. The Russian rouble is now again constantly gaining in real value on the foreign exchange market. This means, in particular, that imported goods are rapidly becoming more affordable for Russian consumers, which is causing an import boom.

At the same time, real wages have been growing at rates of around 20% for over two years now. Thus, the cost advantage created for the enterprise sector by the fall in real wages after the 1998 crisis has been almost completely annihilated. The third factor that deserves mention is the sharp decrease in world market prices for energy sources.

Even if the profit situation in Russia is still comfortable, the sharp decline in profits must nonetheless be considered extremely worrying, for profits in Russia also have the function of compensating for shortcomings in the investment climate, and so they must include a substantial risk premium. Moreover, there are no reliable indications that the large-scale flight of capital (of an estimated US-\$ 20 billion per annum) has eased. The main source of this capital are enterprise profits, and if the latter decline, then investments by enterprises, and not capital flight, will be reduced. Finally, it must also be mentioned that falling enterprise profits are also creating substantial holes in the public budgets.

Russian policy has little influence on world market price trends for energy resources, but the same does not

apply to the rouble exchange rate or to wage increases. Similarly to last year, the nominal exchange rate is not 'planned' to decline perceptibly this year. Given a 'planned' inflation rate of well over 10% and an expected rate which is likely to be closer to 20%, the agenda is set for a further real appreciation – and thus also for a continuation of the import boom which, given the exorbitant wage increases, will increasingly focus on consumption goods. Policy makers could certainly take steps to halt this trend. On the one hand, a somewhat less ambitious exchange rate goal would be worth contemplating. On the other, wage increases in the 'mixed' and in the public sector, which are also an important guideline for wage trends in the private sector, could be influenced by the state. However, policy makers have undertaken nothing in this regard yet, and this year those income trends which can be influenced by the state are to continue at the current pace. The trade and current account surplus will thus continue to fall rapidly, even if its current level may still be considered reassuring.

This kind of policy must be based on the hope that it will be possible to improve the investment climate sufficiently rapidly to allow the flight of capital, in particular, at least to be halted, or preferably quickly reversed to become a large-scale inflow of foreign (direct) investment. Efforts to this end are under way and deserve recognition. These also include the endeavours to quickly join the World Trade Organisation.

However, it must be asked why Russian policy makers are not working harder to stem the erosion of profits. Government representatives usually argue that the rapid growth of wages, in particular, is not only appropriate in view of the low standard of living, but that it is also the decisive factor underlying the gratifying level of economic growth. The simultaneous fall in profits is irrelevant, they say. An alternative explanation might be the fact that Russian policy makers are willing to take considerable risks and believe that they can turn the tide before the situation becomes truly critical. However, a third alternative cannot be ruled out – the possibility that Russian policy is characterised by a significant propensity (or even compulsion) for short-sighted populism, which instead of striving for moderate increases in the standard of living (for example at the same pace as the GDP growth of 5%) seeks rapid, highly perceptible improvements (such as the real wage increase of 20%). Whichever explanation is correct, what can be anticipated is that if the current unbalanced development continues it will be accompanied by serious risks for future economic growth.

Overall, there is no doubt that improvements have been made to the institutional framework in Russia. However, what must be criticised is the failure to imple-

ment new legislation, especially in the regions. However, this is only one side of the problem. Less discussed is the fact that many of the new regulations contain contradictions themselves or contradict existing laws. The result is that once these regulations have entered into force, dysfunctionalities which quickly become apparent mean they cannot be applied. This shortcoming actually has a positive side in as much as the failure to implement new regulations means their dysfunctionalities are also avoided. At any rate, it is clear that the improvement of the investment climate will continue to proceed at a slow pace in the future.

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Maria Lodahl and Mechthild Schrooten