THE RUSSIAN ECONOMY IN MARCH 2000

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Highlights

• From 1989 through 1998, the gross domestic product (GDP) of the RSFSR, then Russian Federation, declined each year apart from a 0.8 percent growth in 1997. In 1999, a growth of 3.2 percent was claimed, primarily attributable to the import substitution effect after the devaluation of August 1998, the increase in value of Russia’s oil exports, and some restructuring. The 1999 GDP was about 58 percent of the 1989 level. At an official rate of exchange of 28.5 rubles to the dollar, the 1999 GDP of 4,476 billion rubles was valued at about $158 billion: at purchasing power parity, the Russian GDP was estimated by the World Bank at around $630 billion.

• The IMF released the first of seven $640 million tranches of its $4.5 billion standby loan on July 30. The second may not be released before April at the earliest because, the Fund maintains, the Russian side has not fully met the commitments it made in the July 13, 1999 joint memorandum of the Russian Government and Central Bank.

• The federal budget for the year 2000 envisages revenues of 797.2 billion rubles ($24.9 billion, or 14.9 percent of GDP), expenditures at 855.1 billion rubles ($26.7 billion, or 16 percent of GDP), with a primary surplus of 3.2 percent of GDP and an overall deficit of 1.1 percent of a GDP of 5,350 billion rubles ($167.2 billion). It includes a substantial nominal increase in defense expenditure to 147 billion rubles ($4.6 billion), although additional resources may be channeled to the military under other budget headings.

• In 1999, an inflation rate of 36.5 percent was registered. An inflation rate of 18 percent is envisaged for the year 2000, with 2.3 percent registered in January.

• The exchange rate was 28.65 rubles to the dollar on March 1. The budget for 2000 is based on an average annual rate of 32 rubles/dollar.

• Real disposable incomes in 1999 were reported to be 15.1 percent below the 1998 level. In December, 35 percent of the population received incomes below the subsistence level of 980 rubles ($34) a month. The average wage in industry in January was 1,826 rubles ($64) a month.
• Wage arrears by February 1 had fallen to 44.9 billion rubles, and are to be eliminated by April 15 2000, according to Acting President Putin. Pension arrears were, it is claimed, eliminated by the end of September.

• After surpluses of $20 billion, $28 billion, $19.8 billion, and $14.4 billion in 1995, 1996, 1997, and 1998 respectively, the merchandise trade balance in 1999 amounted to $32.6 billion, excluding shuttle trade.

• The current account surplus in 1998 was $1.6 billion, after a surplus of $4 billion in 1997. The surplus for the first nine months of 1999 was $14.6 billion. The IMF has projected a surplus of $9.5 billion in 2000.

• The Central Bank’s reserves on February 18 amounted to $13.3 billion, including about $4 billion in gold. Roughly $1 billion held by CBR subsidiaries was excluded from the reserve total, owing to new accounting procedures.

• According to the joint Russian Government/Russian Central Bank Statement on Economic Policies of July 13, Russia’s total external debt then amounted to about $150 billion. This was expected to rise to $166.2 billion by January 1, 2000.

• External debt service coming due in 2000 is estimated at about $9.2 billion after rescheduling. Some $3 billion of this is due during the first quarter.

• On February 11, the London Club agreed to write off 36.5 percent of Russia’s $32 billion Soviet-era debt. The Paris Club is expected to be less generous.

• Seventeen months after the August 1998 crash that left most banks technically insolvent, few banks have been restructured. Central Bank Chairman Viktor Gerashchenko has publicly urged restructuring, the closure of insolvent banks, and the attraction of more Western banks, but has done little.

• On December 9, 1998, the Duma passed amendments to the 1995 production-sharing agreement law that opened up 30 percent of Russia’s hydrocarbon resources to development by Western corporations. Approval of individual sites by the Duma since then has been very slow.

• Fixed capital investment in 1998 was 7 percent lower than in 1997; it was less than one-fifth of the 1991 level in comparable prices. An increase of 1 percent was recorded in 1999.

• Cumulative net foreign direct investment (FDI) in Russia since 1992 has amounted to $11.7 billion, according to Prime Minister Putin, compared with over $350 billion in China during the same period. Net FDI in Russia in 1999 was about $2 billion, out of a global total of $827 billion.

• The average age of Russian manufacturing industry plant and equipment is three times higher than the OECD average. To update or replace it will take hundreds of billions of dollars. This capital is not available from domestic sources. Foreign direct investment is very low and will remain so until Russia cleans up its corporate governance act and creates a welcome environment. This suggests that Russian economic growth will remain low for the short- and medium-term.
The Long Depression

Starting in 1989, the GDP of the RSFSR, and successor Russian Federation, declined continuously with the exception of 1997, when a rise of 0.8 percent was recorded. Goskomstat estimated the cumulative drop at around 40 percent by the end of 1996. After a decrease of 4.6 percent registered in 1998, a GDP growth of 3.2 percent to 4,476 billion rubles, was claimed for 1999 - the largest increase in over a decade - with industrial output growing by 8.1 percent. This recovery is attributed to the import substitution effect after the devaluation of August 1998, the high world price of oil, and to some restructuring. The drop in output by the end of the century was about 42 percent - a far steeper fall than was registered during the Great Depression in the United States in the early 1930s. Yevgeni Yasin has projected an annual GDP of 1.5-2 percent increase over the next 2-3 years.¹

Nine Years of Transition

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¹ Excludes debt service
² Includes debt service

Sources: Derived from Goskomstat and IMF reports; Russian Economic Trends, quarterly and monthly updates; Interfax, March 6, April 12, 1999, & February 21, 2000; Ekonomika i zhizn, no. 2 (1998); Bank of Finland, Russian Economy: The Month in Review, no. 3 (1998); and The Russian Economy: The Week in Review, various issues.

The most disturbing factors in respect to growth prospects are that most industrial plant, equipment, and infrastructure are obsolete or obsolescent and that investment has dropped faster than output and continues to fall. Productive capital investment in 1998 was reported to be less than 20 percent of the 1991 level in constant prices.² A drop of 6 percent was reported for 1997, a decline of 7 percent occurred in 1998,³ but, for the first time in a decade, investment
grew in 1999 by about 1 percent. The exceptionally low rate of investment throughout most of the economy is attributable to a variety of factors. They include the low rate of private saving, the budget deficit that absorbs too many investible resources, disincentives provided by the onerous and opaque tax code and legal system, capital flight, and the understandable unwillingness of banks to invest in the real economy when they have been able to earn up to 180 percent on an annualized basis from government bonds. It might be pointed out that, even if an average 5 percent growth rate of GDP could be sustained in the next century, it would take about 12 years to regain the GDP level recorded in 1989.

Much of the decline of the past years is to be welcomed because it marks the overdue restructuring of the Russian economy toward producing goods and services that meet consumers’ demands rather than planners’ preferences. The output of the defense industry in 1996, for instance, was reported to be only 22.9 percent of the 1991 level, with military hardware at 14.3 percent and civilian goods at 27.1 percent of the 1991 figures. Its size was to be further reduced from 2.7 million employees in 1,760 plants in 1997 to 900,000 employees in 500 plants by the year 2005, although that was before the fallout from the Kosovo crisis. Much or perhaps most of Soviet-era investment went to the military-industrial complex. Moreover, in contrast to the command economy where managers had an incentive to overstate their output data to overfulfill plan targets and win bonuses, executives are motivated now to understate production totals to evade the tax inspector and the mafia and to have surpluses for sale on the side or for use as barter. Official data are also suspect. Goskomstat was set up to monitor manufacturing output but may not fully capture the activity of the service sector and the black and grey economies. More than one-fifth of the GDP - the MinFin estimate is 22 percent, while Goskomstat stays with a figure of 25 percent - derives from the shadow economy, compared with perhaps 13 percent in Italy. A 1997 study by Larissa Pyasheva and Igor Birman argued that the unofficial economy now accounts for 50 percent of the Russian GDP, a recent estimate by the World Bank is 43 percent, while another estimate cited by The Economist is one of 40 percent.

Inflation

After most wholesale and retail prices were freed on January 2, 1992, consumer prices increased by 2,509 percent that year. The monetary overhang disappeared overnight, as did lines and the value of people’s savings. Tight monetary and fiscal policies brought annual inflation down from 840 percent in 1993; to 215 percent in 1994; to 131 percent in 1995; to 22 percent in 1996; and to 11 percent in 1997. With the economic meltdown of August 17, 1998, inflation rebounded that year to an annual total of 84.4 percent. Although an inflation
rate of 30 percent was projected for 1999 in the federal budget, the outturn for the year was 36.5 percent.

The Economics Ministry has projected annual inflation rates of 18 percent in 2000, 10-12 percent in 2001, and 8-10 percent in 2002. Inflation in January 2000 rose to 2.3 percent, while the Economics Ministry sees inflation at 5.5-6 percent during the first quarter.

**The Federal Budget for the Year 2000**

The federal budget for the year 2000 envisages revenues of 797.2 billion rubles ($24.9 billion, or 14.9 percent of GDP), expenditures at 855.1 billion rubles ($26.7 billion, or 16 percent of GDP), with a primary surplus of 3.2 percent of GDP and an overall deficit of 1.1 percent of a GDP of 5,350 billion rubles ($167.2 billion). It includes a substantial nominal increase in defense expenditure to 147 billion rubles ($4.6 billion), although additional resources may be channeled to the military under other headings.

The planned revenues of 14.9 percent of GDP were initially criticized as over-optimistic, but are now looking more realistic in light of improved tax collection due to higher profits and greater compliance. Moreover, revenues are planned on the basis of an annual average world price of $17 a barrel, which currently looks excessively conservative. Projected expenditures are apparently predicated on severe cutbacks in the size and cost of the enormous state bureaucracy.

**Earnings, Incomes, Pensions, Poverty**

The average nominal monthly wage earned in January was 1,826 rubles ($64) a month at the official rate of exchange. The average monthly pension for the 29 million old-age pensioners effective February 1 is 650 rubles a month. The minimum wage was raised to the equivalent of 83.49 rubles a month effective January 1, 1997. The figure is critical because many salaries and transfer payments are set in terms of multiples of the minimum wage. The minimum pension effective February 1 is 410 rubles a month. Supplementary benefits for pensioners range between 85 and 150 rubles a month. Earnings were down by 13 percent in 1995, recovered by 5 percent in 1996, grew by 2.5 percent in 1997 but dropped by 13.8 percent in 1998. After deduction of compulsory payments and adjusted for inflation, real disposable income in October 1998 was reported by Goskomstat to be 51.7 percent of the 1991 level. Real wages in 1999 were reported to be 15.1 percent lower than in 1998. It should be noted that money wages and salaries account for a diminishing share of total income, down from 60.5 percent in 1993 to about 48 percent now.

Disparities in income grew until 1996. Incomes of the top 10 percent of earners in April 1997 were reported to be 12.4 times higher than those of the
lowest 10 percent, compared with a ratio of 13.5 in early 1996; 11:1 in 1993; 8:1 in 1992; and 4.5:1 in 1991.\textsuperscript{19} In December 1999, 35 percent of the population, received incomes below the then subsistence level of 980 rubles ($35) a month.\textsuperscript{20} The personal saving rate is reported to be 8.9 percent.\textsuperscript{21} Ruble household deposits and foreign currency deposits in October 1999 amounted to 196 billion rubles and 258 billion rubles respectively,\textsuperscript{22} in addition to an estimated $30-50 billion in U.S. dollars, mostly under mattresses. About 85 percent of the population has no savings.\textsuperscript{23}

**Unemployment and Bankruptcy**

The number of citizens officially registered as unemployed on December 1, 1999, had fallen to 1.3 million or some 1.7 percent of the population of working age.\textsuperscript{24} For a variety of reasons, the registered numbers are misleadingly low, and the February 1, 2000 estimate of unemployment using the International Labor Organization’s definition\textsuperscript{25} was 9.1 million, or 12.6 percent of the able-bodied population of 72.2 million.\textsuperscript{26} When a more comprehensive measure - which included those on part-time employment, on unpaid leave, and who experienced “suppressed unemployment” - was used, the ILO earlier estimated that Russia’s jobless rate stood at 17 million or 22 percent of the work force.\textsuperscript{27} Enterprises keep surplus workers on their books to avoid additional taxes and redundant payments, and because labor is a relatively cheap input.\textsuperscript{28} The rate is still relatively low; GDP and industrial output have fallen by about 42 percent since 1989, but the work force has declined by only about 15 percent during that period.\textsuperscript{29} The average monthly unemployment benefit is set roughly at the minimum wage level (i.e., 83 rubles).

Unemployment could rise if the bankruptcy measures introduced in 1998 are implemented forcefully. The first was the bankruptcy law that came into effect in March 1998: this allows an arbitration court to declare an enterprise insolvent if it is unable to pay creditors’ bills within 90 days, pay wages, or service outstanding debt.\textsuperscript{30} The second was a May 22, 1998 decree, “On Measures for the More Effective Institution of Bankruptcy Proceedings and Statute on Accelerated Bankruptcy Proceedings.” All creditors - including federal and local governments, UES, Gazprom, the railroads, and supplier enterprises - will be represented in arbitration court by a single creditor representative. The debtor enterprise will be offered two options as alternatives to bankruptcy: either an assessment by the Federal Service for Insolvencies and Financial Recovery (FSDN) that the plant’s solvency can be restored within one year, or the introduction of external management. Failing these, bankruptcy proceedings will be immediately instituted.\textsuperscript{31} Before he was removed from the post of chief tax collector, Boris Fedorov announced bankruptcy proceedings against 28 major tax deadbeats.\textsuperscript{32} The joint Russian Government/Russian Central Bank memorandum of July 13, 1999
commits the government to initiate a bill to make managers responsible where applicable for pushing bankruptcy proceedings.

In 1998, more than 55 percent of all large- and medium-sized companies were unprofitable. An authoritative study of Russian privatization, citing Russian national surveys of corporations in 1995 and 1996, concluded that three-quarters of corporations were in need of radical and far-reaching restructuring, and at least one-quarter of these firms should be declared bankrupt. By September 1996, however, less than 1,000 enterprises had been declared bankrupt. Many cases were bogged down in the courts, exhausting the resources of the federal bankruptcy agency. Threats of bankruptcy have been used increasingly to pressure enterprises into paying their tax arrears; in late January 2000, the tax authorities threatened bankruptcy procedures against 23,328 enterprises which were behind with their tax payments. Wholesale closure or restructuring has been hampered by the need to have a court order before management can be replaced, and it can take up to 18 months to push bankruptcy proceedings through the arbitration court.

More important, bankruptcy proceedings have been delayed because of the political risk of closing hundreds, perhaps thousands, of enterprises - without an adequate social safety net in place - in what are often one-factory towns. In October 1999, there were 940 single-factory towns, with some 24 million inhabitants. In most of these, the single factory provides not only employment, but also supplies housing, schools, clinics, stores, canteens, market gardens, and even free or heavily subsidized vacation resorts. Nearly all of these value-subtracting enterprises are located in the regions, and local authorities are understandably reluctant to press bankruptcy proceedings. For instance, Sverdlovsk governor Eduard Rossel vowed to prevent the bankruptcy or privatization of the Uralvagonzavod plant employing 25,000 workers. Chelyabinsk governor Petr Sumin announced on April 16, 1999, that he would grant 200 of the oblast’s leading firms political protection from bankruptcy. When insolvent state-owned enterprises are sold, the government channels 60 percent of the proceeds to fund the social infrastructure, which has until now been largely the responsibility of the factories themselves.

Strike action is down from 6,001,000 man-days lost in 1997 to 2,882,000 man-days lost in 1998, and its level thus far has been relatively low by the standards of many OECD nations.

**Foreign Direct Investment and Portfolio Investment**

In 1995, worldwide foreign direct investment (FDI) is estimated to have totalled $315 billion. Some $36 billion of this went to China. Russia attracted just $1.9 billion, roughly one-half of 1 percent of the world total. (Since China’s population is roughly nine times that of Russia, the per capita discrepancy is not so marked.) The total for 1996 rose slightly to $2.1 billion (although this
Figure may exclude contract work.)

Figures for 1997 show a reported $3.9 billion in net investment out of a global total estimated at $464 billion. A net total of $1.8 billion was recorded for 1998 out of a world total of $644 billion, and the figure for 1999 is estimated at below $2 billion, out of a global total of $827 billion. The cumulative net figure by October 1999 was put by Prime Minister Putin at $11.7 billion. Some of the principal reasons for this meager share of global FDI include political instability, the unpredictability and lack of coordination of government policies, the exclusion of foreign interests from some privatization auctions, the lack of bilateral investment treaties, the absence of contract law, capricious and exorbitant taxes, the lack of commercial infrastructure, the limits on foreign banks, constant changes in legislation affecting foreign investors, poor protection of property rights, the inability of foreigners to own land, pervasive corruption, the predations of organized crime, and appalling environmental disruption.

There have been prominent figures in the administration and the legislature who argue that Russia does not require foreign capital and can finance all needed investment out of its own resources. This is an internal debate that has yet to be resolved. Much will depend on personalities, such as Sergei Glaziev, the chairman of the Duma’s Economic Committee. There can be little doubt that Russian industry needs massive reequipment: the average service life of the active portion of fixed capital is about three times longer than in OECD countries. Former prime minister Chernomyrdin estimated that Russia could use and absorb up to $50 billion of foreign investment each year. The former economics minister Yevgeni Yasin reckoned that, in the next 15 years, Russia would require some $2.8 trillion in investment, of which one-third could come from abroad. The pent-up demand for consumer services is exemplified by the telephone system. It has been calculated that it will cost at least $40 billion and take many years for Russia to increase telephone penetration to 20 lines per 100 inhabitants (against 61 lines in the United States).

Meanwhile, Russia has stayed near the bottom of the investment league. Russia led the list as the riskiest business location for U.S. and UK companies during the first half of 1999, according to a survey by Merchant International Group. It retained this dubious honor for the third quarter of 1999. Horror stories abound. Documents allegedly leaked from the Federal Counterespionage Agency, published in January 1995, accused some leading Western investors of attempting to “guarantee the technological backwardness of Russia.” Pages have been torn from shareholder registers. Western partners have been squeezed out of successful joint ventures. Komineft instituted what amounted to a 3-for-2 stock split without informing existing shareholders and diluted most holdings. Many enterprises, it is said, now keep three sets of books: one for themselves, one for the authorities, and one for foreign investors. The Moscow office of Johnson & Johnson was seized for alleged failure to pay some $20 million in back taxes, and warrants were issued for two of its expatriate executives.
The invalidation, in August 1997, of Exxon’s tender offer for the development of oil deposits in the Nenets region marked the first time that the Russian government had changed its mind over a highly contested and controversial foreign investment decision. In the opinion of a member of the then-extant Gore-Chernomyrdin Commission: “It raises the question of whether a deal is a deal in Russia, because Exxon is meticulous to a fault in following the letter of the law.” Another major blow to Western investor confidence came with the apparent breakdown of talks over Amoco’s $28 billion, 58-year project to develop the Priobskoye oil field in Siberia in collaboration with Yukos. In the dispute between Aeroflot and IMP over the joint venture Aerostar Hotel in Moscow, IMP won a $5.8 million judgement by the Arbitration Institute of the Stockholm Chamber of Commerce. The ruling was upheld by the Russian Supreme Court, but Aeroflot still refused to pay. More recently, threats to defraud Conoco and other foreign companies out of their stakes in regional mining projects provoked a protest by the U.S. embassy to the governor of Archangel. On March 17, 1999, the Duma passed on first reading a bill to limit foreign voting stakes in 1,150 “strategic” companies to 25 percent of capital (i.e., one share less than a blocking stake).

Receptivity toward foreign direct investment varies greatly between regions. Three-quarters of FDI is concentrated in 10 out of the 89 areas, namely in the Moscow region; St. Petersburg and the Leningrad region; the Tyumen, Archangel, and Maritime regions; and the republics of Tatarstan, Komi, and Mari El. The mayor of Moscow and the president of Tatarstan have welcomed, and have succeeded in attracting, foreign capital (Moscow has attracted 57 percent of all investment in Russia), while others are famous for their suspicion of the motivation and aims of Western business interests. Since May 1998, 31 of the 89 regions have defaulted on agrobonds-secured loans made by the federal government to regional agricultural firms. The State Duma has shown itself to be generally hostile to Western investment in what it considers to be strategic sectors of the Russian economy. On July 15, 1998, when it gave a third reading to a federal draft law - “On Foreign Investment in Russia” - it passed an amendment to the grandfather clause in earlier legislation that appeared to have the effect of watering down investor protection, but this was subsequently vetoed by President Yeltsin. Dmitri Vasiliev, then chairman of the Federal Securities Market Commission, promised a 1998-1999 government program for the protection of investors’ rights. On February 12, 1999, the Duma passed in first reading a new version of a law to protect investors in the securities market. In another field, legislation was passed in June 1999 that could “literally confiscate assets that U.S. and European insurance firms had already invested in the Russian economy.”

In what may have been the single most serious setback for hopes of corporate governance in Russia to date, Dmitri Vasiliev resigned from the post of chairman of the Federal Securities Commission on October 15, 1999. He was reported
to have been frustrated over the obstruction posed by other government agencies to his efforts to instill or improve corporate governance and especially to his efforts to protect the rights of minority shareholders. Vasiliev had been defeated in his attempts to rein in Yukos, which has been widely accused of abusing minority shareholders. Perhaps the final blow was a decision by a St. Petersburg court to renationalize the Lomonosov porcelain factory: this decision annulled the 51 percent stake held by Kohlberg, Kravis, Roberts, & Co, and the US-Russia Investment Fund.69

The first two months of the year 2000 have seen the settlement of some grievances and the reversal of some troubling actions against external partners and share-holders. Thus BP Amoco and Dart appear to have resolved their disputes with Yukos, foreign investors regained control of the Lomonosov porcelain plant, and British Alcem reinstated its management of the Vyborg paper mill. It may be coincidence or perhaps the Putin administration applied pressure to improve the investment climate?

**Production-Sharing Agreement**

After many months of negotiation between the Duma and the Federation Council, with much of the foot-dragging attributed to Vladimir Shumeiko, then chairman of the Federation Council,70 a compromise version of the production-sharing agreement (Soglashenie o razdele produktsii) was passed by the Duma on December 6, 1995. A production-sharing agreement (PSA) is considered to be vital for attracting large scale and long-term foreign investment in the extractive industries: it establishes the share of revenue or output that is claimed by the host government and the tax regime. The heavily amended law was, however, immediately denounced by Aleksei Melnikov, a Yabloko faction member of the Duma, who had been one of the authors of the original draft; Chubais condemned the compromise version as “unworkable”71 and as an “absurdity.”72 It was even suggested that Sergei Glaziev—then number three on KRO’s platform and now chairman of the Duma’s Economic Committee—switched texts at the last minute.73 The Federation Council passed the compromise version on December 19, and President Yeltsin signed it into law on December 30,74 presumably in keeping with the principle that “no law is worse than a bad law.” An expert appraisal concluded:

The current law is clearly less comfortable to foreign investors than had been hoped for by many. The lack of stable investment conditions, including clear procedures for cost and accounting calculations, difficulties with satisfying formalities for concluding production-sharing agreements, provision of customs and export exemptions, coordination with the existing tax regime, and the failure to coordinate or amend the existing law on subsoil will clearly hamper progress in attracting much needed foreign capital.75
The law further required that the Duma approve every oil deal in strategic areas, and it also gave to the Russian side a unilateral renegotiation clause to walk away from contracts should world oil prices change. The former minister of fuel and energy, Petr Rodionov, told Western investors and corporations in October 1996 that mandatory orders for competitive Russian-made equipment would be written into all contracts with foreign investors. In October 1996, the Duma’s audit chamber called for the government to withdraw the list of oil deposits subject to production sharing until it could provide a comprehensive justification for each site.

As late as July 1999, only three production-sharing agreements were actually in force - the grandfathered Sakhalin-1 and Sakhalin-2 projects, and the Kharyaga project signed with Total in 1995. The Piltun-Astokhskoye field in Sakhalin-2 began commercial output of crude in mid-July. On July 22, 1997, the president signed a law authorizing five oil and gas fields, a gold mine, and an iron ore deposit for development under PSA. Only two of the sites - the gold mine and an oil deposit in the Barents Sea - were open to foreign investors: they could attract about $1 billion in FDI. A second batch of nine sites was making its slow way through the Duma. Much enabling legislation remains to be passed. On November 26, 1997, it was announced that three further commissions had been set up to prepare several projects near Sakhalin, on the Barents Sea shelf, in Khanty Mansi, and in Tatarstan. But on July 15, 1998, the Duma adopted a bill amending the PSA law. This amendment stipulated that no more than 20 percent of the country’s proven natural resources and 10 percent of “strategic natural resources” could be given away to foreign investors under production-sharing agreements. A special federal law would be required to approve PSAs concerning the most important natural resources - hardly encouraging for potential investors. An AMOCO executive complained that the amendment could stop his company’s bid to develop the multibillion-dollar Priobskoye field, since the agreements already in place were close to the 20 percent mark. Furthermore, new legislation on the protection of foreign investment, passed in July 1998, fixed a new five-year limit on tax relief, royalty provisions, and other terms that could seriously reduce the viability of the PSAs.

After nearly three years when little progress was recorded in amending the PSA legislation, exhortation to move forward on PSA was included in Primakov’s economic stabilization plan published on November 15, 1998. The former prime minister repeatedly urged the Duma to “support him in passing laws that are necessary for the country’s normal development. First of all, these are amendments to the laws on production-sharing agreements and on foreign investments, and on the adoption of a law on concessions.” On December 3, 1998, a committee of the Duma and the Federation Council approved the groups of fields that can be developed under PSAs without having each site also approved by parliament: these include oil fields with up to 25 million tons of reserves, gas fields with up to 250 billion cubic meters of gas, and fields with up to 50 tons of gold.
(On April 13, 1999, the Duma PSA committee agreed to authorize PSA status for the Priobskoye project, even though it is said to hold 700 million tons in recoverable reserves.\textsuperscript{84}) The new legislation requires PSA participants to purchase 70 percent of their equipment and hire 80 percent of their work force in Russia. The Duma passed the PSA amendments on December 9 and the Federation Council approved them on January 27, 1999. In mid-February, the Duma approved at first reading a list of nine more fields that may be developed under PSA. The fields contain about 10 percent of known oil reserves in Russia.\textsuperscript{85} On April 21, the Duma passed further PSA legislation to cover foreign participation in the development of 37 oil and gas fields, while on April 24, the Federation Council approved unanimously a law on developing the Kirinsky block of the Sakhalin-3 PSA. In early June, President Yeltsin signed into law PSA legislation covering eight more fields, but on June 11 the Duma postponed indefinitely debating bills applying the PSA to the Priobskoye and Northern Territories blocks.\textsuperscript{86} The delay in getting Duma approval of the site has caused Atlantic Richfield Company (ARCO) to withdraw from its Sakhalin-4 gas project.\textsuperscript{87} What are also needed are laws that would integrate PSAs into the existing tax regime.

**Foreign Trade**

Foreign trade recovered quickly after the abrupt severing of ties with the other former Soviet republics and with Comecon, growing for several years in double-digit percentage figures while GDP declined. Merchandise trade surpluses (excluding shuttle trade) of $20 billion, $28 billion, $19.8 billion, $14.4 billion, and $32.6 billion respectively were recorded in 1995, 1996, 1997, 1998, and 1999.

Capital flight continues, although estimates of its scale vary greatly. The IMF was quoted as giving tentative totals of $13 billion for 1992 and $8 billion for 1993.\textsuperscript{88} The head of the Central Bank’s Currency Regulation Directorate gave a cumulative figure of $60-80 billion since 1991.\textsuperscript{89} The Ministry of Internal Affairs estimated the cumulative total of capital flight by the end of April 1996 to be $40 billion.\textsuperscript{90} Yevgeni Primakov, then head of the Foreign Intelligence Service, put the annual level of capital flight at $15-20 billion.\textsuperscript{91} During a conference on money laundering, held in Prague in February 1997, it was suggested that about $60 billion in capital had fled Russia during the preceding five years.\textsuperscript{92} Then Interior Minister Sergei Stepashin put the outflow during the past seven years at nearly $76 billion.\textsuperscript{93} A joint Canadian-Russian study published in 1998 estimated the accumulated capital flight since 1990 at around $120 billion,\textsuperscript{94} a figure considerably higher than the total of loans, credits, and other assistance from the IMF, World Bank, other institutions, and Western governments. The reasons for the massive scale of capital flight include political instability, the loss of confidence in the ruble as a store of value after the high inflation
of 1992, the desire to avoid excessive and arbitrary taxes, and the continuing poor protection of property rights.

Russia’s current account registered surpluses of $12 billion, $3.5 billion, and $2.5 billion in 1996, 1997, and 1998 respectively, and $14.6 billion for the first nine months of 1999. The IMF projects a surplus of $9.5 billion in 2000. On February 18, the reserves of the Central Bank amounted to $13.3 billion, including about $4 billion in gold.

### The Merchandise Trade of Russia, 1992-1999
($ billion in current prices, excluding shuttle trade)

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Oil and petroleum products are Russia’s principal export commodities, and the price and disposition of its exports of crude oil and petroleum products are politically and economically sensitive. Although output fell steadily - from 340 million tons in 1993, to 302 million tons in 1994, and to 296 million tons in 1995 - exports rose from 81 million tons in 1993, to 115.8 million tons of in 1996, and to 127 million tons in 1997. The Near Abroad received an estimated 25.5 million tons of oil in 1995 for an average price of $73.90 a ton, compared with $107.50 a ton for Russian crude supplied to the Far Abroad. Of the 127 million tons exported in 1997, only 17.1 million tons went to the CIS and the rest to the Far Abroad. Earnings from oil sales in 1997 accounted for $14.8 billion, or 17 percent of total export revenues. In addition, 61 million tons of products earned a further $7.2 billion. It has been calculated that a change of $1 in the price of a barrel of crude oil changes export revenues by $1.2 billion. The 1998 budget was reportedly predicated on an average annual world price of $15.50 a barrel, and revenues were seriously affected by the drop in world oil prices. The recovery in world oil prices in 1999 meant that Russia earned much more from a smaller volume of oil. Whereas Russia exported 126.9 million tons of crude for $9.5 billion in 1998, it exported 123.9 million tons in 1999 but earned $13.3 billion. Of the 1999 total, 8.8 million tons went to
CIS countries for $585 million, and 115.1 million tons were sold to the Far Abroad for $12.7 billion.\(^98\)

Arms sales have accounted for a substantial share of Russia’s exports: their value in 1995, 1996, 1997, and 1998 is estimated at about $3.0 billion, $3.4 billion, $2.6 billion,\(^99\) and $2 billion\(^100\) respectively. Revenues from the export of nuclear materials and technology have also been high, earning $2.05 billion, $2.2 billion, and $2.5 billion in 1995, 1996, and 1997 respectively.

**WTO Membership**

Russia first applied to join the GATT (the WTO’s predecessor) in June 1993, and a Working Party was set up by the GATT General Council to consider the accession application.

The first hurdle was the preparation and circulation of a Memorandum on the Foreign Trade Regime. This explains the applicant’s policies and institutions regarding trade in goods and services, and encompasses the financial, insurance, and telecommunications sectors. The issues to be covered include various aspects of macroeconomic policy, especially related to foreign exchange management and controls, investment and competition policy, protection of intellectual and other property rights, as well as enterprise privatization. The memorandum for Russia was circulated to members of the GATT in March 1994.

The second stage consisted of initial questions and requests for clarification posed by members based on the memorandum and the circulation of the answers filed by the applicant. In the case of Russia, this took more than a year (June 1995). The follow-up questions and clarifications are in process.

Some common themes emerge when a transition economy, and especially a former Soviet republic, applies for accession. The first is the concern that the laws and regulations of the acceding country are in conformity with WTO provisions. These include the Law on Customs, the tariff schedule, regulations on imports and exports, laws on joint stock companies, the central bank and credit institutions, licensing of economic activity, and domestic taxation. Second is the degree of privatization and the transparency of the government rules and criteria. The third set of issues relates to the jurisdiction and capacity of national agencies to implement policies on which commitments are made. Other issues of concern in regard to former Soviet republics are the arrangements for the value-added tax (VAT), and the free trade arrangements and customs union agreements signed by several of the CIS countries.\(^101\)

In February 1998, the Russian government submitted to the WTO a list of nearly 10,000 imported goods on which it was prepared to cut import duties. It also sent a list of 500 items to be excluded, including oil, gas, and ferrous and nonferrous metals. In May 1998, Russia submitted a detailed market access offer. This proposed the maximum duty levels that the Russian government would accept if its application to join the WTO were approved. They were
generally viewed as excessively high. Prospects for early WTO membership have been further clouded by an increasingly vociferous “buy-Russian” campaign, articulated by, inter alia, President Yeltsin, and the widespread resistance to foreign direct investment. In July 1998, a presidential decree hiked import tariffs from a prior average of 14 percent, by 3 percent across the board effective August 15. The eighth session of the working party looking at Russia’s accession ended in Geneva on July 30. Satisfaction was noted with progress on some fronts, although there was concern voiced about the pending 3 percent increase in tariffs. A new policy linking import duties to the purchase or lease of domestic goods has been condemned as a possible deviation from the WTO accord on trade-related investment measures or TRIMS.

An early draft of the Primakov administration’s stabilization plan called for increases of up to 100 percent on duties on “imports damaging local producers.” The final version of the plan, published on November 15, softened this considerably, albeit ambiguously, stipulating: “Russia’s accession to the WTO should promote the creation of an environment conducive to expanded access to foreign markets for Russian goods and services and promote protection for Russian products while maintaining the competitive environment essential for state supply for agriculture and protection of the market for agricultural and food products.”

The second draft federal budget for 2000 provides for levying value-added taxes on CIS countries’ goods according to the country of origin, rather than the country of destination. This contravenes the WTO’s country-of-destination rule, and amounts to double taxation of goods from CIS countries in view of the fact that most of these follow the WTO rule. Russian spokesmen, as well as the Russian media, have been very critical of Kyrgyzstan and Georgia, the first two CIS countries to accede to the WTO, as well as of Moldova and Armenia, which are close to joining.

Exchange Rate

Since the devaluation of August 17, 1998, the exchange rate has fluctuated between 6.30 and 30.15 rubles to the dollar. After remaining relatively steady around 23 rubles to the dollar throughout February and the first half of March, the rate fell steadily to 26.84 rubles to the dollar by December 7, but has remained fairly stable at around 28.6 rubles to the dollar for the first two months of 2000. Effective January 1999, exporters have been obliged to sell 75 percent of their export revenues on the market. On at least two occasions, former first deputy prime minister Yuri Maslyukov suggested some kind of currency board for the ruble, tying the currency to a basket of currencies including the Euro, a concept rigorously rejected by his colleague, Viktor Gerashchenko. The budget for 2000 is based on an average annual exchange rate of 32 rubles to the dollar.
External Debts and Credits

By January 1, 1999, Russia’s sovereign debt amounted to $143.9 billion, according to former finance minister Mikhail Zadornov. To this should be added an estimated $14.9 billion in dollar-denominated domestic debt. About $103 billion of the debt was inherited from the former Soviet Union. Owing to the structure of these assumed Soviet obligations, more than half of this debt was originally due for repayment in 1993-1996. The ratio of Russia’s external debt to exports is nearly 200 percent and its ratio of debt to GDP is about 100 percent, with both ratios comfortable in comparison to those being shouldered by many emerging economies. The July 13 joint Russian Government/Russian Central Bank statement put Russia’s total external debt at that date at around $150 billion, and projected the debt to rise to $166.2 billion by January 1, 2000.

After a series of rollover agreements, Russia finalized the rescheduling of its commercial debt to the value then of $32.5 billion with the London Club: after a 7-year grace period, repayment was to be spread over 25 years. A similar agreement on rescheduling sovereign debt of $40 billion owed to the Paris Club was finalized in October 1997: the agreement provided for a grace period through the year 2002, during which Russia was to pay only interest, and then repayment of the principal over 19 years. After the crash of August 17, 1998, the repayment schedule went back to the drawing board. In August 1999, the Russian government and the Paris Club rescheduled about $8.1 billion in Soviet-era debts that were due in 1999 and 2000. Russia agreed to pay $600 million in 1999 and 2000, and deferred overall restructuring of the $38 billion owed to the 18 lender governments of the Paris Club until after the presidential elections set for 2000. On February 11, the London Club agreed to write off 36.5 percent of Russia’s $32-billion Soviet-era debt. The balance will be restructured into 30-year eurobonds, with a seven-year grace period. It appears that the Paris Club will be less generous as Germany, which is owed half of the outstanding debt, has publicly rejected such a write-off.

The Russian government has been differentiating between the Soviet-era “odious” debt and the Russian debt incurred since January 1992, claiming that it is still servicing its own Russian debt, while not able to meet its Soviet-era commitments. In November 1998, a deputy finance minister admitted that Russia had formally sought to reschedule its Soviet-era debts for the second time. He conceded that Russia could not pay more than $10 billion out of the estimated $17.5 billion that fell due in 1999. By mid-February 1999, according to the Ministry of Finance, Russia had missed $1.5 billion in foreign debt service since August 17. Economics Minister Andrei Shapovalyants raised the possibility of writing off sovereign debt, citing the cases of Poland and Bulgaria. A deputy finance minister spoke of the “Polish model,” whereby half of the old debt is written off and the other half rescheduled. At a press
conference in March 1999, then first deputy prime minister Yuri Maslyukov said that the government was seeking to have 75 percent of the Soviet-era debt written off by the London and Paris Clubs. This faced vigorous opposition from Germany, however, which holds about one-half of Russia’s sovereign debt. On May 20, former Finance Minister Zadornov stated that Russia was hoping for a rescheduling of $16 billion out of the total of $17.5 billion due in debt service in 1999. On May 24, Russia asked its London Club creditors to roll over its June 2 Soviet-era debt service by six months: about $22 billion in principal notes (PRINS) and $6 billion in interest arrears notes (IANS) were outstanding. In the year 2000, some $10 billion in Russian Federation debt and about $6 billion in Soviet-era debt would have come due in the absence of restructuring. During the next 12 years, Russia must find between $14 billion and $19 billion annually to service its foreign debt.

The London talks on resolving the frozen domestic (GKO) debt seem to have petered out, with most foreign investors accepting the Russian government’s terms that yield less than 5 percent of the face value of the bonds. Whereas in December 1998, the Russian government offered $550-800 million at 11 monthly auctions, on March 22, 1999, this offer was reduced to $200 million at four monthly auctions.

At the beginning of 1998, Russia’s indebtedness was offset-on paper at least-by the estimated $120.2 billion owed (half of it for military hardware) to the former Soviet Union, and hence to Russia, by former client states such as Cuba, Mongolia, Vietnam, Iraq, Afghanistan, Angola, North Korea, Mozambique, and Ethiopia, and by other states like India, Algeria, Libya, Syria, Yemen, and 43 other nations. This figure and earlier estimates of up to $149 billion appear to derive from an original aggregate of 96.4 billion transfer rubles converted at $1=0.63 rubles, and thus are subject to some dispute. Most of these debtor nations are, in any case, either insolvent or unwilling to repay. Now that Moscow has joined the Paris Club as a creditor nation, those countries still owing money to Russia should not, in principle, be able to borrow new money from other members of the club. This excludes some of Russia’s biggest debtors, like Cuba, Vietnam, Libya, and Iraq. The original draft budget for 1998 counted on the receipt of $1.25 billion that year from debtor countries. It appeared that Moscow would be obliged to accept the so-called Naples conditions, whereby two-thirds of the debt is written off and payment of the balance is extended over 23 years, with a six year grace period. Assets abroad of the former USSR, now accruing to Russia, are valued variously from between $2 billion and $600 billion, although these too may be hard to realize. In November 1999, the State Property Ministry declared that it owned 2,773,000 square meters of property abroad, with a total value of $3.2 billion. A further $6.8 billion - stemming mainly from technical credits issued in 1992-1993 - was owed to Russia by other former Soviet republics, plus over $4.4 billion for fuel and energy deliveries.
Tax Code

Taxes have proliferated during the past eight years and present a major disincentive to full payment of taxes and to domestic and foreign investment. One authoritative U.S. study reckoned that whereas in 1991, joint oil ventures were paying four primarily profit-based taxes, by 1996 they were paying 23 taxes that were mostly based on gross revenues.\textsuperscript{125} The former minister of fuel and power engineering, Petr Rodionov, went further in September 1996 to assert that “oil companies currently pay 42 different taxes, which account for 58.5 percent of the price.”\textsuperscript{126} Although he was presumably including local taxes, it does not reduce the total burden. The government submitted a new version of the tax code - said to be the seventh variant - to the Duma in February 1998. It reduced the number of taxes from 50 (perhaps as many as 150 if local taxes are included) down to 28, cut the corporate tax from 35 to 30 percent, liberalized and simplified depreciation rules, canceled the sales tax, kept the VAT at 20 percent, switched more of the tax burden from enterprises to individuals, and eliminated most tax privileges.\textsuperscript{127}

On December 18, 1998, the Duma passed at first reading a set of 19 proposed changes to the tax system. The principal amendments included a reduction in VAT from 20 to 15 percent; a reduction in the profits tax from 35 to 30 percent; an adjustment of personal income tax to reflect inflation; raises in some excise duties, including those for alcohol and gasoline; and the introduction of an imputed tax.\textsuperscript{128} At the urging of the IMF, the reduction of the VAT will be postponed until the year 2000. In August 1999, Prime Minister Putin complained that Russia is the only developed country where 85 percent of taxes are collected from enterprises and only 15 percent from the population.

The Banking Sector

Until quite recently, many felt that it was a question not so much of if, but when, a major banking shakeout would occur. The Russian financial sector survey, commissioned by the European Union, predicted in early 1996 that 1,500-1,600 of the remaining 2,285 commercial banks then active in Russia, were likely to fold within a few years.\textsuperscript{129} Many or most of the existing banks had simply grown too fast and had never been completely capitalized. A high proportion of the banks’ assets were nonperforming - perhaps 60 percent compared with less than 18 percent in the United States. Having grown fat from cross-currency arbitrage and high-yield, short-term investments, many were suffering from savings and loan disease: they had long-term assets and short-term liabilities. Thus, Black Tuesday of August 1995 may have been just a warning signal. Sergei Dubinin, then chairman of the Central Bank, told a New York audience in October 1996 that 10-15 percent of Russian banks were in a very difficult position. During 1996, licenses of 289 banks were revoked, and by year-end,
some 300 medium- and small-sized banks of the total 2,008 banks were under review. In 1997, the central bank withdrew a further 330 licenses. The sector is still small in relation to the economy: it has been estimated that total banking assets in 1997 equaled only 19 percent of GDP. The placing of Tokobank, one of the top 20 banks, into administration in May 1998, when it was unable to make payments to its foreign creditors, was seen as the first casualty from a widespread practice of borrowing too heavily in the syndicated loan and Eurobond markets. The failure of the rescue attempt for Tokobank was followed by the takeover by Oneksimbank of Unikombank, the thirty-fourth largest bank in the country. By October 1, 1999, the number of banks had declined to 1,351. Effective January 1, 1998, new banks starting up were required to have charter capital of at least 4 million ECU. Some 43 percent of the banks operating in 1997 had charter capital of less than 1 million ECU. Earlier, this amount was going to be the minimum capital requirement for commercial banks effective January 1, 1999, and would have halved the number of banks. The Russian Central Bank is reported to have reduced the interest rate on its loans to commercial banks taking part in intrabank transactions, thereby injecting liquidity into the banking system. The Russian government and the central bank established the Agency for Restructuring of Credit Organizations (ARKO) which was registered in January 1999. The CBR owns 49 percent and the government 51 percent of ARKO’s patently inadequate share capital of 10 billion rubles. ARKO’s functions were meant to include helping with the bankruptcy of insolvent banks, injecting liquidity into salvageable banks, assisting banks in restructuring their debts, and attracting new investment. Little evidence of ARKO’s activity had appeared by October.

At the beginning of 1999, five out of the nation’s 10 largest banks (Inkombank, SBS-Agro, Oneksimbank, Rossiisky Kredit, and Menatep) were deemed to be effectively insolvent, but as late as October, it is not clear how many and which banks have been bailed out by the Central Bank. Earlier this year, the World Bank found that 15 out of 18 large Russian banks had “negative equity” and should be liquidated or restructured. On April 1, Viktor Gerashchenko announced that the CBR would decide “in the next few weeks” which of the troubled big banks would survive. He confirmed that 18 of the country’s most important banks, which control 80 percent of the banking system and hold 45 percent of private deposits, had been having problems. To restructure the entire commercial banking system could take three to five years and could cost anywhere between 100 billion rubles and $20 billion. In mid-May, the Central Bank announced that it would revoke the licenses of 12 major banks, including Menatep and Unikombank. This was widely viewed as not only tantamount to closing down the burnt-out shells of once important banks, but also as clamping down on a widespread tax evasion scheme. But by the end of June, the Central Bank had withdrawn the licenses of only four large banks - Oneksimbank, Mosbiznesbank,
Promstroibank, and Mezhkombank - and that only “under unprecedented pressure from the IMF and World Bank.”

Some leading figures - including Geraschenko, Volsky, and Zhukov - have publicly urged foreign banks to acquire shares in Russian banks, thereby increasing their share in the Russian banking system from the 12.6 percent registered on September 1. In April 1999, Gerashchenko announced that the Central Bank would ask the Duma to adopt a law raising the share of foreign capital in the Russian banking system from 12 to 25 percent. At the end of 1999, there were 1,349 banks still operating.

**IMF**

As of January 31, Russia owed the IMF $14.565 billion, making it the Fund’s biggest debtor, followed by Mexico at around $9 billion. A total $4.6 billion was due to be repaid in 1999 and 2000.

On April 28, 1999, the IMF agreed in principle to release a total of $4.5 billion in new loans over the next 18 months, with $3 billion being made available in 1999. The credit would reportedly be disbursed in six or seven quarterly tranches, with performance being monitored on a monthly basis. The money would, in essence, be rolled over by transferring the amount from one IMF account to another, thus eluding “sticky fingers” in Moscow. Reported conditions required by the Fund included: the passage of new banking legislation, with the possible restructuring or closing of up to 18 of the largest banks; the improvement of an existing law on bank insolvencies; the enactment of new revenue measures amounting to the equivalent of an estimated 3.5 percent of GDP, including the raising of the excise taxes on alcohol and gasoline and rescinding the reduction of the VAT from 20 to 15 percent; the relaxation of restrictions on foreign exchange; and the pressuring of natural monopolies to increase cash tax collection. The Fund’s blessing was expected to clear the way for some $2 billion from the World Bank, about $1 billion from the Japanese government, and for negotiations to continue with the Paris and London Clubs for re-rescheduling of Russia’s Soviet-era debts.

In March 2000, the IMF was still withholding disbursement of the second tranche. In addition to the conditions stipulated above, the Fund, the World Bank, and the G-7 have expressed concern over proposed increases in defense expenditure arising from the second Chechen war, with the concomitant charges that IMF moneys were being used for this purpose. There were renewed demands for the Russian Central Bank to clean up its act; with requests for quarterly audits of its reserves and for transparency over the activities of its subsidiaries; for the government to submit an anti-money-laundering bill to the Duma; for the release of a third audit on how Russia has used IMF funds in the past; for a schedule for switching the Central Bank and commercial banks to international accounting standards; for a wide-ranging audit into the operation of Sberbank;
for the passage of legislation on bankruptcy; and for the railways, Gazprom, UES, and Transneft to report their financial statements in accordance with International Accounting Standards (IAS). Disbursement of the second tranche is now expected not until after the presidential election on March 26.

**World Bank**

Since 1992, the World Bank has approved spending of $11 billion on 42 projects in Russia and disbursed some $6.5 billion of that sum. Over $4 billion has gone to budget-substituting loans for restructuring the Russian economy, and $2 billion has been allocated for various investment loans.\(^{143}\) In April 1999, World Bank president James Wolfensohn said that he would recommend $2.3 billion in new loans to Russia over the next two years and help arrange another credit from the Japanese government for $1 billion. As much as one-third of the new money could go to paying off interest on previous World Bank loans.\(^{144}\)

**The Duma Election of December 19, 1999**

The voter turnout on December 19 was 61.8 percent, far higher than equivalent counts in the US or in most West European countries. As of January 21, the CPRF was the largest faction in the new Duma with 90 seats, followed by Unity with 82, FAR with 45, the Union of Right-Wing Forces with 32; People’s Deputies 57; Russia’s Regions 41; Agro-Industrial Group 39; Yabloko 21; and the Zhirinovsky Bloc with 17. New elections must be called in March in nine districts.

After the controversial deal between the CPRF and the Unity bloc on January 18, an incomplete listing of the speaker, deputy speakers, and chairmanships of Duma committees follows\(^{145}\):

- **CPRF**
  - Speaker: Gennadi Seleznev
  - Economic Policy and Entrepreneurship: Sergei Glaziev
  - State-Building: Anatoli Lukyanov
  - Industry, Construction, and High Technology: Yuri Maslyukov
  - Labor, Social Policy, and Veterans’ Affairs: Valery Saikin
  - Federation Affairs and Regional Policies: Leonid Ivanchenko
  - Education and Science: Ivan Melnikov
  - Women, Family, and Youth Affairs: Svetlana Goryacheva
  - Non-Governmental and Religious Organizations Affairs: Viktor Zorkaltsev
  - Culture and Tourism: Nikolai Gubenko

- **Unity**
  - Property: Vladimir Pekhtin
  - Energy, Transportation, and Communications: Vladimir Katrenchko
Prospects for Economic Growth

The Russian GDP in 2000 is projected to rise to 5,350 billion rubles. At the forecast official annual average rate of exchange of 32 rubles to the dollar, this is equivalent to $158 billion, or less than 2 percent of the US GDP that amounted to $9.5 trillion in 1999. At purchasing power parity, according to the World Bank, Russia’s GDP will be equivalent to about $650 billion.

Now it is evident to any visitor to Moscow or any other Russian city that a great deal of economic activity goes unrecorded (and untaxed). The official Russian statistical authority, Goskomstat, is aware of this gray, black, or shadow economy, and factors in an additional 25 percent of the value of the formal economy to cover its activity. Other estimates go as high as 50 percent. Yet countering this understatement of the size of the economy is the fact that up to 70 percent of transactions within it are, it is reported, conducted in the form
of barter, the value of which is notoriously overstated. So we are looking at an economy in roughly the same ballpark as Spain.

The Russian manufacturing industry now constitutes a gigantic rust belt. The average age of plant and equipment is roughly three times higher than the OECD average. The only Russian manufactured products that are, generally speaking, competitive on the world market are military hardware, nuclear power plants, and space engineering. The domestic demand for these products is severely restricted by budgetary constraints, and the overseas market is limited. After decades of neglect, the infrastructure—roads, railways, pipelines, power lines, water supply, sewage—must also be renewed.

To update or replace this aged plant and equipment, and to renew the infrastructure, will require hundreds of billions of dollars. Yevgeni Yasin has estimated that Russia will need some $2.5 trillion in investment during the next 20-25 years, of which about one-quarter will have to come from abroad. But the domestic money supply M2 (currency in circulation, demand deposits, and time deposits) in November 1999 was reported to be only 646.6 billion rubles ($22.7 billion) while the estimated $30-50 billion in hard currency (now stored largely under mattresses) is unlikely to be entrusted to domestic banks until or unless Western banks are given guaranteed and secure access to the Russian retail banking system and provided with sufficient incentive to do so. Russia registered a current account surplus of about $20 billion in 1999, which was roughly equal to the amount of capital flight. Very little of the estimated $150 billion of flight capital since 1991 is expected to be returned to Russia in the short- or medium-term. The bulk of investment capital must therefore come from abroad in the form of foreign direct investment (FDI).

Russia is currently attracting less than one percent of the world’s FDI. In 1999, net FDI in Russia amounted to about $2 billion, out of a global total of $827 billion (China drew nearly $40 billion). The reasons are well known: they include political instability; virtual absence of corporate governance; capricious and exorbitant taxes; the lack of commercial infrastructure; poor protection of property rights; pervasive corruption; and the depredations of organized crime. This hostile environment will take many years to correct, and thus FDI in Russian manufacturing capacity is unlikely to grow substantially in the near future. (More attractive prospects prevail for the extractive sectors, after recent progress in advancing production-sharing agreements (PSAs) and enabling legislation).

With domestic and foreign capital wholly inadequate to finance the necessary reconstruction and re-equipment of the manufacturing sector, former first deputy prime minister Yuri Maslyukov promised, until he was fired in May 1999, that state funding would suffice. But the federal budget for the year 2000 provides for total revenues of only $24.9 billion and total expenditures of $26.7 billion. After the anticipated boosting of defense expenditure, all additional government funding for the foreseeable future will have increasingly to be devoted to
countering the acute deterioration of the nation’s health, to combating environmental disruption, and to restoring an educational system that was perhaps the most positive legacy of the Soviet era.

The scale of capital required for the massive re-equipping and replacement of Russia’s manufacturing industry and the infrastructure is not in sight. With its vast natural resources and its highly educated workforce, Russia’s economy may well experience the boom or chudo (miracle) predicted for it by some informed observers. But this will not happen anytime soon.

Notes

1 Interfax, February 23, 2000.
3 Rossiiskaya gazeta, March 2, 1999.
4 Krasnaya zvezda, August 3, 1996.
8 NTV, April 23, 1999.
9 The Economist, August 28, 1999.
15 Interfax, January 22, 1999.
19 Interfax, February 17, 1997; cf. Interfax, November 15, 1996; ITAR-TASS, October 15, 1996; Komsomolskaya pravda, July 17, 1996; Rossiiskaya gazeta, August 5, 1995. Ekonomika i zhizn, no. 1 (1995) put the multiple in 1994 at 21, but this is thought to have taken into account income that is concealed from taxation.
25 A person is deemed unemployed if he or she has no job in the preceding week and is available and looking for work.
27 Transition, April 1997, p. 27.
33 ITAR-TASS, March 1, 1999.
35 Financial Times, October 16, 1996.
95 Interfax, January 17, 1996.
100 Novoye vremya, June 1, 1999.
101 Drawn from Constantine Michalopoulos, “WTO Accession for Countries in Transition,” Post-
104 Reuters, October 27, 1998.
105 See Jamestown Foundation’s Fortnight in Review, October 8, 1999.
107 Interfax, June 10, 1999.
110 For instance, NTV, September 21, 1998.
113 Interfax, February 11, 1999.
120 Rossiiskaya gazeta, October 14, 1997.
121 Interfax, August 5, 1996.
126 Interfax, September 2, 1996.
19, 1997.
131 Reuters, October 25, 1999.
133 Moscow Times, October 8, 1998.
134 Moscow Times, April 29, 1999.
135 ITAR-TASS, April 15, 1999.
137 Reuters, April 14, 1999, citing an EBRD official.
139 Interfax-Vremya, June 27, 1999.
140 Interfax, April 15, 1999.
141 Interfax, February 17, 2000.
143 Interfax, November 6, 1998.