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Russian Federation: Recent Economic Developments

This Recent Economic Developments report on the Russian Federation was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with this member country. As such, the views expressed in this document are those of the staff team and do not necessarily reflect the views of the Government of the Russian Federation or the Executive Board of the IMF.

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INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Recent Economic Developments

Prepared by a staff team consisting of Gérard Bélanger (head), Poul M. Thomsen, Geoffrey Barnard, Alfred Kammer, Sanjaya Panth, James Roaf, Izabela Rutkowska, Jerald Schiff, Nikola Spatafora, Yan Sun (all EU2), Adnan Mazarei (PDR), and Calvin McDonald (FAD)

Approved by the European II Department

July 14, 1999

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Russian Federation: Basic Data

Social and demographic indicators 1/	
Area	17,075,200 sq. km
Population (in millions)	146.7
Urban (As a percent of total population)	73
Rate of population growth (Percent per annum)	-5.2
Life expectancy at birth (Years)	66.6
Infant mortality rate (Per 1,000 live births)	17.2
Literacy (Percent of population)	99.1

	1993	1994	1995	1996	1997	1998
Share of gross domestic product			(In percent of GDP)			
Agriculture	7.7	6.2	7.5	7.1	6.9	...
Industry	33.0	32.0	29.3	28.3	26.9	...
Services	...	...	...	...	...	...
GDP						
Nominal GDP (in billions of rubles)	171.5	610.7	1,540.5	2,146	2,522	2,685
Real GDP (percentage change)	-8.7	-12.6	-4.1	-3.6	0.9	-4.6
Consumer prices (percentage change, period average)	875	307	197	48	15	28
Enlarged government finances			(In trillions of rubles)			
Total Revenue	62.1	211.5	515.8	708.2	917.8	850.2
(in percent of GDP)	36.2	34.6	33.5	33.0	36.4	31.7
Total expenditure	74.7	275.2	610.3	898.5	1,116.7	1,065.5
(in percent of GDP)	43.6	45.1	39.6	41.9	44.3	39.7
Fiscal balance	-12.6	-63.6	-94.4	-190.4	-198.8	-215.2
(in percent of GDP)	-7.3	-10.4	-6.1	-8.9	-7.9	-8.0
Money and credit (end-period)						
Ruble broad money (in billions of rubles)	28.9	92.4	220.5	287.9	374	452
Ruble money velocity (level)	11.1	11.0	9.1	8.9	7.9	8.5
Balance of payments			(In billions of U.S. dollars)			
Total exports	44.3	67.8	82.7	90.6	89.0	74.8
Total imports	32.8	48.5	64.0	72.8	77.4	56.8
Current account balance	2.6	8.4	4.8	3.9	-3.0	2.3
Official reserves (in months of imports of goods and nonfactor services)	1.2	1.2	2.4	2.0	2.2	2.0
Exchange rate, rubles per U.S. dollar, end-period	1.25	3.55	4.64	5.56	5.96	20.65

Sources: Russian authorities; and Fund staff estimates.

1/ Data for 1997 or latest available.

I. Overview

1. **The period since the last Article IV consultation with the Russian Federation has witnessed perhaps the greatest contrast in the fortunes of the economy since Russia became an independent state in 1992.** This swing in economic performance and prospects was most emphatically marked by the financial and economic crisis that erupted with the events of August 17, 1998. Expectations reached a high-point in mid-1997, when aggregate output was at last growing, interest rates on treasury bills had fallen below 20 percent, the Central Bank of Russia (CBR) was accumulating about $1½ billion a month in reserves, the Moscow Stock Exchange was the best-performing equity market in the world, and inflation had virtually ceased. By September 1998, in contrast, the economy had descended to a point of collapsing output and trade volumes, disorderly disruption of relations with domestic and external creditors, paralysis of the banking system, decimated financial asset prices, and surging inflation.

2. **Beneath these sharp swings in key economic indicators, however, there were steadier processes at work which, when not reversed, made a crisis such as that of August 1998 virtually inevitable.** Most fundamentally, the erosion of federal government revenues, particularly cash payments, made a robust fiscal consolidation and durable macroeconomic stabilization impossible (Figure 1). The inability to collect adequate revenues in turn owed much to the lack of progress in structural reform—notably the failure to impose hard budget constraints throughout the economy—which was manifest most clearly in an inadequate restructuring of the economy and the steady growth of economy-wide nonpayments (see Annex II, "Nonmonetary Transactions and Arrears Accumulation"). The causation was not, however, unidirectional: the government's fiscal policy itself contributed to the lack of financial discipline. In particular, recourse to tax offsets—mutual cancellation of tax and budgetary arrears—both reduced incentives for tax compliance and contributed to nonpayments more generally.

3. **Despite the limited fiscal adjustment, the stabilization gains earned in 1993–95 were prolonged through mid-1998 by the maintenance of a fixed exchange rate regime supported by heavy external borrowing, much of it short term.**[1] However, the government's decision to allow foreign currency-denominated and short-term obligations to account for a growing proportion of total government debt (Figure 2) made budget financing increasingly vulnerable to shifts in market sentiment.

4. **While the authorities' inability to come to grips with the underlying fiscal problems made the financial stability that prevailed from 1996 through mid-1998**

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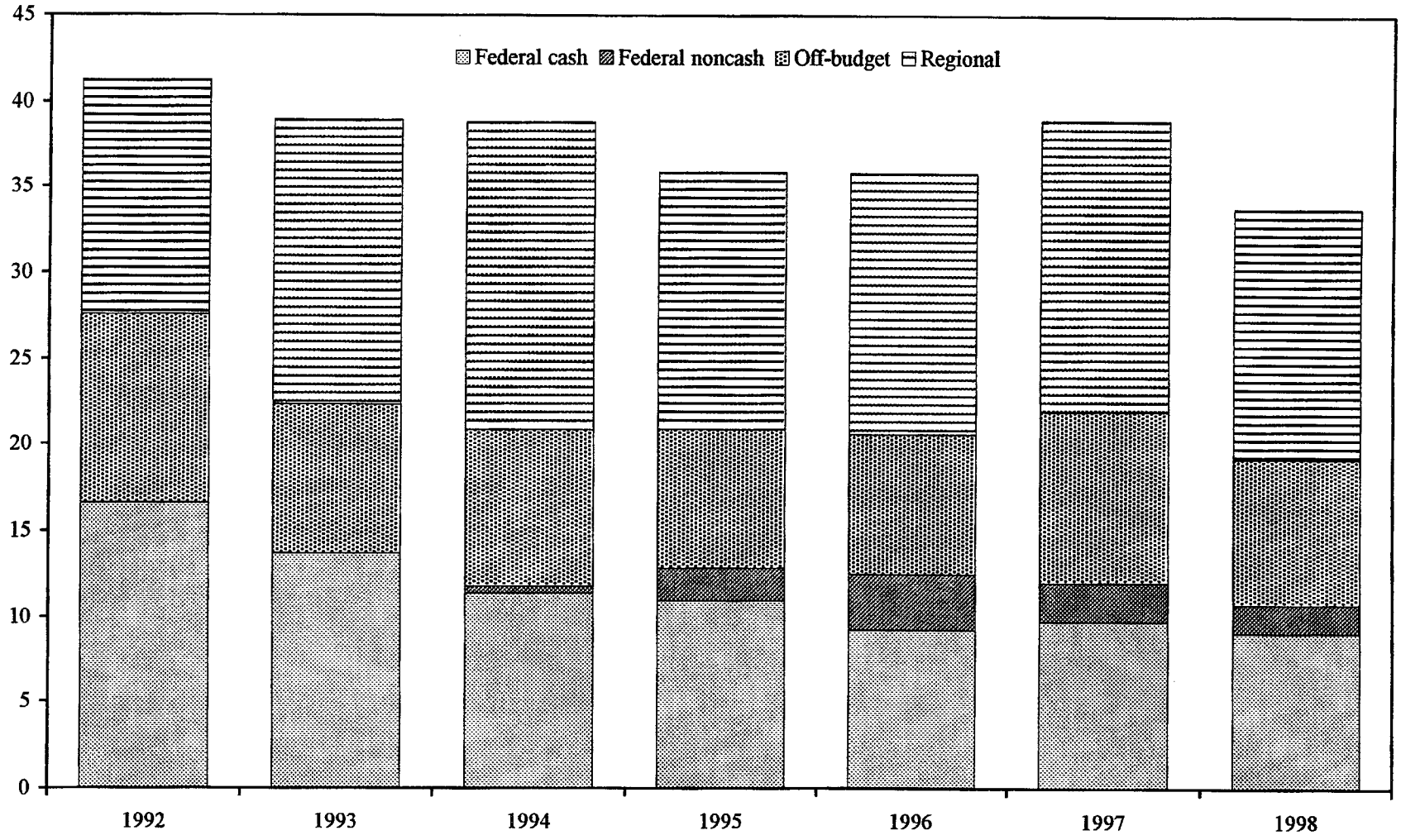
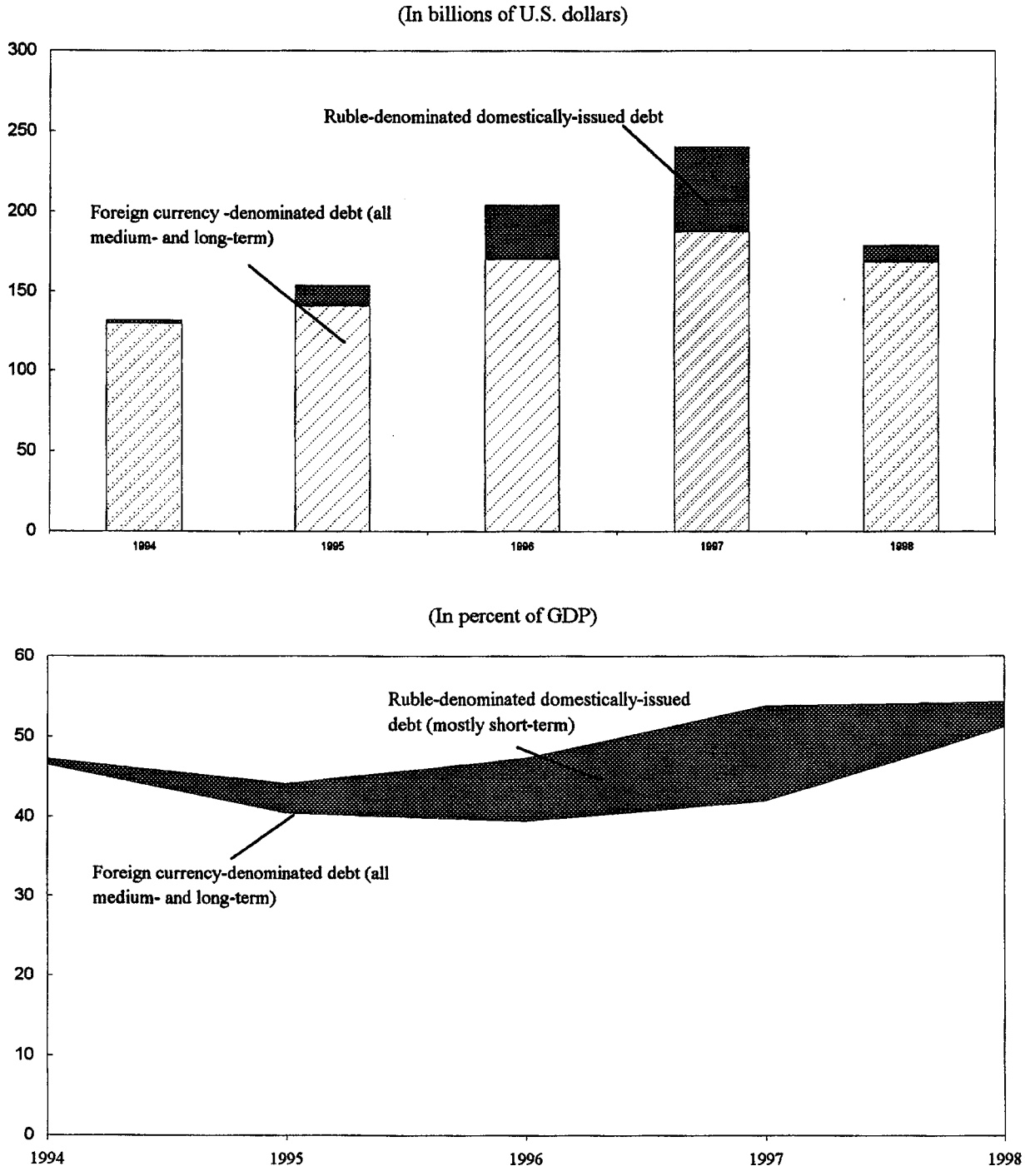
[1]The policy of allowing the ruble to depreciate gradually within a preannounced corridor, which was maintained from 1995 to August 1998, had all the attributes of a fixed exchange rate policy in so far as the constraint on monetary policy was concerned.

Figure 1. Russian Federation: Enlarged Government Revenues, 1992-98
(In percent of GDP)



Source: Russian authorities; and Fund staff estimates.

Figure 2. Russian Federation: Composition of Sovereign Debt, 1993-98



Sources: Data provided by the Russian authorities; and Fund staff estimates.

inherently tenuous, the timing of the shattering of that stability undoubtedly owed much to the souring of the external environment from late-1997 onward. Most importantly, there were significant spillover effects from the economic crisis that swept across Asia from mid-1997. That crisis led to a rise in interest rate spreads on debt issued by borrowers in emerging market economies (Figure 3). At the same time, Russia's terms of trade deteriorated by about 37 percent between January 1997 and December 1998, led by steep declines in the price of oil, natural gas, and base metals. Compared to end-1996, the fall in the terms of trade by mid-1998 implied an annualized deterioration in the balance of payments of about $25 billion.

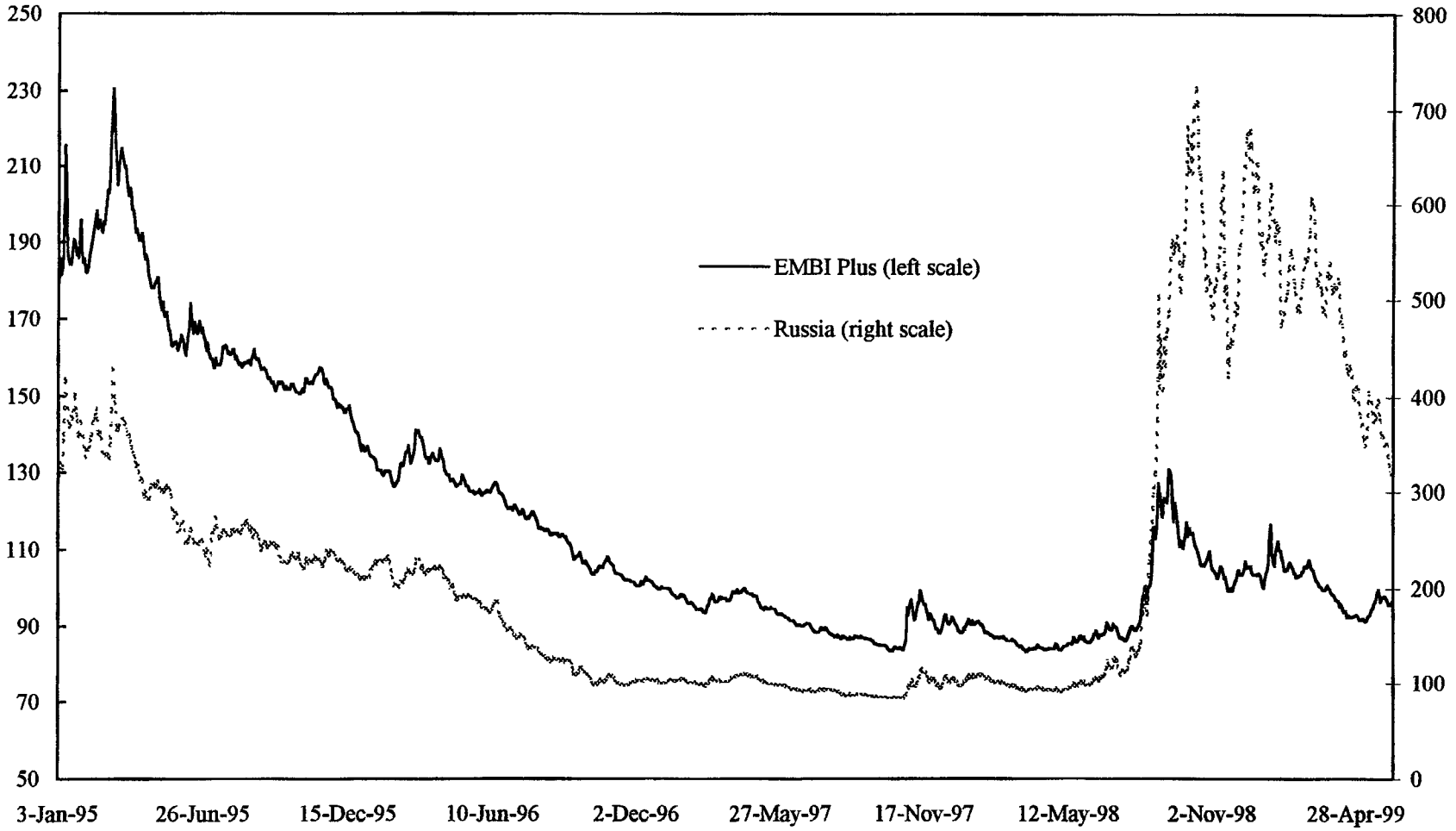
5. **Clear though it is that these adverse exogenous developments played a key role in triggering the 1998 crisis, it is also evident that the external environment had previously been unusually positive.** From 1995 through 1997 U.S. long-term interest rates were stable at relatively low levels, while spreads over U.S. government bond yields for emerging market borrowers (as measured by the benchmark Emerging Market Bond Index) fell rapidly from above 12 percent in late-1995 to a record-low of about 3 percent in the fall of 1997. Corresponding to that narrowing of spreads was a large increase in volumes of capital flows to emerging markets. The growth in emerging markets' gross primary market financing on all instruments (equities, bonds, loans, and other fixed income) quickened from annual rates of about 15 percent in 1994–95 to about 40 percent in 1996 and the first three quarters of 1997. Apart from this positive global capital market environment, which prevailed until late-1997, Russia's terms of trade also saw an improvement of 16½ percent from a trough in October 1995 to their January 1997 peak. Although the terms of trade index then began the fall that was to extend through 1998, in August 1997 it was still 11½ percent above its October 1995 level.

6. **Although the undermining of financial stability by persistent fiscal imbalances was the salient feature of the 1992–98 period, slow progress in creating a favorable business environment also contributed to a stagnating economy throughout the period**. The lack of decisive structural reform in areas such as corporate governance, bankruptcy procedures, property rights enforcement, labor mobility, and accounting standards was bound up with the continued failure of aggregate output to rebound, the slow pace of foreign direct investment, and the low and falling level of overall investment as a percentage of GDP (Figure 4). In addition, this meant that the very large upward move in the real effective exchange rate from 1992 to mid-1998 was not underpinned by a corresponding increase in labor productivity.

A. 1992–96: The First Five Years of Transition

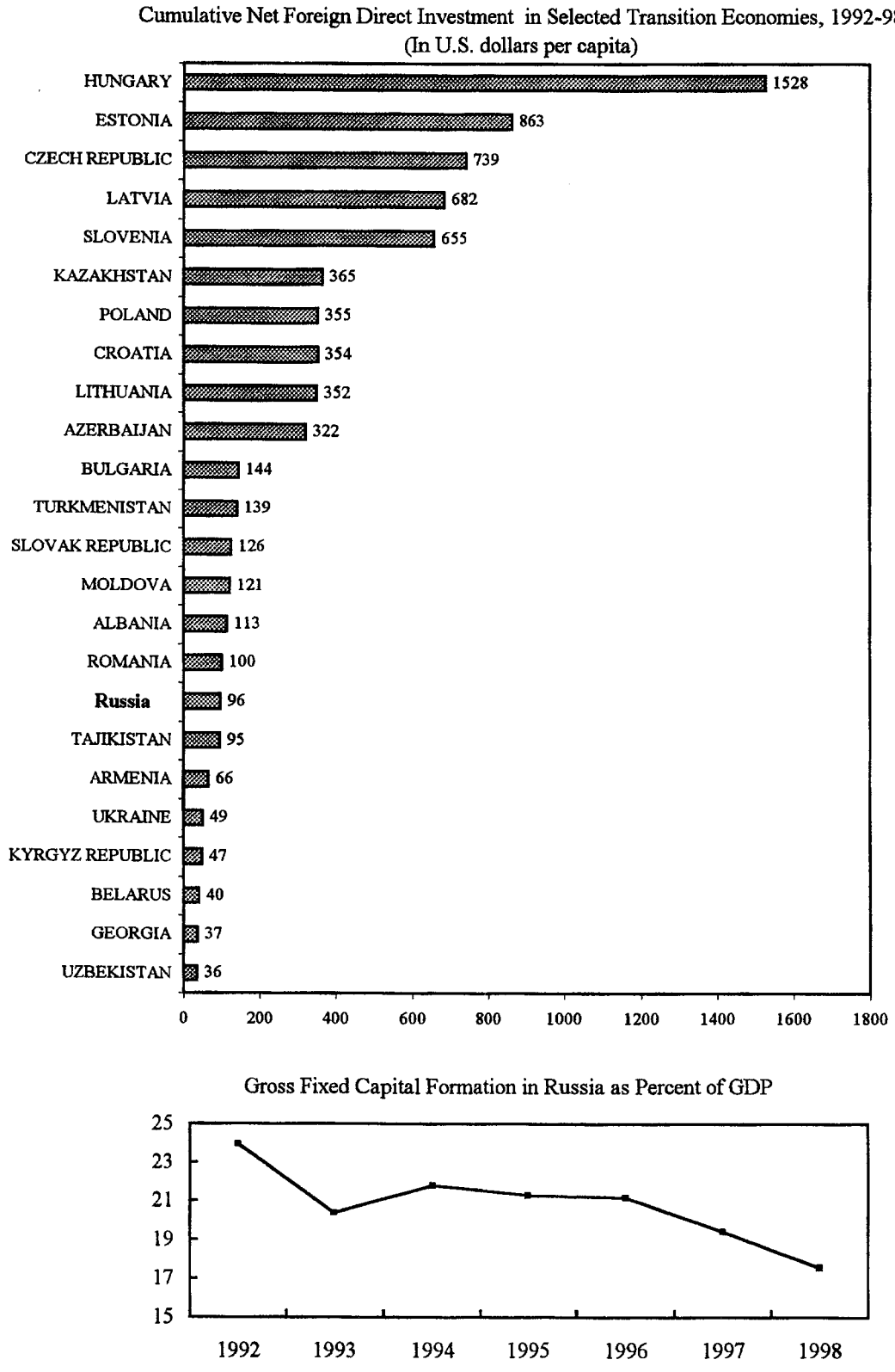
7. **The authorities' reform efforts in 1992–94 were focussed on reducing macroeconomic imbalances that had widened in the final years of the Soviet Union, allowing markets to begin performing their allocative function, and developing the basic**

Figure 3. Emerging Market and Russian Bond Indices, 1995-99
(Inverse of total return index, end-1996=100)



Source: J.P. Morgan Emerging Market and Russian bond indices, and Fund staff estimates.

Figure 4. Russian Federation: Investment Activity, 1992-98



Source: Russian authorities; Fund database; Fund staff estimates.

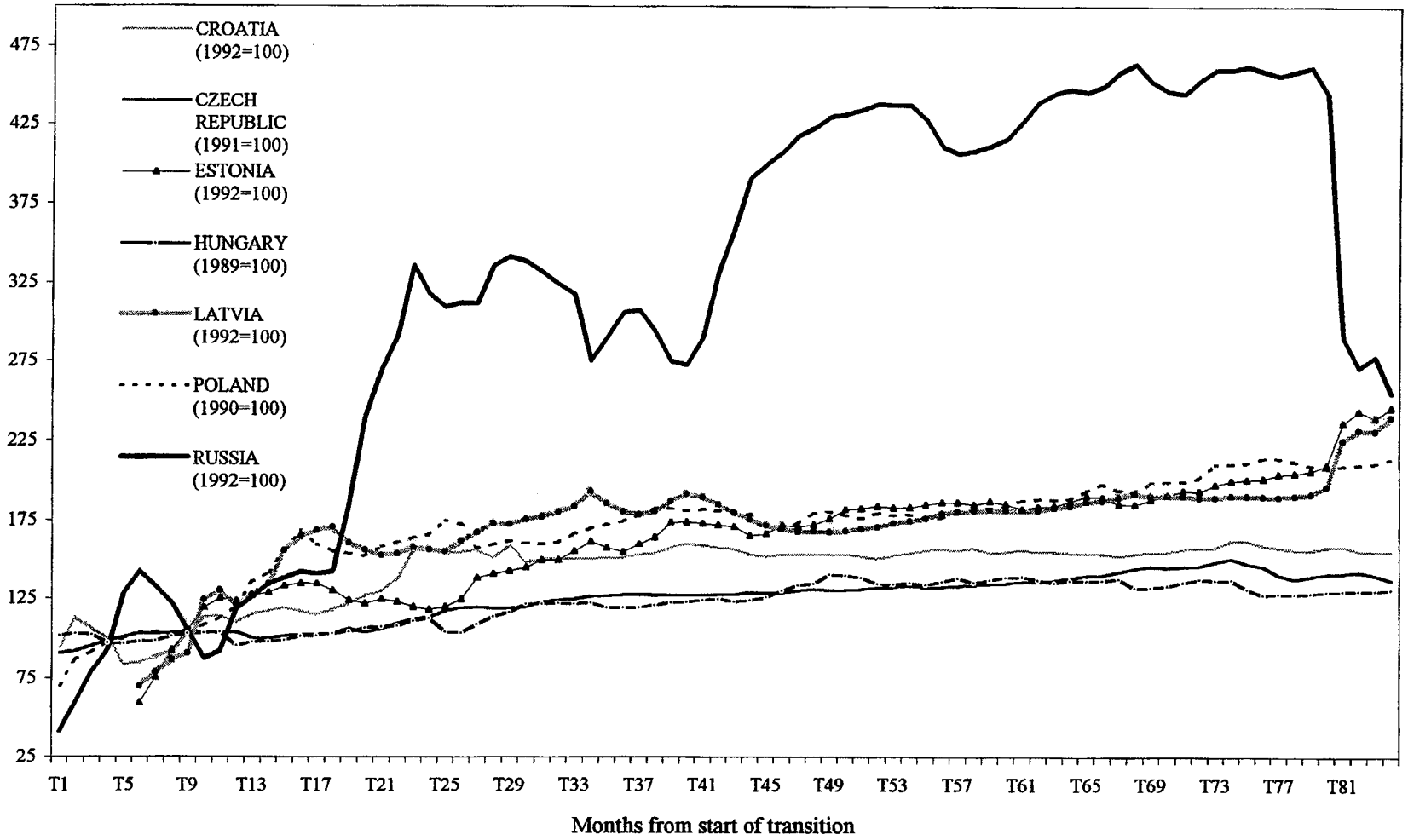
institutional and legislative frameworks required by a market economy. Although the authorities made some progress in these areas, stabilization was only partial, and many of the goals of the reform process were not met, particularly in terms of institutional reforms and enterprise restructuring. Inflation fell, but remained high, and federal revenues declined precipitously as a percentage of GDP. Moreover, there was a systematic tendency to relax fiscal and monetary policies in the second half of each year, damaging the credibility of the authorities and adding to uncertainty about the policy environment.

8. **Against that background, the authorities resolved in 1995 to achieve a decisive reduction in inflation via a tight monetary policy supported by a halving of the federal budget deficit to under 6 percent of GDP**. Also, chastened by the exchange crisis of October 1994 which saw a one-day drop of 20 percent in the ruble's value against the U.S. dollar (on "Black Tuesday"), they sought to bolster confidence in their determination to achieve macroeconomic stabilization by legislating a prohibition on direct lending from the CBR to the budget. Finally, to foster stability of the ruble, they adopted an exchange rate band system from July 1995. Despite political pressures, the authorities stuck to their program, and their main goals were achieved: the federal budget deficit (on a cash basis) was contained to about 5 percent of GDP, inflation fell to 131 percent (December to December) from 215 percent in 1994, and economic activity in some sectors stabilized. However, continuing revenue shortfalls made the fiscal situation increasingly vulnerable. In response, noninterest cash expenditures were compressed well below the levels of previous years, but a lack of control of expenditure commitments led to an accumulation of arrears, and spending pressures built up late in the year. Also, inertial inflation combined with the exchange rate band led the ruble to appreciate in real terms by 65 percent in 1995 (December to December), creating increasing difficulties for the tradeables sector.

9. **The pressures evident at the end of 1995 continued into the following year, when the run-up to the June 1996 presidential elections saw an easing of financial rigor**. Tax collection efforts slackened and large tax offsets were permitted. Adding to the fiscal problems, the Chechen war is estimated to have cost at least 1 percent of GDP. While the federal (cash) deficit widened to 8 percent of GDP in 1996, inflation continued to decline, supported by the exchange rate anchor and reliance on nonmonetary government financing. At the same time a number of important structural reforms—such as land reform, the creation of an adequate legal framework for the capital market, and privatization—continued to lag.

10. **The erosion of federal revenue and the lack of institutional reform during the first five years of transition were partly a function of the lack of the necessary political consensus.** Such a large part of the economy was economically nonviable on the basis of normal market relations—and barriers to the reallocation of resources, especially labor, were such—that there was a powerful constituency against the hardening of budget constraints. The major appreciation of the ruble in real effective terms that characterized the period since 1992, and which was unusually marked compared to the experience of more successful transition economies (see Figure 5), tended to increase the number of nonviable enterprises, and may

Figure 5. Real Effective Exchange Rate Movements, Selected Transition Economies
(Index, first year of transition = 100)



Source: IMF database.

have swelled the constituency opposing necessary reforms. The result was that, despite a number of economic policy successes in the period through 1996—including taming hyperinflation, and progressively opening the economy to trade and investment—the inability to break the culture of nonpayment (Annex II) and reverse the revenue decline meant that fiscal deficits remained stubbornly high, while growing budgetary arrears led to further nonpayments throughout the economy (Figure 6).

B. The Zenith of Expectations, January–September 1997

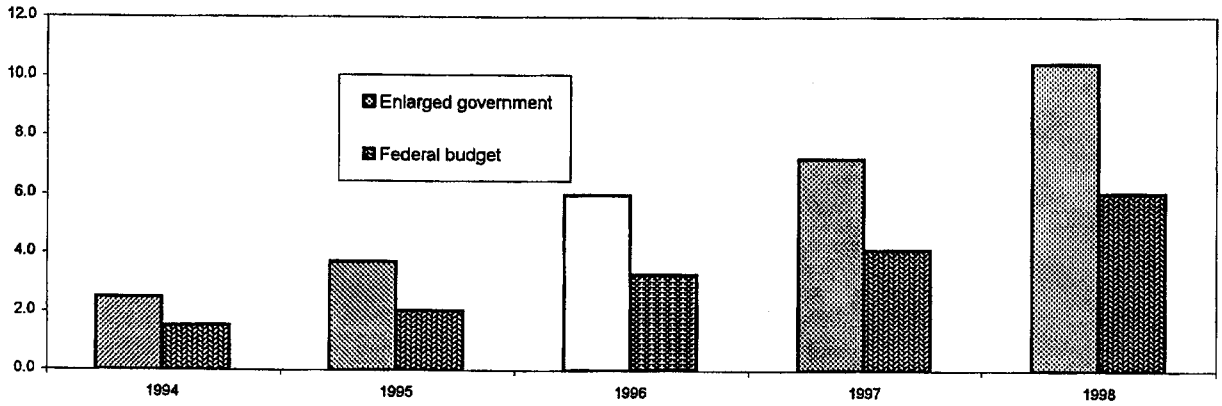
11. **The policy mix of 1996, with high fiscal deficits and declining inflation reconciled by an exchange rate anchor and heavy government borrowing, continued through 1997.** By early 1997 the fragility of this policy mix was well recognized, both by outside observers and within the government. There was, however, renewed optimism that the fiscal problems could be overcome. To begin with, the presidential elections were over, President Yeltsin's health was less in doubt than it had been, and the position of market-oriented reformers in the government was seemingly strengthened. Further, the authorities had publicly recognized the seriousness of the problem of insufficient federal revenues, and had launched successive waves of measures designed to raise compliance and enhance collections. In addition, the completion of a rescheduling accord with Russia's Paris Club creditors (and the nearing of final agreement with the London Club) removed concern about the government's near-term debt service burden, while an apparent incipient turnaround in the output decline in Russia and through much of the former Soviet Union gave rise to widespread expectations of a resumption of growth in the region. Finally, Russia benefitted from an improvement in investor perceptions of emerging markets in general: private capital flows to emerging markets were again surging after the brief retrenchment following the Mexico crisis of 1995.

12. **Thus, from late-1996 through much of 1997 there was a considerable appetite for Russian government securities, both domestically and abroad.** Between November 1996 and December 1997 the federal government was able to issue $4½ billion in Eurobonds at spreads over comparable U.S. government securities of between 330 and 375 basis points. At the same time, GKO yields declined from around 100 percent in September 1996 to 18½ percent in July 1997. Net GKO/OFZ issues in 1997 amounted to 4.2 percent of GDP, with nonresidents making net purchases equivalent to $11 billion, and raising their share of outstanding GKOs from under 20 percent in December 1996 to about 33 percent by the end of 1997.

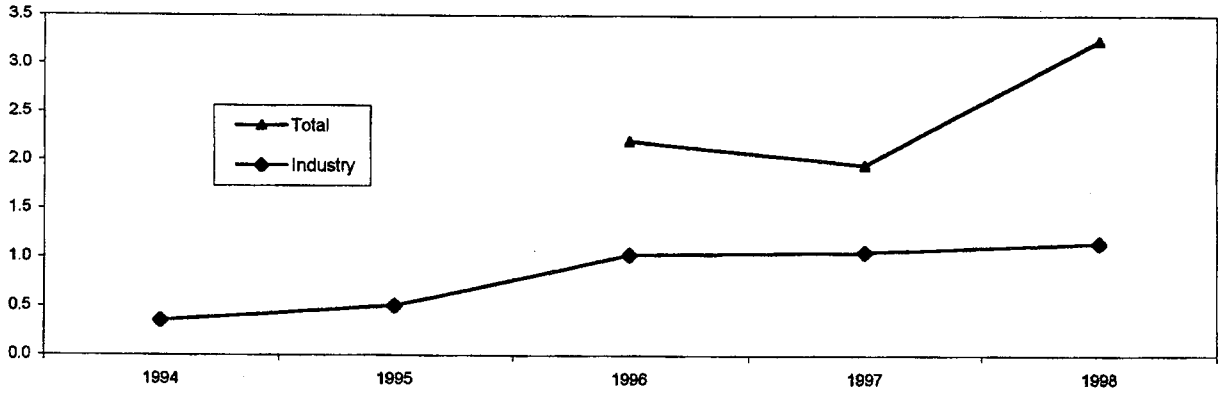
13. **The resort to extensive foreign budgetary finance through Eurobond and GKO/OFZ sales from late-1996 through 1997 is understandable, as the government was able to borrow via the GKO market at relatively low real interest rates for much of this period** (Figure 7). Also, the virtually uninterrupted real appreciation of the ruble against the U.S. dollar made dollar yields of around 10 percent on Russian government Eurobonds look very reasonable. It should be emphasized, however, that the decision of the government to

Figure 6.
Russian Federation: Measures of Nonpayments, 1994-98 1/
(In percent of GDP)

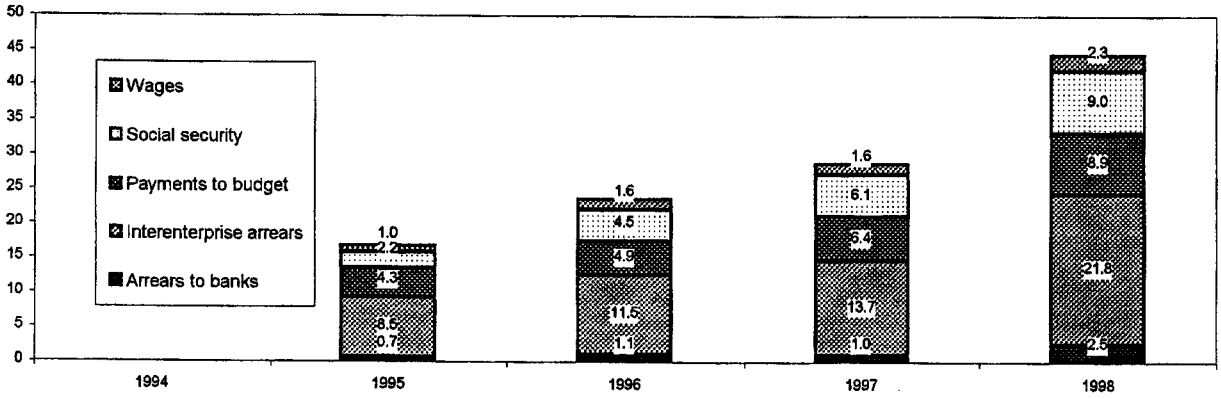
Tax arrears



Wage Arrears



Overdue Payables of Enterprises

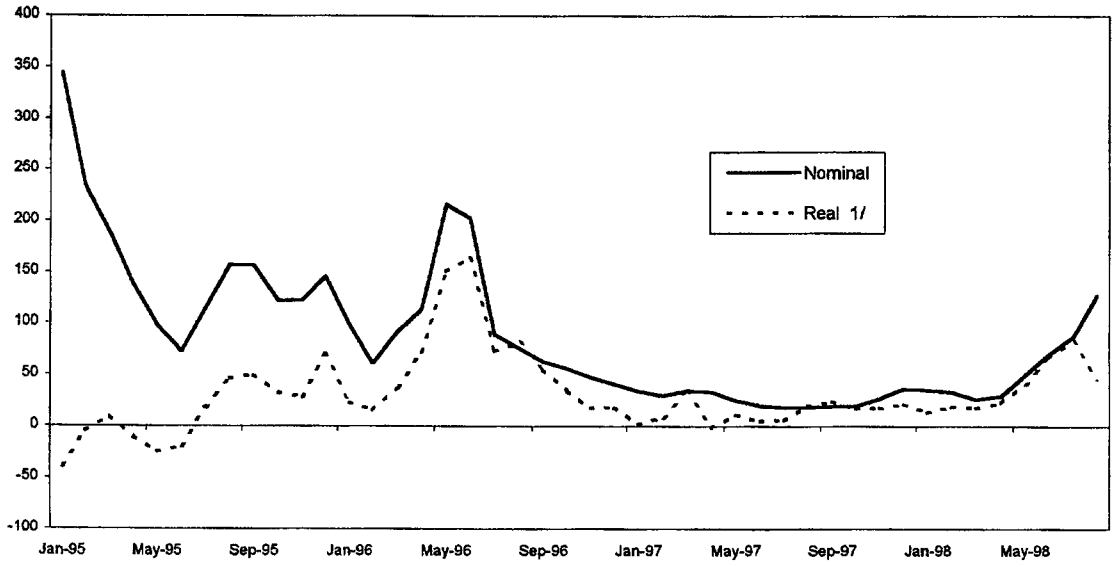


Sources: Goskomstat.

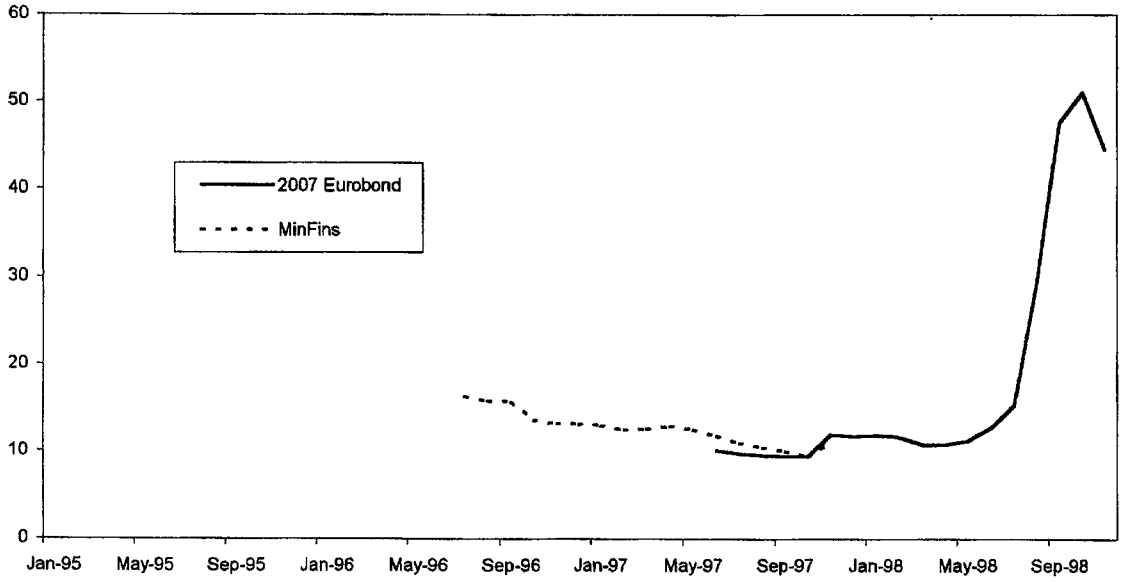
1/ For 1998 November data.

Figure 7.
Russian Federation: Interest Rates, 1995-98
(In percent, annualized)

GKO Yields



Yields on Dollar Denominated Debt



Sources: Bloomberg, Reuters, SKATE Agency, Goskomstat, and Fund staff estimates.

1/ Corrected by annualized monthly price change.

open the GKO market to nonresidents in 1996 was premised on the ability of the government to overcome its fiscal problems which, in the end, it was unable to do.

14. **For much of 1997, the balance of macroeconomic news was positive, sustaining market optimism**. In the third quarter, aided by a good grain harvest, Russia experienced its first positive real GDP growth since independence. At the same time, inflation fell to 2 percent at an annualized rate, with the CPI actually falling in August and September (Figure 8). In addition, until September 1997, the terms of trade were more favorable than in the corresponding period of 1996 (Figure 9). This positive environment helped propel the stock market to new highs: in the first nine months of 1997 the main index more than doubled in U.S. dollar terms. Also, the improvement in market sentiment allowed the authorities to reverse the shortening of the maturity profile of domestic government debt.[2]

C. Rising Pressure and Policy Responses, October 1997–July 1998

15. **By late 1997, however, the economic and financial environment was deteriorating**. The realization that 1997 was not bringing the hoped-for rebound in federal revenues and associated fiscal consolidation, combined with the deterioration in market sentiment towards emerging markets following the onset of crisis in Thailand in July 1997 (and even more so following the turmoil in Hong Kong's financial markets in October), meant that in November 1997 the authorities were forced—for the first of what was to be several times—to raise interest rates sharply to defend the exchange rate band and roll over maturing GKOs. At the same time, the CBR intervened heavily in the foreign exchange market: reserves declined by $6 billion in November 1997 alone.

16. **From late-1997 onward, other developments also turned negative**. Russia's export prices declined by more than 20 percent between August 1997 and July 1998, driven in large part by the fall in oil and gas prices. Real GDP began to fall again, led by a sharp contraction in investment. With a more difficult external environment and a renewed downturn in domestic economic activity, combined inward foreign direct and portfolio investment—excluding purchases of government debt—shrank from some $8 billion in 1997 to an annual rate of only about $2½ billion in the first half of 1998. The Moscow Times U.S. dollar equity index retreated rapidly from its peak of August 1997, falling by 43 percent by end-November, and a further 31 percent by end-June 1998 (Figure 10). By August 13, even before the devaluation of the ruble, equities had lost nearly 80 percent of their value in U.S. dollar terms compared to their August 1997 peak.

17. **There was also a growing awareness of the fragility of the Russian banking system, as many large banks had become reliant on GKOs and other securities whose**

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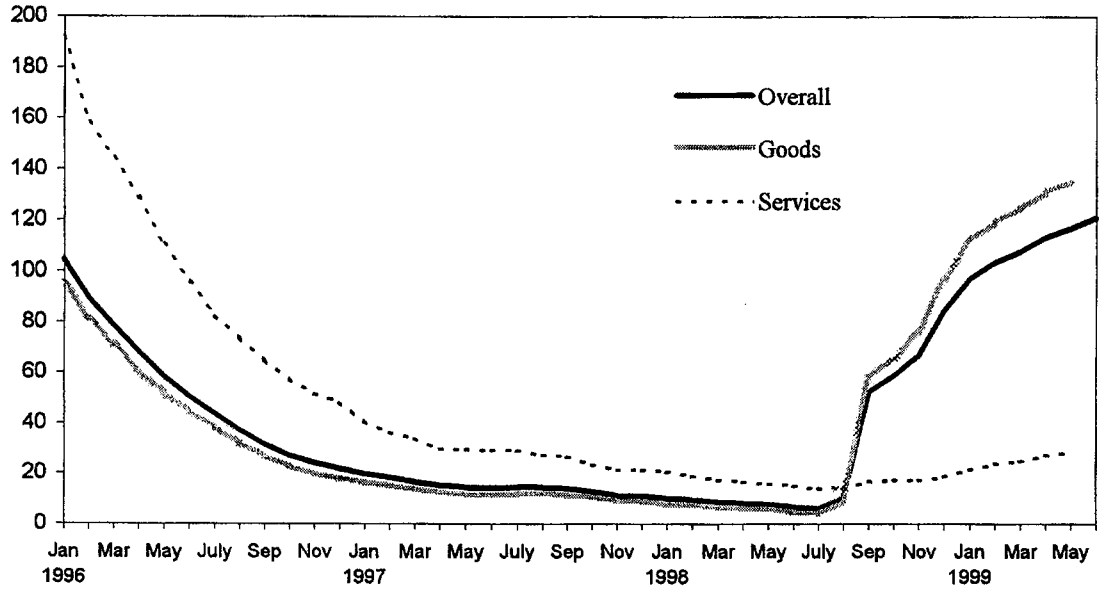
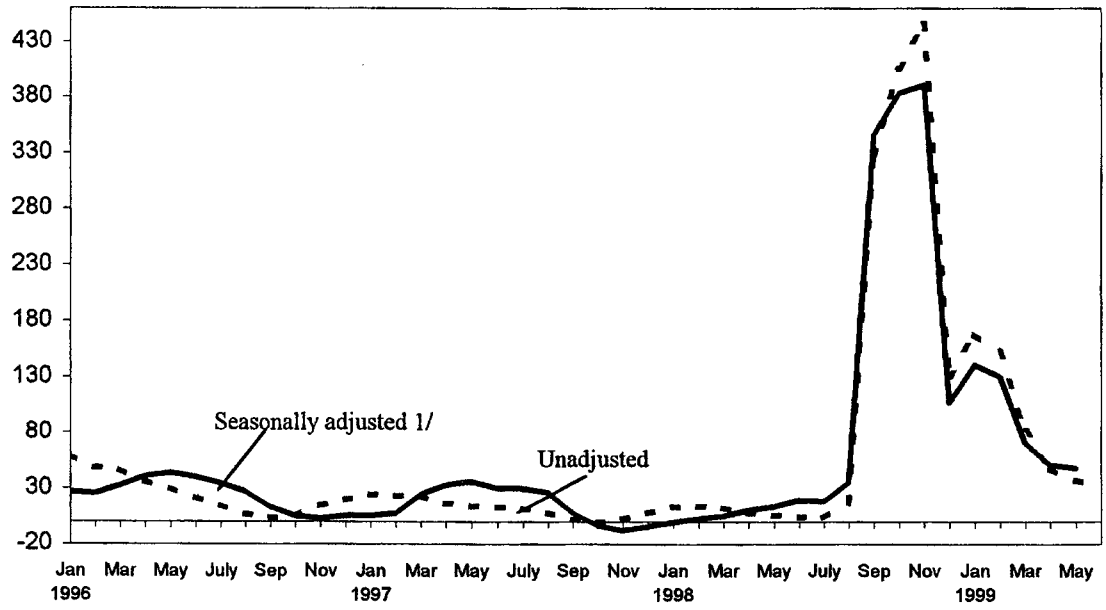
[2] Including GKOs, which are short-term discount instruments, and OFZs, which are coupon-bearing bonds with a maturity of 1–3 years.

Figure 8.
Russian Federation: Consumer Price Inflation, January 1996-June 1999
(percent changes)

12 - Month Changes



3- Month Changes (annualized)

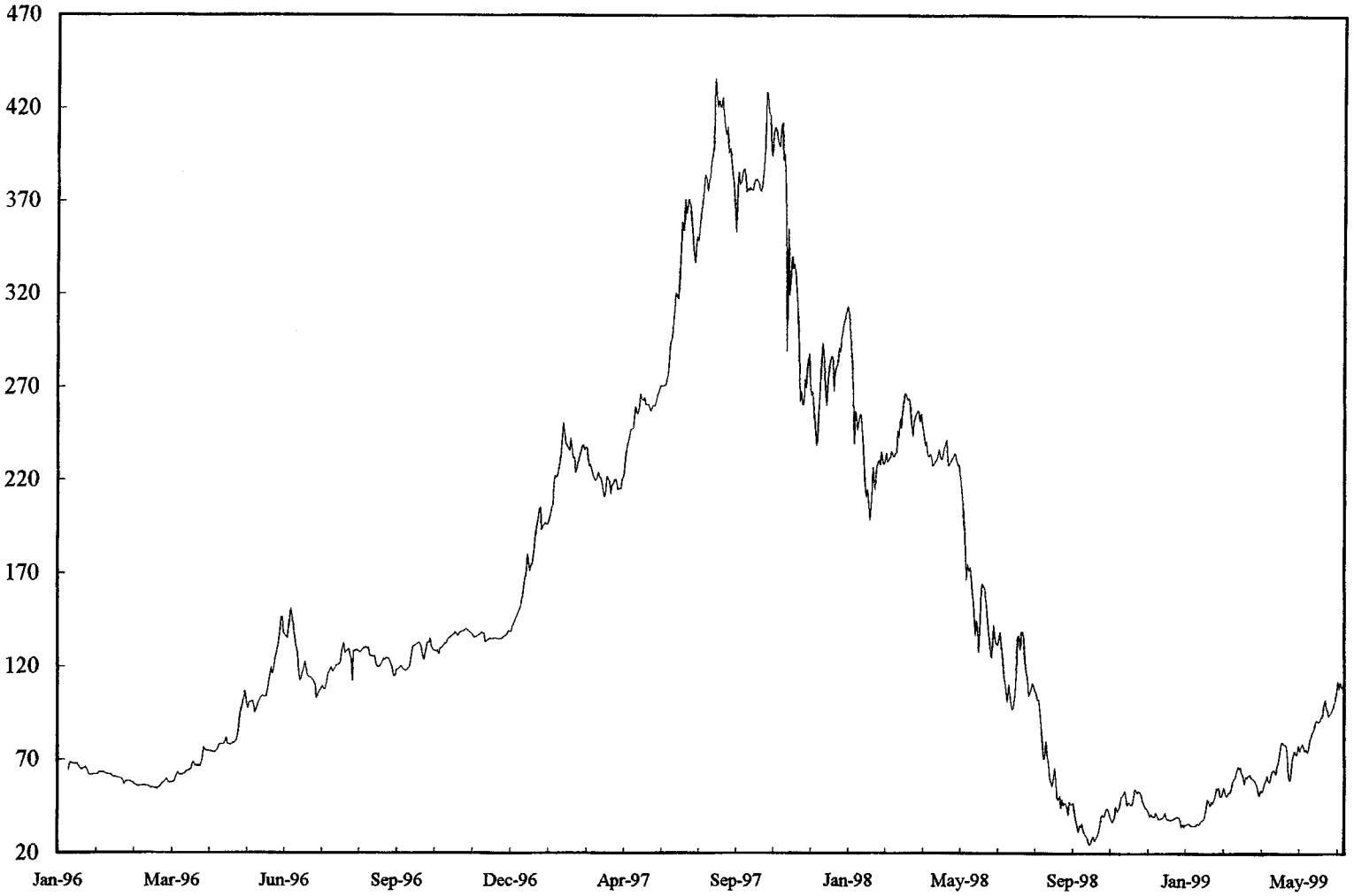


1/ Adjusted with X11 multiplicative procedure from index data.

Figure 9. Russian Federation: Terms of Trade, January 1995 - March 1999
(Index, 1995=100)

Source: Fund staff estimates.

Figure 10. Russian Federation: Moscow Times U.S. Dollar Equity Index, 1996-99
(September 1994=100)



Source: Moscow Times.

prices were falling rapidly. From early-1998, this exposed some banks to margin calls, forcing sales of assets which further depressed financial markets and added to the pressure on bank balance sheets. Also, the banking system as a whole had become vulnerable to devaluation; foreign investors holding GKOs had hedged their ruble exposure by buying dollar forward contracts from Russian banks. As a result, the banking system was caught in the downward spiral of Russia's fiscal fortunes, as a failure to solve the fiscal problem was leading to higher interest rates, lower financial asset prices, and an ever-higher probability of devaluation.

18. **At the same time, deep-seated fiscal problems remained, while political uncertainty became an increasingly important factor**. Federal government revenue as a percentage of GDP had fallen again in 1997, and the deficit remained close to 7 percent of GDP. Moreover, further government reshuffles and a standoff between the President and the Duma in March–April 1998 over the President's choice for Prime Minister, Mr. Kiriyenko, weakened market confidence in the government's ability to overcome parliamentary resistance to a reform agenda. The heightened risks were reflected in successive warnings and downgradings of Russia's credit ratings by one or more of the main agencies in December 1997 and March, May, June, and August 1998.

19. **A financing crisis ensued as interest rates rose sharply**. After large, though short-lived, upward moves in GKO yields in late 1997 and January 1998, the pressure intensified in May–June 1998, when yields were briefly driven above 100 percent, and averaged about 60 percent. Faced with this crisis, the Russian authorities attempted to restore confidence by strengthening their efforts to correct the fiscal imbalance and accelerate structural reforms. In support of these efforts, the authorities sought the help of the international financial institutions in assembling an official financing package large enough to bolster confidence in the adequacy of reserves. At the same time, a voluntary swap of about $4.4 billion in GKOs into Eurobonds was arranged.

20. **In mid-July 1998, after the announcement of new fiscal and structural policy measures and agreement with the IMF on a package of additional official assistance (the total value of which, including contributions from the World Bank and Japan, was to be about $17 billion), pressure on interest rates and reserves temporarily eased**. GKO yields declined from nearly 200 percent on July 10 to 54 percent by July 15. However, when the Duma balked at passing certain key promised measures, the credibility of the program was crippled. By mid-August GKO yields had reached a new high of nearly 300 percent and reserves had fallen by some $3½ billion from late-July.

D. The August 1998 Crisis

21. **Faced with dwindling international reserves despite the massive spike in interest rates, on August 17, 1998 the authorities announced a series of emergency measures.**

These included a de facto devaluation of the ruble (with an upward shift and widening of the exchange rate band), a unilateral restructuring of ruble-denominated government debt falling due between August 19, 1998 and December 31, 1999, and a 90-day moratorium on private sector payments on external liabilities. The measures, announced without supporting macroeconomic policies, only aggravated the decline in investor confidence and the associated outflow of private capital. Moreover, a new wave of political uncertainty was unleashed with the dissolution of the Kiriyenko government on August 23. Thus, despite continued heavy intervention by the CBR, the ruble rapidly reached the new ceiling of Rub 9.5 per U.S. dollar established on August 17, forcing the authorities to abandon the exchange rate band on September 2. The exchange rate quickly jumped beyond Rub 20 per U.S. dollar, before settling back to Rub 16 per U.S. dollar by the end of September. Driven by the depreciation of the ruble, monthly inflation hit 38 percent in September.

22. **The most immediate and dramatic result of the August 17 measures was the virtual collapse of the banking system**. Banks' portfolios were generally heavily skewed towards government securities, and the effective default on GKOs had a powerful negative effect on the balance sheets of many banks. A large number of banks were also wrong-footed by the abandonment of the quasi-fixed exchange rate, holding major short-dollar positions in the forward market which they were unable to square after the devaluation. Interbank transactions virtually ceased, and the payments system was paralyzed for over a month. Also, in the chaotic post-August 17 environment, even nonmonetary transactions were temporarily disrupted. As a result, there was a severe contraction in output and trade. By October 1998 industrial production, which had been up year-on-year in the first half of the year, was down 15 percent relative to October 1997. Imports, affected also by the massive change in relative prices, fell to about $2 billion a month in the last four months of 1998, roughly half the level during the same period of 1997.

E. The Post-Crisis Period

23. **After the initial aftershock of August 17, economic policy was initially passive, but the worst post-August fears concerning macroeconomic stability were not realized in the following months**. Inflation remained higher than before the crisis, averaging about 7 percent a month from October 1998 through February 1999, but declined steadily, reaching 2 percent per month by May–June. Further, after the initial sharp depreciation, the exchange rate stabilized in the range of Rub 24–25 per U.S. dollar from March through mid-July 1999. A relatively tight fiscal policy, aided by efforts to restrain cash expenditures, allowed CBR ruble credit to the federal government to be contained to about 2 percent of GDP in the fourth quarter of 1998 and the first quarter of 1999. (The CBR also provided U.S. dollar credit for the payment of external debt service equal to about 5 percent of GDP over this period). Also, while the CBR was slow to begin withdrawing the licenses of insolvent banks, central bank liquidity support for ailing banks was moderate. Output, after declining sharply immediately after the onset of the crisis, stabilized in late 1998. By March-April 1999, owing to the

depreciation of the ruble, there were incipient signs of an economic recovery led by import substitution and exports, as industrial output exceeded its level of the same period of 1998. Also, since mid-March 1999 real incomes and dollar exports have been boosted by the strong rebound in world oil prices.

24. **It remained clear, however, that without strong measures to improve federal government revenue collection and advance structural reforms, this period of stability would represent only an interlude between crises.** While cash revenues improved significantly in the first quarter of 1999 relative to the immediate post-crisis months, they remained at the pre-crisis level of about 10 percent of GDP, despite the positive impact on revenues of the large depreciation of the ruble. Further, the fiscal adjustment for 1999 outlined in the budget was initially based on a severe compression of real noninterest expenditures, including wages and pensions, which would likely not have been sustainable over the medium term.

25. **Meanwhile, the effect of the ruble's depreciation on the ruble value of the government's debt service obligations was immediate**. The federal government's total foreign currency-denominated debt service stands at $17.5 billion in 1999, equivalent to about 80 percent of budgeted revenue. The government has initiated negotiations with its external creditors on a rescheduling of its Soviet-era debts, but even a full rescheduling of those obligations would leave foreign currency debt service at over 40 percent of budgeted revenue. The price of the government's traded debt clearly reflected the perception of significant default risk; by early March, 1999, the interest rate spread on Russia's Eurobonds had increased to about 6,000 basis points, although it subsequently declined to about 2,500 by end-May. Further, in February 1999 Russia's sovereign credit ratings were again downgraded by two of the major agencies.

26. **Moreover, until April 1999, structural reforms largely stalled, with reversals in some areas**. Access to the oil pipeline was used as a lever to force energy companies to supply nonpaying customers. Privatization came to a virtual halt. Slow progress on bank restructuring facilitated asset stripping and capital flight. State initiation of bankruptcy proceedings against tax debtors was suspended. Interbank currency exchanges were first closed, then (from early October 1998) regulated to provide for a segmented exchange market. Also, as from the beginning of 1999 surrender requirements on export receipts were raised from 50 to 75 percent. At the same time, the trade regime became less liberal with, for instance, the introduction of a ban on alcohol imports and restrictions on food exports.

27. **From April 1999 onward, however, there were signs that these trends were being reversed and the causes of the August 1998 crisis belatedly being addressed.** In order to address the underlying fiscal imbalance, the authorities introduced several new revenue-enhancing tax measures and took action to force oil companies with tax arrears to move toward full compliance with statutory tax obligations. There was also a sharp change in direction in the structural policy area: in June, the authorities unified the interbank currency

markets, passed legislation to facilitate bank restructuring and began to withdraw the licenses of major insolvent banks, canceled the state directives to oil companies to supply nonpaying refineries, and rescinded the decision to suspend new bankruptcy proceedings. After the trough of macroeconomic performance and sentiment in late-1998, by mid-1999 there were signs—on the basis of the relative macroeconomic stability in the last several months and the output recovery driven by the depreciation of the ruble—that the crisis was over.

II. Domestic Economy

A. Output and Expenditure

Overview

28. **Output fell precipitously in 1992–94 in response to the withdrawal of subsidies and the disruption in traditional economic relations, but the decline then began to taper off, and real GDP registered a small increase in 1997.**[3] However, the recovery proved short-lived, and GDP was already on a downward trend by the first half of 1998. This contraction was severely aggravated by the economic crisis that erupted in mid-1998 (Table 1, Figure 11). A significant erosion of real income, a loss of trade financing, and a temporary disruption of the payments system contributed to a seasonally-adjusted real output decline of 6 percent in the third quarter of 1998.

29. **Recent developments have, however, proved more positive than had initially been expected**. Seasonally-adjusted real GDP fell by less than 1 percent in the last quarter of 1998, and preliminary data indicate that it grew by 4 percent in the first quarter of 1999. Seasonally-adjusted industrial output grew by 12 percent over the last quarter of 1998 and the first quarter of 1999 combined, and in April–May it stood 4 percent higher than its level one year earlier. The recovery initially appears to have been led primarily by import substitution in response to the real depreciation of the ruble. However, with recent improvements in the prices of Russia's key exports, there is now some evidence of a pickup in exports as well.

30. **The fact that sustained growth has not materialized until now reflects, in part, the failure to advance reforms following the initial price liberalization,** and in particular the failure to secure property rights, generate economic restructuring, and create a stable business environment (see Chapter VI for further details). Widespread corporate governance problems have prevented viable enterprises from improving efficiency and making the needed investments to enhance competitiveness. These problems have also dissuaded entry by new businesses, while the failure to impose hard budget constraints throughout the economy has allowed many non-viable firms to survive (see Annex II, "Nonmonetary Transactions and Arrears Accumulation"). The persistent fiscal imbalances have furthermore limited the

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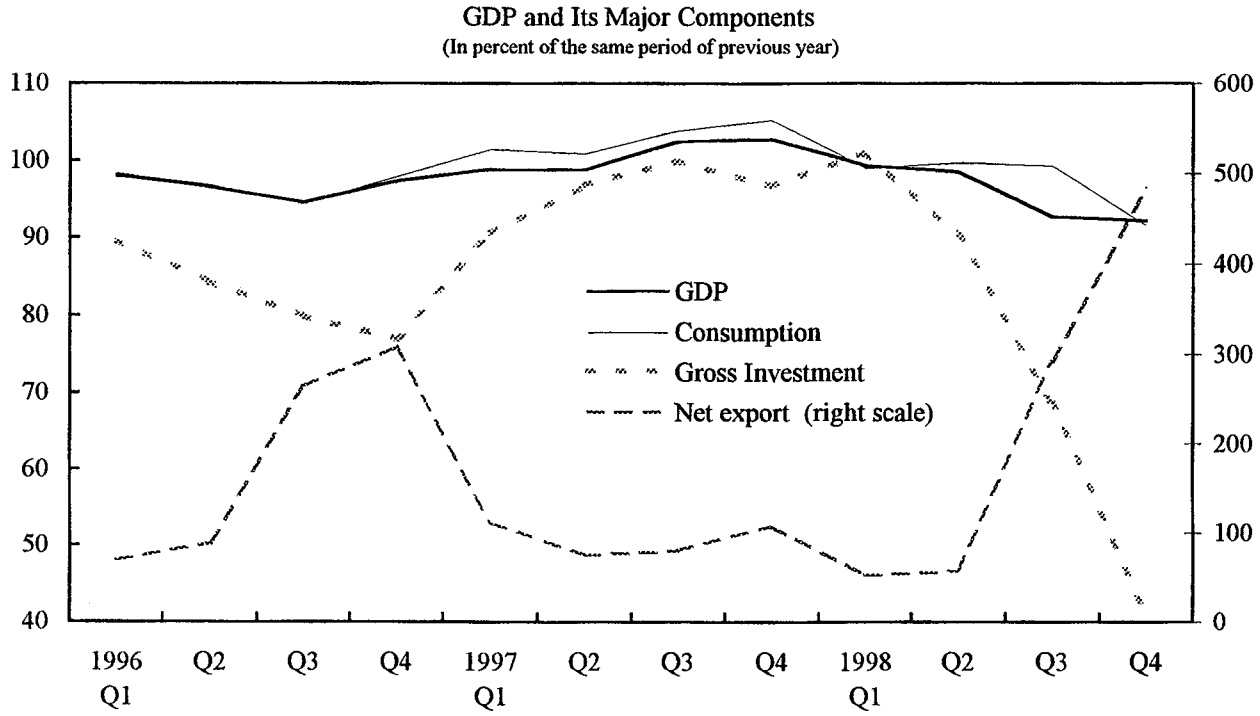
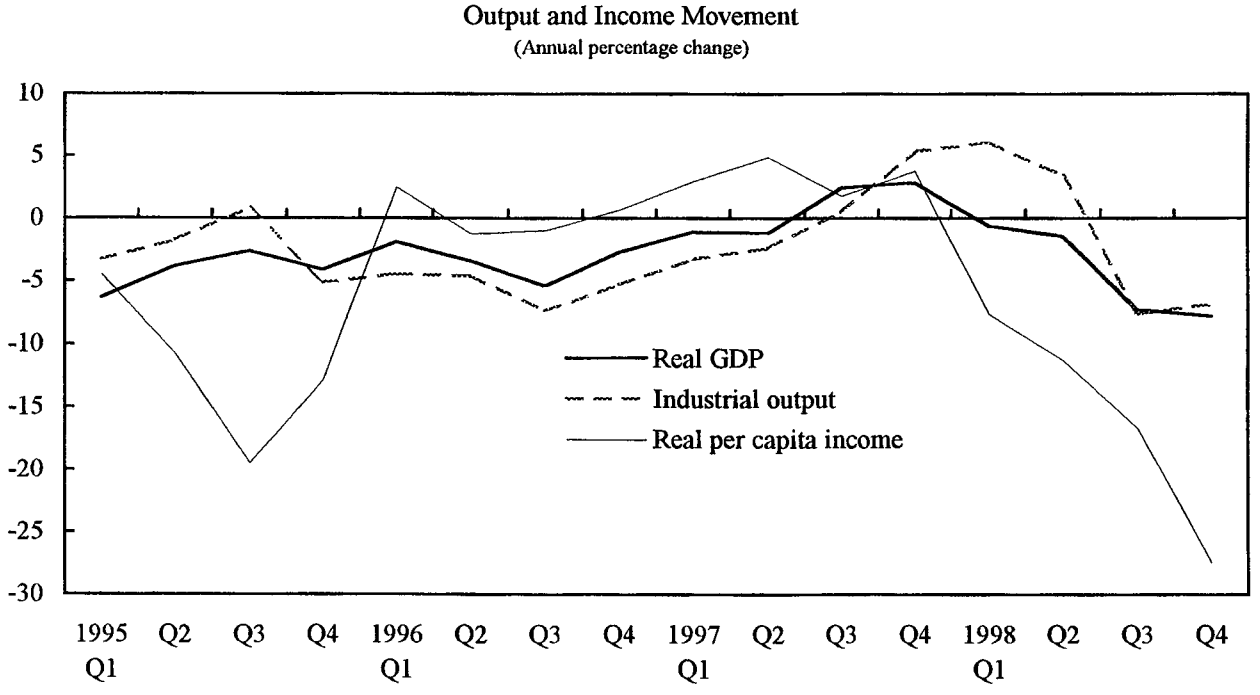
[3] While economic contraction has clearly taken place since 1992, an accurate assessment of GDP developments is hindered by problems in estimating the size of the informal economy and calculating the value of non-monetary transactions. While official GDP estimates since 1996 have incorporated improved estimates for informal sector activity, they may still overestimate the overall decline in economic activity since 1991. In particular, inherited price distortions and their corrections during the earlier years of transition make it difficult to assess output movements accurately. On the other hand, value-added may be overestimated by the fact that nonmonetary transactions are often made at inflated prices (see Annex II, "Nonmonetary Transactions and Arrears Accumulation").

Figure 11. Russian Federation: Output and Income, 1995-98





Source: Goskomstat.

channeling of resources for investment to the private sector. The lack of adequate investment has, in turn, resulted in the deterioration of the economic infrastructure, potentially affecting the long-term prospects for the economy as well.

The main components of demand: 1996–98

31. **During 1996–97, movements in real output were dominated by domestic demand**, which fell by over 7 percent before registering a small turn-around (Table 2). Changes in net exports were relatively less important. In contrast, in 1998 net exports exercised a significant positive influence: while the collapse in domestic demand acted to reduce GDP by almost 8 percent, the increase in net exports (occurring mainly in the last quarter) offset about half of this amount.

32. **The decline in output over the transition period has been accompanied by an even sharper contraction in investment whereas consumption, in particular by households, has seen relatively little decline**. The shift of expenditure towards consumption partly reflects a correction of policies in the Soviet planned economy, which heavily encouraged capital accumulation above all else. In this context, the decline in investment can partly be seen as a positive outcome of the transition process that reduced inefficient areas of investment. However, much-needed investment has not been forthcoming, and where it has occurred, it has not been broad-based, having increasingly concentrated in a few areas, including the energy sector.

33. From 1996 until late 1998, the growth in consumption continued to outpace GDP, fueled by rising real wages and income, and the lack of public sector adjustment. In the wake of the crisis, however, this relationship has been reversed. Real consumption growth outstripped GDP growth by at least 2 percentage points 1996–97, and seasonally-adjusted real household consumption grew by a further 1 percent during the first half of 1998. In the second half of 1998, however, the crisis reduced seasonally-adjusted real per capita income by over 14 percent. In response, **household consumption was initially financed by a drawdown of personal savings and by nonpayment, but then contracted sharply, by about 21 percent during September 1998–March 1999**. As for government consumption, it rose in each of the years 1995–97, and was largely unchanged in 1998 (Table 2).

34. With economic prospects still uncertain and the business climate remaining largely unfavorable, investment in capital goods continued to decrease in 1996 and 1997. After a fall of 19 percent in 1996, the decline moderated in 1997, reflecting a sharp one-time rise in imports of machinery and equipment prompted by the government's plan to eliminate tax exemptions for imports of investment goods, and by an increase in inventories. **In 1998, the investment decline accelerated, as economic prospects deteriorated**. For the year as a whole, capital formation fell by 9 percent. Further contributing to the decline in investment, inventories dwindled rapidly as consumption shifted to domestically produced goods following the sharp depreciation of the real exchange rate.

35. **Performance of net exports swung dramatically over 1996–98**. In 1997, as the terms of trade deteriorated, exports decreased and imports increased by 10 percent each in dollar terms. In 1998, however, despite the continued worsening of the terms of trade, net exports rose by 5 percentage points of GDP, reflecting developments in the second half of the year. While export revenues continued to decline with commodity prices, imports were compressed, owing to the decline in incomes, the depreciation of the ruble, and the short-run impact of the breakdown in the payments system. In the last quarter of 1998, imports were less than half their level one year earlier.

36. **The import compression has continued in 1999**. In the first quarter, imports remained about half their level one year earlier. The limited available data suggests that this compression has been broad-based, with a particularly large reduction in imports of consumer goods. In contrast, there is only very recent evidence of a pickup in exports; in April 1999, the dollar value of exports was higher than its level one year earlier, the first such rise since 1997. One reason for the delayed response of exports to the devaluation is that the oil and gas sector, which accounts for 40 percent of exports, faces severe extraction and transportation constraints.

Sectoral developments

37. **Despite the generally slow progress on structural reforms, the Russian economy has nevertheless undergone a significant transformation since 1991, with a sizable shift in resources from industry and agriculture to the services sector taking place alongside the secular decline in output** (Table 3). By 1997, industrial activity accounted for less than 30 percent of GDP, compared with 39 percent in 1991. After a dramatic decline of about 45 percent in 1991–94, the contraction of the industrial sector slowed, as exports to new markets began to mitigate the impact of the earlier drop of demand in traditional markets and of the reduction in government subsidies, and as domestic income gradually recovered. Although industry has experienced an across-the-board decline, the sectors hit most severely have been light industry, construction materials, and machinery building. In contrast, those sectors which have managed to expand exports (such as fuels and metallurgy), and nontradeables (in particular electricity generation), have been able to cushion the decline (Table 4). The agricultural sector has also seen a decline, falling from 14 to 7 percent of GDP during 1991–97. This decline largely reflected the gradual reduction of government financial support to the sector, but was exacerbated by slow progress in land reform and farm restructuring. Over the same period, the services sector has been expanding, increasing its share of output from 36 percent to about 50 percent.

38. **In 1997, domestic demand contributed to a brief recovery in industrial output, but the momentum stalled quickly and the output decline resumed in 1998**. As real incomes increased and the real exchange rate stabilized in 1997 (following a sharp appreciation beginning in 1995), demand shifted toward domestic products, eliciting strong growth in the automobile industry. This in turn underlay a 3.5 percent growth in the machine

building industry, and stimulated ferrous metallurgy output. Robust activity in the nonferrous metal industry in 1997, owing to a continued expansion of exports, also contributed to overall growth. However, the decline in oil and gas prices and constrained external demand for steel products in late 1997 hit the export sectors hard, and their impact was felt quickly throughout the economy. In 1998, the decline in industrial output was aggravated across the board by the August crisis; industrial output ended the year 5 percent lower than in 1997. However, toward the end of 1998, output began to recover from low levels in September as demand for domestically-produced goods increased in the wake of the depreciation of the ruble.

39. **While a bumper grain harvest allowed total agricultural output to increase slightly in 1997, a severe drought led to a 12 percent reduction in output in 1998**. The drought affected almost a quarter of the sown area, and stocks accumulated in 1997 were significantly reduced. Livestock production has declined steadily, and is estimated to have fallen by 9 percent in 1998.

40. **The services sector's contribution to economic output has continued to increase**. In 1997, activity in market services and trade rose by 4 percent, reflecting the generally buoyant consumer demand, before slowing significantly in 1998 as the economic crisis took its toll. Activity in nonmarket services (including publicly-provided goods such as defense, administration, education, health care, and culture) rose by more than 1 percent in 1997, and is expected to remain largely unchanged in 1998.

B. Labor Market Trends

41. **The transition has seen a sizeable reallocation of labor within the economy**. The share of total employment in industry was reduced by 7 percent during 1991–97, while the share of employment in commerce-related and non-market services increased. These trends were particularly marked in the period 1995–97.[4] Within the industrial sector, a few sectors such as food processing, forestry, and machine building have seen productivity recover to 90 percent of the 1991 level, after falling sharply in the early years of transition (Table 5). Further, labor turnover statistics indicate a relatively active labor market, with an average annual separation rate of above one quarter of total employment during the period 1991–97, and annual rates of new hires of approximately 20 percent of total employment (Table 6).

42. **Despite the significant reallocation of labor, the pace of labor shedding has in most cases lagged well behind the output decline**. Compared with the major losses in output since 1992, formal employment has declined much more slowly, falling by just 12 percent during 1992–97, and by a further 2 percent between end-1997 and April 1999

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[4]There also appeared to have emerged a very active market for professionals in finance, real estate, and other services, stimulated by strong growth in these sectors since 1996, especially in Moscow and St. Petersburg. However, the economic crisis hit these sectors very severely.

(Table 7). This pattern is most pronounced in public administration and the social sector; employment has increased by 63 percent for the former and declined by only 3 percent for the latter in 1992–98, reflecting slow progress in public sector reform. There are several reasons why enterprises continue to hoard labor in the face of continued output declines, including legal restrictions on severing labor contracts,[5] and potential bargaining advantages vis-à-vis regional and local government loath to see unemployment increase. While formally laying-off workers is considered to be difficult, managers resort to hidden unemployment—putting employees on administrative leave or part-time schedules—and to wage arrears to contain wage costs.[6] Some 4–6 percent of workers work shortened workdays, and forced-leave days averaged about 30 days per person in 1997–98 (Table 8). Workers are often willing to tolerate wage arrears and lower wages because of the relative importance of non-wage social benefits provided by firms, an inadequate social safety net, and the limited opportunities for geographic mobility resulting from the high costs of moving and of housing, relative to workers' cash incomes.

43. **Open unemployment is increasing, while differences in regional unemployment rates remain large**. By ILO definitions, the unemployment rate increased from 9.4 percent in 1996 to 13.3 percent at end-1998, and to 14.2 percent at end-April 1999 (Table 9). However, because of the low unemployment benefits and strict eligibility requirements, registered unemployment is much lower, and actually showed a decline from 3.1 percent in 1996 to 2.2 percent in 1998 (Table 9).[7] Regional variation in unemployment rates, and more generally in economic activity, is extremely high, reflecting limited labor mobility (see Annex I, "Regional Developments"). For example, in October 1997, unemployment rates of 3–5 percent in the Evenkiyski Autonomous District and in Moscow contrasted with the rate of 58 percent in the Republic of Ingushetia (Table 10). Survey results indicate that unemployment spells have become slightly longer, with the average duration of job search increasing from 8.2 months in 1996 to 9.1 months in 1998 (Table 11). Accordingly, persistent unemployment has become increasingly significant, as the share of long-term unemployed has increased, in particular for those approaching retirement age. This suggests that there is a sizable group of Russians who lack the skills to find employment in an increasingly market-oriented economy.

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[5]Current regulations require severance pay of two months' wages; if the worker does not find a job in the third month, one more month's wage must be paid.

[6]Goskomstat data indicate that wage arrears are relatively more prevalent for lower wage workers in poorer regions (and industries). This suggests that managers are responding to market pressures for retaining more productive workers.

[7]Registered unemployment only includes workers officially laid off from jobs in the enterprise sector. Because new private sector firms generally do not register their employment rolls with the Federal Employment Service, workers who lose such jobs cannot register as unemployed.

44. **Unemployment is increasingly the result of enterprise restructuring, but voluntary resignation remains almost as important in accounting for unemployment**. Survey results indicate that an increasing share of the unemployed are involuntarily laid off. In 1998, about 37 percent of the unemployed lost their jobs because of redundancy or enterprise liquidation (compared to 34 percent in 1997), while 22 percent resigned voluntarily (compare to 25 percent in 1997) (Table 12). Only about 37 percent of the unemployed contacted employment agencies for job search assistance in 1998, a drop from the 1996–97 levels, while over half of the unemployed relied on information from friends, relatives and acquaintances in job search. Since the number of registered vacancies has hovered around 0.5 percent of the number of workers employed since 1992, it appears that little job market activity takes place in government-sponsored job agencies (Table 13).

45. **Geographic mobility is limited, but appears to reflect regional differences in economic conditions**. During 1992–98, most regions experienced net in and out migration of about 3–4 percent of 1991 populations (Table 14). However, the Far East region as a whole has experienced an outflow of 9 percent, and several individual sub-regions have experienced outflows of 20–45 percent. Regression analysis indicates that annual migration into or out of a region is determined primarily by the region's per capita income and by the region's unemployment rate.

C. Prices and Wages

46. **Inflation in both consumer and producer prices declined sharply after the adoption of the exchange-rate based stabilization strategy in 1995** (Tables 15 and 16). In 1997, annual consumer price inflation fell to 11 percent. Due to a significant decline in fuel prices, producer prices inflation fell even faster, to 7 percent in 1997, reversing the historical relationship between consumer and producer prices.[8] This trend has persisted and inflation as measured by the PPI has been consistently lower than CPI inflation.

47. **With the onset of the financial crisis in August 1998 and the consequent sharp depreciation of the ruble, inflation accelerated dramatically**. Cumulative inflation for September through December 1998 stood at close to 70 percent for the CPI and 25 percent for the PPI. Within the CPI basket, prices for goods increased significantly, while the prices of services rose much more gradually for two reasons. First, the approximately 60–70 percent of service prices that are administered were not fully adjusted. Second, services are relatively labor-intensive, and real wages declined substantially over the period.

48. **The rate of inflation has slowed in 1999, to 25 percent on a cumulative basis through June**. This was achieved partly as a result of a fairly tight fiscal policy, which has allowed for only moderate Central Bank financing of the government. In addition, a significant

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[8]Producer price inflation consistently exceeded CPI inflation prior to 1997, as basic commodity prices moved closer to international levels from artificially low levels.

improvement in the external current account has reduced pressures on the exchange rate and therefore on domestic prices.

Wage developments

49. **Average real monthly wages showed significant increases in 1996–97, after the continuous large declines in earlier years** (Table 17).[9] For the first eight months of 1998, real wages continued to increase, rising by over 6 percent compared to the same period in 1997. However, in the wake of the August crisis and the sharp depreciation that followed, real wages plummeted: during September–December, they were two-thirds of the level during the same period in 1997. As of April 1999, real wages stood at 59 percent of the level a year earlier, but the decline appears to have bottomed out.

50. **The implications for Russia's competitiveness of the trends in wages have been mixed.** Although real wages as measured against the CPI from 1995 onward have generally been lower than in the 1992–94 period, U.S. dollar wages—which are more relevant from the point of view of competitiveness—have increased from very low levels since the beginning of 1992, reflecting the real appreciation of the ruble. On the other hand, the ULC-based real effective exchange rate remained broadly unchanged from 1995 until the August crisis (Figure 12). The crisis has led to dramatic declines in all three indicators, as well as in the real effective exchange rate based on relative CPIs. (For further discussion of competitiveness, see Chapter V.)

51. **Wage arrears in industry, agriculture and construction have increased dramatically in real terms since 1992, with a particularly large rise in 1996** (see Table 18 and Annex II, "Nonmonetary Transactions and Arrears Accumulation"). Wage arrears continued to increase, albeit more slowly, in 1997 and 1998. In the face of chronic wage arrears, many workers have increasingly relied on a second job or other activities to supplement their income.

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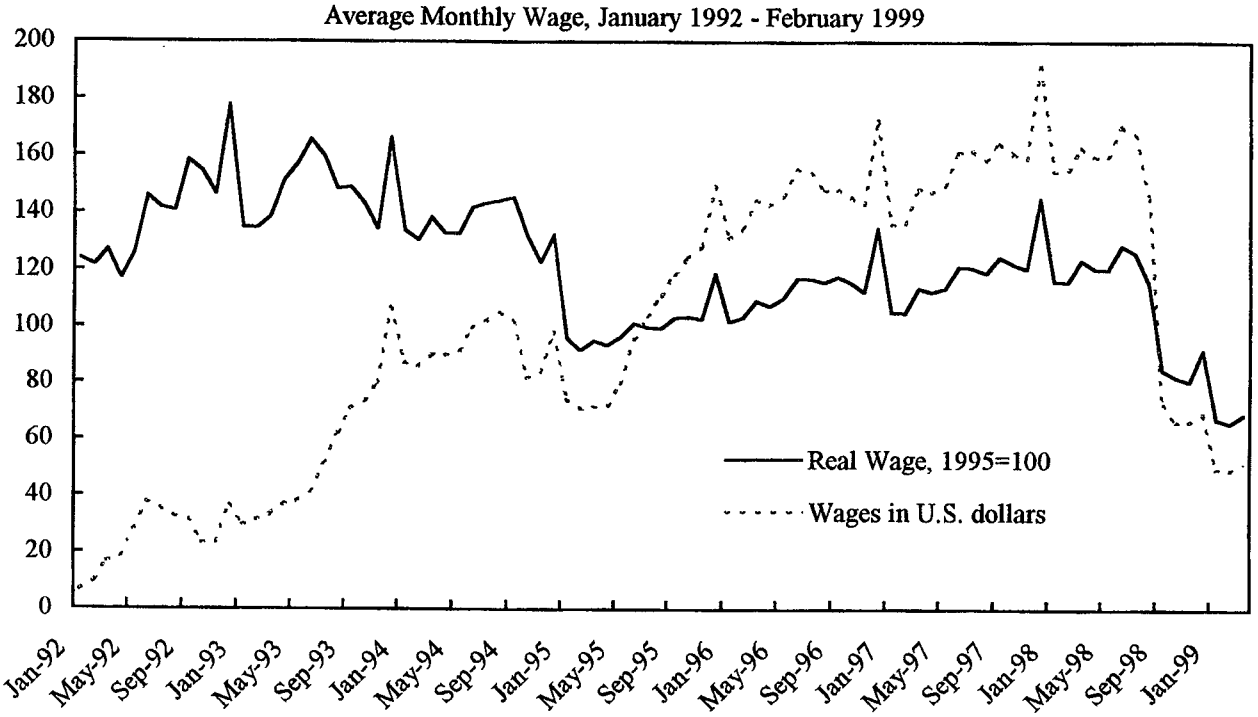
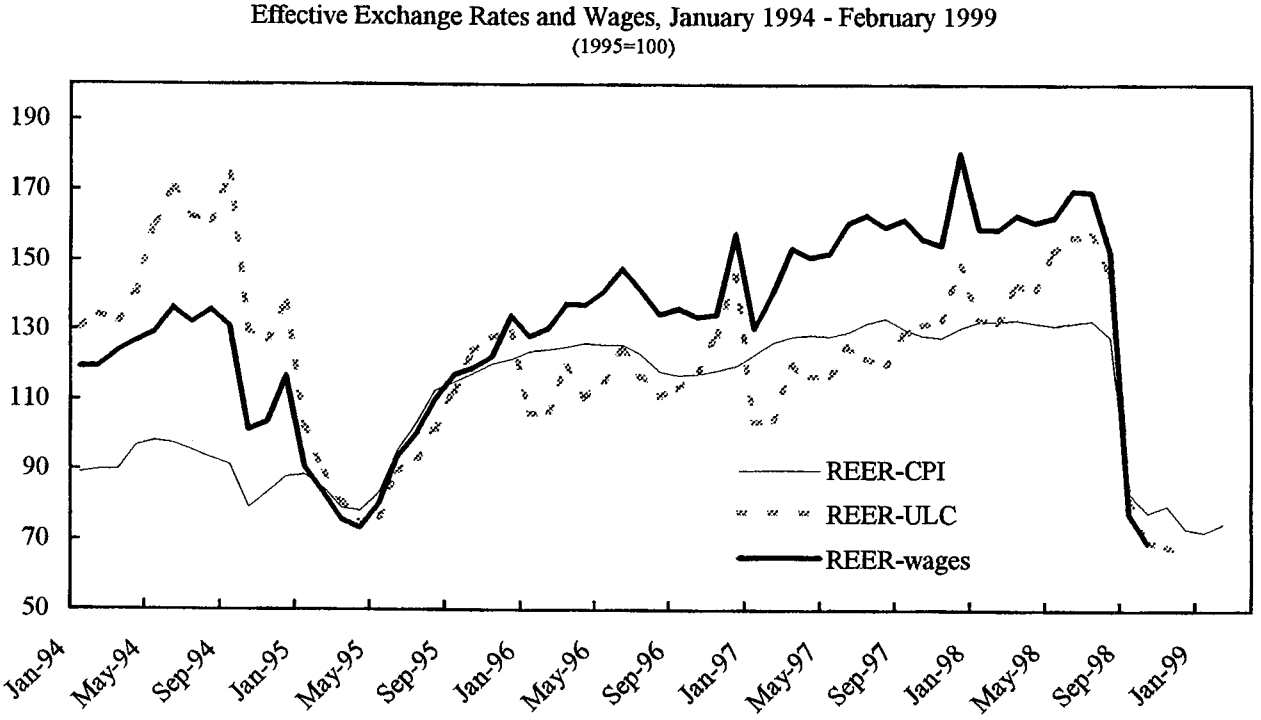
[9]The official wage statistics refers to wage payments due, which do not reflect actual payment because of arrears. In some cases, wages may under-represent true compensation because employers use implicit compensation schemes such as taking out insurance policies and bank deposits in workers' names to avoid high payroll taxes, and because workers usually receive fringe benefits such as subsidized housing, utilities, and food.

Figure 12. Russian Federation: Competitiveness Indicators, 1992-99





Source: Goskomstat, IMF staff calculations.

52. **Real income recovered in 1996 and 1997 as general economic conditions began to improve somewhat.**[10] In 1997, real per capita income increased by 3 percent, reflecting relatively buoyant economic activity (Table 17). However, it fell sharply because of the economic crisis and, during the first quarter of 1999, was 32 percent below its value a year before. Over the whole period since reform started, living standards broadly measured have deteriorated significantly (see Box 1).

[10]Real income is defined as the overall cash income received by households in the form of wages, social transfers, property income, and entrepreneurial income.

Box 1. Living Standards in Russia: The Picture After Reform

Indicators of living standards suggest that social conditions have worsened during transition:

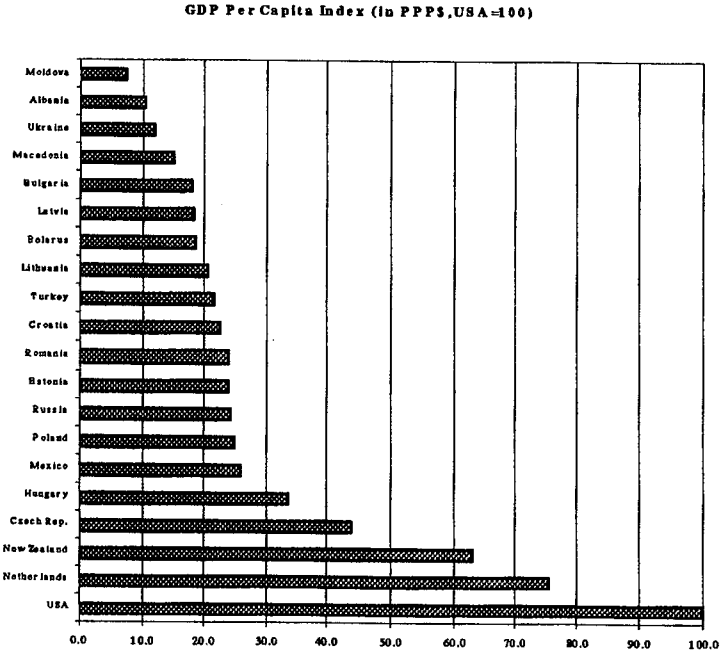
Selected Indicators of Leaving Standards [1/]

	1991	1992	1993	1994	1995	1996	1997	1998
Life expectancy at birth	69.0	67.9	65.1	64.0	64.6	65.9	66.6	...
of which: male	63.5	62.0	58.9	57.6	58.3	59.8	60.8	...
GDP per capita (in thousand rubles, in 1990 prices)	4.1	3.5	3.2	2.8	2.6	2.6	2.5	2.4
Distribution of income (GINI coefficient)	0.26	0.29	0.40	0.41	0.38	0.38	0.38	0.38
Population below subsistence level (in percent)	...	33.5	31.5	22.4	24.7	21.0	20.8	23.8
Number of divorces (per 1000 people)	4.0	4.3	4.5	4.6	4.5	3.8	3.8	3.4
Deaths for psychiatric reasons (per 100000 people)	2.8	3.6	6.3	9.6	10.2	7.1	5.1	...

Source: Goskomstat Yearbook 1998; "Poverty Policy in Russia: Targeting & the Longer-Term Poor", World Bank (1998).

1/ For 1998, data is for November only.

Almost all social indicators show significant worsening in 1992–1994, including increasing human mortality, declining real income, increasing income inequality, rising social stress, and increasing poverty. While most indicators have subsequently recovered, the deterioration over the entire period remains sizable.



Based on 1995 data, the United Nations Human Development Index placed Russia in the "Medium Human Development" category, 72nd among 173 countries. Compared to the 1991 figures, based on data for 1985–90, which placed the USSR 31st out of 160 countries—about midway among the list of "High Human Development" countries—the reduction is significant. Countries judged to have overtaken Russia includes Bulgaria, Poland, Brazil, Mexico and Turkey. The most recent official estimate of per capita income at PPP$ (at $6,744) is about ¼ lower than the level in 1990, and ranks Russia similar to Poland and Estonia (see chart). UN estimates suggest a similar drop in per capita income.

Table 1. Russian Federation: Selected Indicators of Economic Activity, 1991-98

(Annual percentage change)

	1991	1992	1993	1994	1995	1996	1997	1998
Gross domestic product	-5.0	-14.5	-8.7	-12.6	-4.1	-3.6	0.9	-4.6
Industrial output	-8.0	-18.5	-13.3	-20.9	-3.3	-4.0	1.9	-5.2
Extraction industries	-4.0	-11.0	-10.0	-10.0	-1.0	-2.0	3.0	...
Processing industries	-8.0	-19.0	-15.0	-24.0	-4.0	-5.0	2.0	...
Agricultural output	-4.5	-9.4	-4.0	-12.0	-8.0	-5.1	1.3	-12.3
Crops	-23.6	19.9	-7.3	-18.0	-22.0	9.4	27.7	...
Livestock	-4.1	-4.5	-6.3	-11.5	-8.3	-11.6	-10.2	...
Freight transport	-7.0	-14.0	-12.0	-14.0	-1.0	-5.0	-3.6	-3.5

Source: Goskomstat.

Table 2. Russian Federation: GDP by Expenditure, 1991-98

	1991	1992	1993	1994	1995	1996	1997	1998	1995-98	
									Cumulative Change	Change in GDP: Decomposition
	(Annual percentage change at constant prices)									
Gross domestic product	-5.5	-19.4	-10.4	-11.6	-4.8	-6.7	1.0	-3.8	-11.6	-11.6
Consumption	-4.9	-5.5	-1.0	-2.5	-3.1	-3.1	3.0	-2.8	-5.9	-4.2
Households	-4.6	-3.0	1.2	1.2	-2.8	-4.7	5.4	-4.0	-6.2	-3.0
General government	-11.3	-11.8	-6.4	-2.9	1.1	0.8	-2.4	0.1	-0.4	-0.1
Non-profit institutions	34.5	-1.0	0.2	-35.9	-30.5	-0.5	-1.8	-3.5	-34.5	-1.1
Gross Investment	-3.1	-39.5	-28.1	-29.6	-10.4	-20.6	-3.6	-27.6	-45.6	-11.5
Capital formation	-15.5	-41.5	-25.8	-26.0	-7.5	-19.3	-5.7	-8.6	-34.5	-7.6
Changes in inventory	264.1	-29.2	-37.4	-47.1	-30.4	-27.3	8.9	-128.3	-128.2	-4.1
Net exports of goods and services	171.4	-159.7	66.2	-18.1	1.1	21.2	-8.8	98.3	129.5	4.2
Memorandum Items										
GDP at production basis	-5.0	-14.5	-8.7	-12.6	-4.1	-3.4	0.9	-4.6	-10.9	n/a
	(In percent of GDP at current prices)									
Consumption	63	50	64	70	71	71	74	76	5	n/a
Households	41	34	41	44	49	49	51	56	7	n/a
General government	17	14	18	23	19	20	21	18	-1	n/a
Non-profit institutions	4	2	5	3	2	2	2	2	0	n/a
Gross Investment	37	36	28	26	25	24	23	16	-9	n/a
Capital formation	24	25	21	22	21	21	19	17	-4	n/a
Changes in inventory	13	11	7	4	4	3	4	-1	-5	n/a
Net exports of goods and services	0	15	8	5	3	4	3	8	4	n/a
Exports goods and services (fob)	14	64	39	28	28	25	23	32	4	n/a
Imports of goods and services (fob)	13	50	31	23	24	20	21	24	0	n/a

Source: Goskomstat and Fund staff estimates.

Table 3. Russian Federation: GDP by Sector, 1991-98

	1991	1992	1993	1994	1995	1996	1997	1998
Total GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	14.0	7.2	8.2	6.5	7.2	7.3	6.7	6.0
Industry	38.2	33.7	34.4	32.8	29.0	29.5	28.4	29.1
of which:								
processing industry	...	31.2	28.6	27.1	24.7	23.7	22.5	...
Construction	9.4	6.3	7.9	9.1	8.5	8.4	7.9	7.2
Wholesale, retail, foreign trade, public catering, procurement	12.2	29.1	19.0	18.3	19.6	18.3	17.8	20.3
Transportation and communications	7.5	7.4	8.6	9.9	11.9	12.4	12.7	11.5
Finance, credit, insurance, real estate operations, science and research, housing, geology, subsoil resources, exploration, meteorology, computer services, others	9.2	9.4	12.0	11.0	11.3	10.9	12.2	12.7
State administration and defense	2.5	2.1	3.1	4.7	5.2	5.2	6.0	5.5
Education, culture and art, health care, physical education & social security, utilities, non-production activities services to households, people's associations	7.0	4.8	6.8	7.7	7.3	8.0	8.3	7.7

Source: Goskomstat and Fund staff estimates.

Table 4. Russian Federation: Gross Industrial Output by Sector, 1991-98

	1991	1992	1993	1994	1995	1996	1997	1998
			(Annual average percentage changes)					
Total	-8.0	-18.0	-14.1	-20.9	-3.3	-4.0	2.0	-5.2
Electric power generation	0.3	-4.7	-4.7	-8.8	-3.2	-1.6	-2.1	-2.5
Fuel	-6.0	-7.0	-11.6	-10.2	-0.8	-1.5	0.3	-2.5
Ferrous metallurgy	-7.0	-16.4	-16.6	-17.3	9.6	-2.5	1.2	-8.1
Nonferrous metallurgy	-9.0	-25.4	-14.1	-8.9	2.8	-3.6	6.0	-5.0
Chemicals and petrochemicals	-6.0	-21.7	-21.5	-24.5	7.6	-7.1	2.0	-7.5
Machinery	-10.0	-14.9	-15.6	-30.8	-9.1	-4.6	3.5	-7.5
Forestry, timber processing, paper and pulp	-9.0	-14.6	-18.7	-30.5	-0.7	-16.5	0.9	-0.4
Construction materials	-2.0	-20.4	-16.0	-27.3	-8.0	-16.3	-4.0	-5.8
Light industry	-9.0	-30.0	-23.0	-46.0	-30.2	-22.5	-2.4	-11.5
Food processing	-9.0	16.4	-9.0	-17.5	-8.2	-4.2	-0.8	-1.9
			(In percent of 1991 level)					
Total	100.0	82.0	70.4	55.7	53.9	51.7	52.8	50.0
Electric power generation	100.0	95.3	90.8	82.8	80.2	78.9	77.2	75.3
Fuel	100.0	93.0	82.2	73.8	73.2	72.1	72.4	70.5
Ferrous metallurgy	100.0	83.6	69.7	57.7	63.2	61.6	62.4	57.3
Nonferrous metallurgy	100.0	74.6	64.1	58.4	60.0	57.9	61.3	58.3
Chemicals and petrochemicals	100.0	78.3	61.5	46.4	49.9	46.4	47.3	43.8
Machinery	100.0	85.1	71.8	49.7	45.2	43.1	44.6	41.3
Forestry, timber processing, paper and pulp	100.0	85.4	69.4	48.3	47.9	40.0	40.4	40.2
Construction materials	100.0	79.6	66.9	48.6	44.7	37.4	35.9	33.9
Light industry	100.0	70.0	53.9	29.1	20.3	15.7	15.4	13.6
Food processing	100.0	116.4	105.9	87.4	80.2	76.9	76.2	74.8

Source: Goskomstat.

Table 5. Russian Federation: Employment and Labor Productivity in Industry by Sector, 1991-98

	1991	1992	1993	1994	1995	1996	1997	1998 1/
				(In thousands of people)				
Employment								
Total	20,117	20,020	18,864	17,440	16,006	14,934	14,009	11,856
Electric power generation	563	626	666	710	750	790	810	949
Fuel	815	870	886	860	846	856	821	1,017
Ferrous metallurguy	772	795	788	738	727	727	683	736
Nonferrous metallurgy	502	532	542	517	549	537	508	492
Chemicals and petrochemicals	1,115	1,143	1,109	1,011	968	923	891	793
Machinery	9,093	8,767	7,933	7,029	6,190	5,628	5,262	4,189
Forestry, timber processing, paper and pulp	1,725	1,813	1,641	1,535	1,383	1,261	1,138	763
Construction materials	1,067	1,136	1,095	1,040	973	868	783	538
Light industry	2,145	1,845	1,699	1,600	1,332	1,133	1,006	687
Food processing	1,533	1,554	1,556	1,554	1,506	1,487	1,454	1,179
				(In percent of 1991 levels)				
Labor Productivity 2/								
Total	100	82	75	64	68	70	76	85
Electric power generation	100	86	77	66	60	56	54	45
Fuel	100	87	76	70	71	69	72	57
Ferrous metallurguy	100	81	68	60	67	65	70	60
Nonferrous metallurgy	100	70	59	57	55	54	61	60
Chemicals and petrochemicals	100	76	62	51	58	56	59	62
Machinery	100	88	82	64	66	70	77	90
Forestry, timber processing, paper and pulp	100	81	73	54	60	55	61	91
Construction materials	100	75	65	50	49	46	49	67
Light industry	100	81	68	39	33	30	33	42
Food processing	100	115	104	86	82	79	80	97

Source: Goskomstat and Fund staff calculation.

1/ As of November 1998.
2/ Calculated as the ratio of output to employment.

Table 6. Russian Federation: Labor Force Turnover, 1993-98 1/

	1993	1994	1995	1996	1997	1998
			(In thousands)			
Total number of separations	14,284	14,597	13,069	11,372	11,017	10,650
of which: in industry	5,381	5,305	4,284	3,697	3,385	3,333
Number of newly hired	11,963	11,079	11,480	8,982	8,981	8,984
of which: in industry	3,770	3,039	3,192	2,311	2,426	2,387
			(As percent of total employment)			
Total number of separations	25.1	27.4	25.7	23.9	24.5	24.9
of which: in industry	28.8	32.8	28.4	27.0	26.8	27.7
Number of newly hired	21.1	20.8	22.6	18.9	19.9	21.0
of which: in industry	20.1	18.8	21.1	16.9	19.2	19.8

Sources: Goskomstat.

1/ Data for large and medium enterprises.

Table 7. Russian Federation: Employment by Sector, 1991-98 1/

	1991	1992	1993	1994	1995	1996	1997	1998 estimate
				(In percent of 1991 level)				
Total	100.0	97.6	95.9	92.7	90.0	89.3	87.5	86.2
Industry	100.0	95.2	92.9	82.9	76.7	73.0	66.5	63.1
Agriculture and forestry	100.0	103.7	103.8	105.6	100.3	95.4	88.6	83.1
Construction	100.0	92.9	84.1	80.0	73.1	69.2	66.6	63.7
Transportation and communication	100.0	97.9	94.1	93.1	91.4	90.8	89.0	87.7
Commerce, food service, material and technical supply, marketing and procurement	100.0	100.9	113.3	115.3	118.7	120.8	154.7	158.2
Public health, physical training, social security, education, art, culture and science	100.0	98.0	95.6	94.9	93.7	93.1	90.5	91.1
Administrative staff, lending and state insurance	100.0	94.2	106.0	115.5	137.6	175.2	170.4	168.9
Other sectors (housing, pub. utilities, nonproduction types of gen. services to the public)	100.0	100.2	94.0	92.0	93.6	101.6	96.2	103.2
				(In percent of total employment)				
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100
Industry	30.3	29.6	29.4	27.1	25.9	24.8	23.0	22.2
Agriculture and forestry	13.5	14.3	14.6	15.4	15.1	14.4	13.7	13
Construction	11.5	10.9	10.1	9.9	9.3	8.9	8.7	8.5
Transportation and communication	7.8	7.8	7.6	7.8	7.9	7.9	7.9	7.9
Commerce, food service, material and technical supply, marketing and procurement	7.6	7.9	9.0	9.5	10.1	10.3	13.5	14
Public health, physical training, social security, education, art, culture and science	19.4	19.5	19.4	19.9	20.2	20.3	20.1	20.6
Administrative staff, lending and state insurance	2.7	2.6	2.9	3.3	4.1	5.2	5.2	5.2
Other sectors (housing, public utilities, nonproduction types of general services to the public)	7.2	7.4	7.0	7.1	7.4	8.2	7.9	8.6

Source: Goskomstat.

1/ Average for the year; does not include students.

Table 8. Russian Federation: Indicators of Hidden Unemployment, 1993-98 1/

	Shortened Workday 2/		Forced Leave 3/	
	Thousands of persons	In percent of workforce	Thousands of persons	Avg. leave days per person per quarter
1993				
Q1	950	2.8	1908	14.0
Q2	924	2.8	2819	18.0
Q3	1074	3.3	3682	23.6
Q4	1558	4.9	4876	28.9
1994				
Q1	3274	10.6	4632	19.0
Q2	4348	14.2	6782	25.0
Q3	4858	16.0	7274	35.0
Q4	5048	16.7	7727	42.0
1995				
Q1	2244	4.4	2466 4/	14.7 5/
Q2	1991	3.9	1868 4/	11.1 5/
Q3	1900	3.8	1621 4/	9.6 5/
Q4	2051	4.1	2401 4/	14.4 5/
1996				
Q1	2952	6.1	2925	11.0
Q2	3292	6.8	3292	10.0
Q3	3184	6.6	3184	12.0
Q4	3409	7.7	3409	10.0
1997				
Q1	2382	5.2	1708 4/	32.3 5/
Q2	2552	5.6	1688 4/	27.3 5/
Q3	2482	5.5	1223 4/	33.0 5/
Q4	2596	5.8	1494 4/	27.8 5/
1998				
Q1	1731	4.0	1284 4/	32.3 5/
Q2	1804	4.2	1285 4/	30.7 5/
Q3	2037	4.8	1630 4/	33.3 5/
Q4	2006	4.8	1429 4/	30.3 5/

Source: Goskomstat.

1/ In industry, construction, transportation, communication, services, science, and scientific support.
2/ For 1993, 1995-98 data include number of people on shortened workday at the end of each quarter; for 1994 data show those on shortened workdays over the course of the period.
3/ Without pay or with partial pay.
4/ Data for last month of the quarter.
5/ Full-quarter estimate based on data for last month of the quarter.

Table 9. Russian Federation: Selected Labor Market Indicators, 1992-98

	Total Employment 1/	Registered Vacancies	Registered Jobseekers	Registered Unemployment		Unemployment According to ILO Definition
				Total	Receiving Benefits	
			(In percent of labor force)			
End-year 1992	-2.4	0.4	1.3	0.8	0.5	4.8
End-year 1993	-1.7	0.5	1.5	1.1	0.7	5.9
End-year 1994	-3.3	0.4	2.6	2.2	1.9	7.3
End-year 1995	-3.0	0.4	3.5	3.2	2.8	8.4
End-year 1996	-0.7	0.4	3.8	3.4	3.1	9.4
End-year 1997	-2.0	0.5	3.0	2.8	2.4	11.1
End-year 1998	-2.1	0.5	3.0	2.7	2.2	13.3

Source: Goskomstat.

1/ Annual percentage change.

Table 10. Russian Federation: Unemployment Rate by Regions (ILO methodology), 1993-97
(In percent; for 1993-95 and 1997, data are for October; for 1996, data are for March)

	1993	1994	1995	1996	1997
Northern Region					
Karelian Republic	6.9	7.7	11.6	11.3	12.1
Komi Republic	5.1	9.0	11.7	11.2	14.1
Arkhangel'sk Oblast	6.1	10.1	11.3	12.8	13.7
Nenets Autonomous Okrug					13.4
Vologodsk Oblast	3.8	7.2	8.1	8.0	10.1
Murmansk Oblast	7.4	10.3	12.9	15.9	19.5
North-western region					
Saint Petersburg	7.4	9.1	9.8	9.5	9.0
Leningrad Oblast	7.0	10.1	11.0	10.7	13.6
Novgorod Oblast	5.7	7.8	9.3	8.6	13.3
Pskov Oblast	7.4	11.5	11.7	13.8	14.1
Central region					
Bryansk Oblast	4.2	8.0	9.3	8.6	12.9
Vladimir Oblast	5.6	9.6	12.3	11.5	11.5
Ivanovo Oblast	8.2	13.2	14.9	16.8	16.8
Kaluzhska Oblast	4.4	5.1	8.3	8.0	11.1
Kostromska Oblast	7.0	8.5	8.7	9.8	9.2
Moscow	5.2	6.1	5.2	4.9	3.7
Moscow Oblast	5.8	8.2	9.5	9.9	11.0
Orlov Oblast	3.9	5.8	7.2	9.3	9.1
Ryazan Oblast	4.8	6.2	6.4	6.5	10.1
Smolensk Oblast	5.5	6.6	9.6	11.6	12.5
Tver Oblast	3.8	6.6	8.0	5.8	9.9
Tula Oblast	3.9	6.2	5.9	6.6	9.3
Yaroslavl Oblast	5.0	7.9	11.5	10.3	8.5
Volga region					
Marii-El Republic	4.5	8.5	11.2	10.0	16.0
Mordoviya Republic	5.5	7.4	10.3	12.8	11.1
Chuvash Republic	6.1	9.1	9.6	11.0	13.6
Kirov Oblast	6.0	9.6	9.2	9.1	11.4
Nizhegorod Oblast	4.8	6.0	7.8	8.7	9.2
Central-Chernozem region					
Belgorod Oblast	3.4	4.7	5.5	6.3	9.9
Voronezh Oblast	4.1	5.1	7.4	8.8	7.6
Kursk Oblast	3.3	5.7	5.9	7.2	7.5
Lipetsk Oblast	4.6	5.2	6.3	6.7	9.8
Tambov Oblast	5.2	7.0	10.0	11.1	12.2
Povolgski region					
Kalmykiya Republic	9.0	10.9	19.7	12.6	22.5
Tatarstan Republic	3.2	5.8	6.4	6.6	7.7
Astrakhan Oblast	6.5	8.8	13.1	12.4	14.0
Volgograd Oblast	5.1	6.6	10.3	10.4	13.0
Penzensk Oblast	5.4	7.8	12.5	13.9	11.4
Samara Oblast	4.1	5.8	7.3	8.4	9.3
Saratov Oblast	4.8	7.8	9.6	10.0	14.5
Ulyanov Oblast	4.1	5.7	7.8	8.2	10.0

Table 10 (continued). Russian Federation: Unemployment Rate by Regions (ILO methodology), 1993-97
(In percent; for 1993-95 and 1997, data are for October; for 1996, data are for March)

	1993	1994	1995	1996	1997
North-Kaukaz region					
Adygeya Republic	7.3	12.7	11.8	11.0	11.8
Dagestan Republic	14.9	14.7	22.3	23.5	21.6
Ingush Republic			45.2	31.8	52.0
Kabardino-Balkar Republic	10.0	14.8	14.7	16.6	17.1
Karachaev-Circassian Republic	9.3	11.9	24.0	19.9	18.7
North Ossetian-Alaniya Republic	2.8	3.8	24.0	30.3	22.7
Chechen Republic					
Krasnodarsk Krai	6.3	7.8	8.8	10.7	15.6
Stavropol Krai	5.5	5.7	9.2	9.4	13.2
Rostov Oblast	4.7	7.1	8.2	8.1	11.1
Ural					
Bashkortostan Republic	3.7	6.0	7.3	7.9	10.8
Udmurt Republic	5.7	8.3	11.2	12.9	11.8
Kurgan Oblast	5.0	9.0	8.5	9.9	12.4
Orenburg Oblast	3.0	5.6	6.9	5.6	8.9
Perm Oblast	5.4	8.3	8.6	8.5	10.7
Komi-Permyatsk Autonomous Okrug					17.5
Sverdlovsk Oblast	6.0	8.0	8.5	8.9	10.6
Chelyabinsk Oblast	6.0	7.8	8.3	9.2	9.7
West-Siberia					
Altai Republic	8.3	11.6	11.3	12.3	17.7
Altai Krai	5.9	7.5	10.8	10.6	13.7
Kemerovo Oblast	4.7	6.8	6.6	6.9	11.5
Novosibirsk Oblast	6.3	8.0	9.5	9.2	11.0
Omsk Oblast	5.0	6.8	5.2	6.8	12.2
Tomsk Oblast	6.8	9.3	8.5	8.0	11.9
Tyumen Oblast	4.2	6.8	6.1	8.0	10.8
Khanti-Mansi Autonomous Okrug					12.6
Yamalo-Nenetsk Autonomous Okrug					10.7
East Siberia					
Buryat Republic	5.8	9.8	13.7	13.3	19.1
Tyva Republic	6.4	9.8	14.7	13.5	18.9
Khakasian Republic	4.7	6.5	9.6	11.6	13.3
Krasnoyarsk Krai	4.6	8.0	9.0	8.2	12.8
Taimyrsk Autonomous Okrug					7.1
Evenkisk Autonomous Okrug					3.5
Irkutsk Oblast	6.1	8.6	9.2	11.9	13.9
Ust-Ordinsk Buryat Autonomous Okrug					7.7
Chitinsk Oblast	6.0	7.7	10.2	15.6	19.0
Aginsk Buryat A. Okrug					28.2
Far East region					
Sakha republic (Yakutiya)	4.2	5.8	6.4	6.3	11.4
Jewish Autonomous Oblast	6.5	12.7	15.9	13.0	25.1
Chukotsk A. Oblast	1.8	3.6	5.2	...	10.8
Primorye Krai	5.4	7.8	10.7	10.7	13.5
Khabarovsk Krai	7.1	10.1	11.6	12.9	12.8
Amur Oblast	5.4	9.0	12.5	10.9	15.5
Kamchatka Oblast	6.3	10.0	8.5	7.6	12.6
Koryak Autonomous Okrug					6.9
Magadan Oblast	6.1	10.2	10.4	10.5	13.3
Sakhalin Oblast	6.9	8.9	12.7	12.2	15.3
Kaliningrad Oblast	6.2	9.1	9.4	14.8	11.5

Source: Goskomstat.

Table 11. Russia Federation: Unemployment Composition by Duration of Job Search and Age Group, 1996-98

	Job search time (months)						
	Under 1	1-3	3-6	6-9	9-12	12+	Average
	(In percent of total)						
Total unemployed, October 1996	7.4	10.3	26.8	12.3	10.7	32.5	8.2
of which: ages							
Under 20	10.4	13.1	29.2	15.1	12.7	19.6	6.8
20-24	7.1	11.6	28.0	13.3	11.1	28.8	7.8
25-29	8.1	8.4	27.4	10.3	9.3	36.6	8.5
30-34	7.1	10.1	25.5	12.8	8.1	36.3	8.5
35-39	6.8	9.6	27.0	11.9	10.4	34.3	8.4
40-44	5.9	10.3	25.8	12.3	12.2	33.5	8.4
45-49	6.8	8.9	24.9	11.5	11.5	36.4	8.7
50-54	5.5	10.3	24.8	12.6	12.4	34.4	8.6
55-59	6.7	9.1	26.7	10.5	11.2	35.7	8.6
60-64	11.7	12.7	22.6	12.3	3.9	36.9	8.0
65-72	16.3	14.3	35.8	6.5	5.5	21.7	6.0
Total unemployed, October 1997	7.8	15.9	15.8	10.7	11.6	38.1	8.8
of which: ages							
Under 20	11.7	23.2	24.1	10.1	10.8	20.1	6.5
20-24	9.1	19.1	19.9	10.1	10.7	31.1	7.9
25-29	8.6	16.0	15.1	10.2	11.0	39.1	8.8
30-34	7.8	14.9	13.9	10.9	12.4	40.1	9.1
35-39	6.6	14.9	13.2	11.4	11.8	42.2	9.3
40-44	6.6	14.0	14.3	11.9	12.5	40.6	9.3
45-49	5.7	12.2	13.2	11.1	12.4	45.4	9.8
50-54	5.9	11.1	11.7	12.5	12.9	45.9	10.0
55-59	7.1	11.7	13.7	8.7	12.8	45.9	9.8
60-64	6.0	15.9	15.3	6.6	5.4	50.7	9.7
65-72	5.3	12.7	13.3	4.9	10.2	53.6	10.4
Total unemployed, October 1998	6.1	16.0	15.9	10.3	10.8	40.9	9.1
of which: ages							
Under 20	7.6	24.6	27.4	9.2	8.8	22.4	6.7
20-24	7.7	18.9	18.5	10.2	10.3	34.4	8.3
25-29	6.3	15.3	16.5	12.6	10.4	38.9	9.0
30-34	5.2	15.1	13.3	10.5	12.5	43.4	9.5
35-39	5.8	14.1	12.9	10.0	11.0	46.2	9.7
40-44	5.2	13.1	14.4	9.5	10.8	47.1	9.8
45-49	5.5	13.7	13.4	10.1	11.4	45.9	9.7
50-54	4.6	15.4	13.9	8.3	9.2	48.6	9.8
55-59	6.4	16.0	12.5	9.3	10.5	45.3	9.5
60-64	4.6	13.9	15.9	13.4	13.1	39.1	9.3
65-72	6.6	12.7	11.3	7.4	15.0	47.0	10.0

Source: Goskomstat Statistical Bulletin No.9 (48), 1998.

Table 12. Russia Federation: Unemployment by Reason of Being Unemployed, 1992-98
(In percent of total unemployed)

	1992	1993	1994	1995	1996	1997	1998
Total unemployed							
Those who had a previous job	79.9	81.3	83.6	84.9	83.7	88.0	85.9
of which: left the previous employment because of:							
release, redundancy, liquidation	21.0	22.9	28.9	31.6	29.8	34.0	37.1
resignation	34.8	40.4	39.3	38.5	38.4	25.0	22.2
completion of term of temporary, seasonal or contract work	7.0	5.8	4.9	4.6	4.0	4.4	5.3
discharge from military	1.9	1.7	1.3	1.4	1.1	0.9	1.2
other reasons	15.3	10.5	9.2	8.9	10.6	23.7	20.2
Those who have not had a job before	20.1	18.7	16.4	15.1	16.3	12.0	14.1
Total unemployed: male							
Those who had a previous job	80.7	82.1	85.4	85.4	85.6	89.0	86.8
of which: left the previous employment because of:							
release, redundancy, liquidation	14.3	17.2	23.8	27.0	26.0	31.1	34.4
resignation	40.0	45.7	44.5	42.6	42.4	29.5	25.7
completion of term of temporary, seasonal or contract work	7.6	5.4	4.6	4.3	3.7	5.2	5.8
discharge from military	3.4	3.0	2.4	2.4	1.8	1.6	2.1
other reasons	15.4	10.8	10.1	9.2	11.7	21.7	18.9
Those who have not had a job before	19.3	17.9	14.6	14.6	14.4	11.0	13.2
Total unemployed: female							
Those who had a previous job	79.1	80.4	81.6	84.3	81.5	86.8	84.8
of which: left the previous employment because of:							
release, redundancy, liquidation	28.3	29.2	34.8	37.2	34.2	37.5	40.3
resignation	29.1	34.5	33.3	33.5	33.6	19.7	18.0
completion of term of temporary, seasonal or contract work	6.4	6.3	5.1	5.0	4.3	3.6	4.7
discharge from military	0.2	0.1	0.2	0.1	0.2	0.1	0.1
other reasons	15.2	10.2	8.2	8.4	9.2	25.9	21.6
Those who have not had a job before	20.9	19.6	18.4	15.7	18.5	13.2	15.2

Source: Goskomstat.

1/ As of end October 1997.

Table 13. Russia Federation: Distribution of the Unemployed by Job Search Methods, 1992-98
(In percent of total)

	1992 Oct.	1993 Oct.	1994 Oct.	1995 Oct.	1996 May	1997 Oct.	1998 Oct.
Application to the state employment service	28.1	28.3	34.4	37.6	39.0	39.9	37.2
Application to a commercial employment service	1.0	3.1	3.7	4.0	4.2	2.4	2.4
Placing ads in papers, responding to ads	8.7	13.6	15.6	15.7	17.6	16.3	18.6
Contacting friends, relatives, acquaintances	29.9	36.7	37.8	36.7	37.0	55.0	57.8
Directly contacting the management/employer	26.3	30.9	29.0	28.1	25.6	28.8	29.5
Search for land, machines and equipment, raw materials, financial resources for starting own business, applying for licenses, etc.	1.8	1.9	1.4	1.2	0.9	1.1	1.0
Other methods	9.0	12.9	12.0	14.0	14.3	14.7	15.6

Source: Goskomstat.

Table 14. Russian Federation: Migration Between the Regions of Russia, 1989-98
(In thousands)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1992-98	
											Total	Total as percent of population 1/
Northern Region	-9.5	-13.2	-39.2	-45.6	-37.5	-40.8	-25.3	-24.3	-30.4	-31.7	-235.6	-3.9
Karelian Republic	0.5	0.8	0.4	0.9	-0.7	1.6	1.8	0	0.2	-0.2	3.6	0.5
Komi Republic	-5.6	-7.8	-15.7	-11.9	-15.1	-22.3	-12.1	-9.1	-11.1	-10.6	-92.2	-7.4
Arkhangel'sk Oblast	-4.8	-3.4	-9.2	-7.6	-5.4	-3.5	-4.8	-6	-7.6	-7.7	-42.6	-2.8
Vologodsk Oblast	0	-0.2	1.5	4.1	6.3	4.3	5.5	4.2	3	2.6	30.0	2.3
Murmansk Oblast	0.4	-2.6	-16.2	-31.1	-22.6	-20.9	-15.7	-13.4	-14.9	-15.7	-134.3	-11.7
North-western region	12.4	19.1	-6.6	-3.9	7.4	47.8	40.3	41.5	28.2	34.3	195.6	2.5
Central region	91.1	7.8	9	61.5	113.2	216.2	166.2	138.5	139.3	13.9	848.8	3.0
Volga region	-8.6	-1.5	4.3	22.2	26	50.8	31.6	21.7	19.9	18.7	190.9	2.3
Central-Chernozem region	12.4	23.2	26.3	80.1	91.8	102.4	62.6	53.2	38.8	37.6	466.5	6.3
Povolgski region	20.7	40.1	33.4	104.4	131.2	167.2	104.7	62.9	67.3	59.3	697.0	4.3
North-Kaukaz region	19.7	78.6	149.5	103.1	143	167.3	86.4	35.2	36.5	26.7	598.2	3.5
Ural	-39.4	-23.1	-4.1	36.6	41.3	123.6	74.4	49	66.8	54.5	446.2	2.2
West Siberia	6.1	-2.2	-32	-8.2	26.3	112.2	49.7	30.4	64.3	34.3	309.0	2.1
East Siberia	-25	-24.5	-28.6	-36.2	-22.6	-7.3	3.9	-7.7	-21.4	-20.6	-111.9	-1.2
Far East region	-0.2	-9.6	-66.1	-150.4	-101.1	-147.8	-102.8	-65	-69.7	-64.6	-701.4	-8.8
Sakha republic (Yakutiya)	1.6	-4.5	-28.4	-27.9	-20.4	-30.9	-18.7	-12	-17.2	-19.7	-146.8	-12.8
Jewish Autonomous Oblast	0.3	0.1	-0.1	-2.6	-1.4	-5.5	-1.4	-1.8	-1.8	-1.9	-16.4	-7.5
Chukotsk A. Oblast	-3.6	-3.7	-9.3	-22.2	-11.5	-13.6	-9.3	-5.2	-4.7	-4.0	-70.5	-45.8
Primorye Krai	7.6	6	1.9	-7.9	-7	-5.4	-9.4	-9.4	-11	-4.2	-54.3	-2.4
Khabarovsk Krai	1.2	-0.3	-2.9	-13.7	-8.3	-14.8	-10.9	-7.5	-5.3	-6.3	-66.8	-4.2
Amur Oblast	-0.4	-0.7	-4.1	-15.2	-4	-13.6	-1.1	-3.9	-5.7	-6.2	-49.7	-4.7
Kamchatka Oblast	0.1	0.1	-3.6	-16.6	-16.5	-15	-11.7	-7	-7	-6.4	-80.2	-16.8
Koryak Autonomous Okrug	-0.3	0	-0.5	-1.9	-2.3	-1.6	-0.9	-0.6	-1	-1.0	-9.3	-23.2
Magadan Oblast	-5.2	-6.7	-18.7	-38.1	-18.9	-26.8	-20.4	-6.6	-5.4	-6.0	-122.2	-33.2
Sakhalin Oblast	-1.8	0.1	-0.9	-6.2	-13.1	-22.2	-19.9	-11.6	-11.6	-10.0	-94.6	-13.5
Kaliningrad Oblast	3.2	6.3	5.7	12.5	11.1	18.4	10.5	8.2	13	13.0	86.7	10.0

Source: Goskomstat.

1/ Total as percent of regional population at end-1991.

Table 15. Russian Federation: Consumer Price Inflation, 1992-98 1/

		Overall CPI	Food 2/	Nonfood 3/	Paid Services 4/
		(Percentage changes from December to December)			
1992		2508.8	2526.2	2573.4	2120.5
1993		839.9	804.9	641.8	2311.2
1994		215.1	214.1	169.0	522.4
1995		131.3	123.4	116.3	232.2
1996		21.8	17.7	17.8	48.4
1997		11.0	9.1	8.1	22.5
1998		84.4	96.9	99.5	18.3
		(Monthly percentage changes)			
1997	Jan	2.3	3.1	1.0	2.3
	Feb	1.5	1.4	0.6	3.6
	Mar	1.4	1.4	0.8	2.5
	Apr	1.0	1.0	0.5	1.6
	May	0.9	0.8	0.6	2.0
	June	1.1	1.5	0.5	1.0
	July	0.9	0.8	0.4	2.3
	Aug	-0.1	-0.9	0.6	1.1
	Sep	-0.3	-1.4	0.8	1.2
	Oct	0.2	-0.5	0.9	1.2
	Nov	0.6	0.4	0.7	1.1
	Dec	1.0	1.2	0.6	0.7
1998	Jan	1.5	2.1	0.5	1.7
	Feb	0.9	1.2	0.3	1.0
	Mar	0.6	0.7	0.2	1.2
	Apr	0.4	0.3	0.2	1.0
	May	0.5	0.6	0.1	1.1
	June	0.1	0.0	0.0	0.6
	July	0.2	-0.1	0.1	1.2
	Aug	3.7	2.4	7.1	1.2
	Sep	38.4	39.5	54.3	3.4
	Oct	4.5	3.9	7.4	1.6
	Nov	5.7	7.6	4.3	1.3
	Dec	11.6	17.1	6.3	1.8
1999	Jan	8.5	10.4	6.4	4.1
	Feb	4.1	4.4	3.9	3.1
	Mar	2.8	2.8	3.2	1.9
	Apr	3.0	2.6	4.0	3.1
	May	2.2	2.0	2.7	2.1
	June	1.9	...	...	...

Source: Goskomstat.

1/ The Russian authorities have discontinued the practice of publishing average monthly inflation rates since November 1994. Data reported in this table, since December 1994, are on an end of period basis.
2/ Includes food, beverages, and tobacco.
3/ Includes clothing and footwear, household goods, medicines, recreation, education, and culture, and personal care and effects.
4/ Includes rent, water, fuel and power, transport, and communication.

Table 16. Russian Federation: Industrial Producer Prices, 1991-98

	Overal PPI Index	Electricity	Fuel	Ferrous Metallurgy	Chemicals	Machinery	Construction Materials	Light Industry	Food Industry
				(Percentage changes from December to December)					
1991	236	110	129	237	165	212	215	371	314
1992	3,278	5,409	9,166	3,525	3,791	2,621	2,714	1,158	2,628
1993	895	1,258	634	1,086	848	949	1,169	681	1,229
1994	233	229	201	242	262	230	212	241	208
1995	175	199	187	185	168	178	171	163	156
1996	126	35	40	16	18	24	34	20	22
1997	7	9	11	1	5	9	9	10	12
1998	23	3	1	12	26	29	13	44	53
				(Monthly percent changes)					
1997 Jan	1.1	1.4	1.6	0.0	1.2	0.8	0.8	1.1	1.8
Feb	1.6	2.5	2.3	0.2	1.7	1.5	1.9	1.4	2.0
Mar	1.3	1.3	2.6	0.7	0.8	0.7	0.8	0.7	1.3
Apr	0.8	0.6	1.3	-0.1	0.6	1.0	0.8	1.4	1.1
May	0.5	-0.2	0.8	0.2	0.4	0.5	0.9	0.8	1.0
Jun	0.8	1.4	0.6	0.9	2.7	0.8	0.3	0.4	0.4
Jul	0.2	1.4	-0.7	-0.4	0.3	0.4	0.5	0.4	0.1
Aug	0.5	-0.9	0.7	0.1	2.8	0.6	0.4	0.5	0.4
Sep	0.1	-0.1	0.7	-0.6	0.1	0.2	0.3	0.7	0.8
Oct	0.1	1.3	-0.3	0.3	-0.2	1.2	0.4	1.3	0.7
Nov	0.2	-1.0	0.6	1.4	-3.0	0.5	0.4	0.6	0.7
Dec	0.0	0.6	0.5	-1.4	-2.4	0.2	0.7	0.5	0.8
1998 Jan	0.9	1.2	1.1	0.4	1.1	0.9	1.0	1.0	0.9
Feb	0.5	0.5	0.0	0.5	-0.8	1.2	0.6	0.9	0.3
Mar	-0.1	-0.3	-0.7	0.8	-1.2	0.4	0.4	0.6	0.4
Apr	0.0	1.7	-1.9	0.5	-1.0	0.4	0.6	0.3	-0.1
May	-0.9	-1.8	-3.4	-1.0	0.8	0.7	0.0	0.1	-0.2
Jun	0.0	1.0	-1.6	0.1	0.5	0.4	0.1	0.1	-0.5
Jul	-0.8	0.1	-4.9	1.0	0.6	-0.1	0.3	-0.2	-0.2
Aug	-1.2	-2.1	-5.6	-1.7	-0.3	0.1	0.3	0.2	-0.2
Sep	7.4	1.2	1.8	2.4	8.3	8.6	3.6	10.5	21.1
Oct	5.9	1.4	5.3	2.9	7.5	3.8	2.7	9.2	5.1
Nov	5.1	-0.9	7.3	1.9	4.5	5.9	1.0	8.2	7.6
Dec	4.8	-0.5	4.2	3.2	3.9	4.1	1.6	7.3	11.3
1999 Jan	6.9	1.3	5.3	6.2	4.9	8.5	3.1	7.8	9.2
Feb	5.5	3.8	2.9	4.9	3.5	5.8	1.6	8.3	8.7
Mar	3.9	0.3	3.6	7.6	3.7	3.3	1.9	5.4	6.3
Apr	3.6	0.9	3.6	4.4	4.0	3.6	1.6	2.6	4.2
May	3.5	...	...	...	...	...	...	...	...

Source: Goskomstat.

Table 17. Russian Federation: Wages, Pension and Per Capita Income, 1991-98 1/

	1991	1992	1993	1994	1995	1996	1997	1998
				(In new rubles)				
Average wages	1	6	59	220	472	790	950	1,095
Minimum wages	0	1	15	21	61	73	76	83
Pensions		2	20	79	188	302	328	399
Income per capita	6	48	538	2,476	6,365	9,338	11,064	11,682
				(Annual percentage change 2/)				
Real wages	...	-40	0	-8	-28	13	5	-10
Minimum wages	...	-73	67	-66	-1	-19	-9	-14
Pensions	...	...	28	-3	-19	9	-5	-5
Real income per capita	...	-53	16	13	-14	-1	3	-17

Source: Goskomstat and staff calculations

1/ Wages and pensions are monthly figures. Income refers to annual figure.
2/ Nominal numbers deflated by CPI.

Table 18. Russian Federation: Wage Arrears in Industry, Agriculture, and Construction, 1992-98

	Industry		Agriculture		Construction	
	Nominal 1/	Real 2/	Nominal 1/	Real 2/	Nominal 1/	Real 2/
End year 1992	15	3.6	6	1.4	9	2.2
End year 1993	364	9.2	287	7.2	168	4.2
End year 1994	2,170	17.4	1,301	10.4	868	7.0
End year 1995	7,734	26.8	2,572	8.9	1,941	6.7
End year 1996	22,149	63.1	5,913	16.8	6,183	17.6
End year 1997	26,607	68.3	7,965	20.4	7,069	18.1
End year 1998	30,826	79.1	9,234	23.7	8,992	23.1
1997 Jan	22,930	63.8	6,088	16.9	6,696	18.6
Feb	24,013	65.9	6,159	16.9	6,554	18.0
Mar	24,941	68.4	6,240	17.1	6,840	18.8
Apr	25,367	67.9	6,110	16.4	6,774	18.1
May	25,902	68.7	6,165	16.3	6,674	17.7
Jun	26,508	69.5	6,583	17.3	6,710	17.6
Jul	27,077	70.3	6,942	18.0	6,760	17.6
Aug	27,463	71.4	7,268	18.9	6,765	17.6
Sep	27,565	71.9	7,742	20.2	7,056	18.4
Oct	27,491	71.6	8,149	21.2	7,253	18.9
Nov	27,758	71.9	8,193	21.2	7,333	19.0
Dec	26,607	68.3	7,965	20.4	7,069	18.1
1998 Jan	26,725	67.5	8,285	20.9	7,597	19.2
Feb	28,213	70.7	8,393	21.0	7,403	18.5
Mar	29,331	73.0	8,388	20.9	7,499	18.7
Apr	30,442	75.5	8,331	20.7	7,668	19.0
May	32,073	79.1	8,504	21.0	7,985	19.7
Jun	33,473	82.5	8,848	21.8	7,550	18.6
Jul	34,936	86.0	9,240	22.7	8,363	20.6
Aug	37,436	88.8	9,645	22.9	8,993	21.3
Sep	39,264	102.5	9,909	25.9	10,095	26.3
Oct	35,103	91.5	9,848	25.7	9,712	25.3
Nov	34,067	88.2	9,561	24.8	9,571	24.8
Dec	30,826	79.1	9,234	23.7	8,992	23.1

Source: Goskomstat.

1/ In millions of rubles.

2/ In constant March 1992 prices, deflated by CPI.

III. PUBLIC FINANCES

53. **Since 1995, Russia has had only limited success in achieving its main fiscal policy objectives, which have been a reduction in the unsustainably high deficit, a reversal of the prolonged decline in revenues, and a reduction in the size of government and in unproductive expenditures.** The enlarged government primary deficit rose from 2½ percent of GDP in 1995 to 3 percent in 1996 and to 3½ percent in 1998, and the overall deficit increased from 6 to 8 percent of GDP during the same period (Table 19).[11] [12] At the same time, revenues of the enlarged government declined from 33 percent of GDP in 1996 to 31.7 percent of GDP in 1998, while expenditures remained relatively constant at about 40 percent of GDP. At the federal level, the primary deficit rose from 2.2 to 2.4 percent of GDP between 1995 and 1997, but decreased to 1.3 percent of GDP in 1998, as revenues declined from almost 13 percent of GDP in 1995 and 1996 to 10.7 percent in 1998 (Table 20). While the size of the enlarged government (as measured by the share of government expenditures in GDP) has remained relatively stable since 1995, there has been a notable shift in government expenditures from the federal level to local and regional governments. Thus although federal noninterest spending has declined significantly as a share of GDP, only minimal success has been achieved in reducing unproductive spending and controlling expenditure commitments, with the result that attempts to reduce cash spending have generated sizable expenditure arrears.

A. Overview 1996–99

54. **The government's economic program for 1996 envisaged a consolidation of the fiscal position, but the actual outcome fell short of expectations.** Spending pressures were carried over from the previous year, there was a further marked decline in cash revenues, and interest rates surged in the second quarter due to uncertainty surrounding the approaching Presidential election. Although the federal government primary balance was contained to approximately its 1995 levels on a cash basis, the overall federal deficit grew by 2.7 percent of

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[11]The public sector in Russia encompasses several levels of government, including the federal government, and local and regional governments. The enlarged government concept includes, together with a consolidation of these levels of government, a number of extrabudgetary funds. There are four primary social extrabudgetary funds that are included in the definition of the enlarged government: the Pension Fund, the Social Insurance Fund, the Employment Fund and the Medical Insurance Fund.

[12]There are some difficulties in comparing fiscal outcomes over time. Owing to the lack of data on arrears, the enlarged government deficit was measured on a cash basis prior to 1997. In 1997, a partial move to a commitments based measure was made, as wage and pension arrears were included as spending. In 1998, all federal budgetary arrears and local arrears for wages and pensions were included as expenditure.

GDP, to 8.4 percent of GDP, as a result of increased interest payments. The enlarged government deficit was slightly higher due to a small deficit at other levels of government. Further, tight control over cash spending led to an accumulation of federal arrears on wages, obligations to the Pension Fund and goods and services expenditures, including for energy consumption.

55. **In 1997, plans to address the underlying fiscal imbalance were again not fulfilled.** Despite the first signs of recovery in the real economy, revenues continued to languish, and in October 1997, the budget began to suffer from the fallout of the Asia crisis, in particular owing to increasing interest rates. By diverting financing to cover the growing interest bill, the government incurred new arrears, reversing gains made earlier in the year. Cash revenues fell in the fourth quarter, in anticipation of a year-end offset operation (see below) while noninterest spending jumped. The federal government primary deficit for 1997 as a whole remained largely unchanged compared to the previous year, while the overall deficit declined to 7 percent of GDP. The reduction in interest payments as a share of GDP for that year reflected a large decline in the beginning of the year before the onset of the Asia crisis. As in 1996, the enlarged government deficit was slightly higher than that of the federal government due to a small deficit on local budgets.

56. **During the first half of 1998, government interest payments rose sharply and revenues continued to fall short of expectations.** There was, however, some success in reducing noninterest expenditure commitments. For the second half of 1998, events were largely shaped by the August crisis. Federal government cash revenues plummeted to unprecedented levels in the third quarter, reaching 7 percent of GDP. While cash revenues recovered slightly in the fourth quarter, as the payments system began functioning again, compliance remained low. Despite the economic crisis, the primary balance of the federal government (on a commitments basis) was reduced from 2.4 percent of GDP in 1997 to 1.3 percent of GDP, reflecting the improved expenditure control as well as a continued shift of expenditures from the federal level to the regions (see below). Due to this latter development, local wage arrears increased by ½ percent of GDP, while pension arrears rose by about 1 percent of GDP. The enlarged government's overall deficit ended the year at 8 percent of GDP, a slight increase over the previous year.

57. **Fiscal policy has been reasonably tight through the first quarter of 1999.** Federal cash revenues rebounded to over 10 percent of GDP compared to 8.4 percent in the fourth quarter of 1998, partly due to a determined effort to improve tax compliance. A number of endogenous factors have also contributed to the improved revenue performance. These include the output recovery in the wake of the large ruble depreciation, which has also boosted tax revenues. The revenue situation has also been helped by the improvements in the external terms of trade occasioned by higher oil prices on world markets, which increased the tax base of the energy sector. Expenditures were restrained in the first two months of 1999—largely reflecting the fact that spending was limited to 1/12 of the previous year's nominal levels prior to the passage of the 1999 budget—but spending increased significantly

in March. The primary deficit was 1.1 percent of GDP, allowing CBR financing to be limited primarily to covering debt service. The overall federal deficit was 7.8 percent (commitments basis), while the enlarged government deficit was somewhat lower, at 6.5 percent of GDP, reflecting a surplus for the Pension Fund.

B. Key Features of 1996–99 Developments

Federal government revenue performance

58. The revenue problem in Russia is deeply entrenched. The authorities did not succeed in reversing the sharp reduction in revenues that had taken place since the beginning of transition. Cash revenues of the federal government, in fact, declined by a further 0.2 percent of GDP during 1996–98 (Figure 13). **This decline reflects a number of fundamental factors, but perhaps most importantly, continued recourse to nonmonetary fiscal operations or tax offset schemes** (see Box 2). These operations arose in the context of the need to settle mutual claims between the budget and taxpayers, but have evolved over the years into various arrangements that have generally exacerbated the government's problems of collecting tax revenues in cash and meeting budgetary obligations in a timely manner. Often arrears are accumulated as a means of forcing the government to purchase the goods and services supplied by tax delinquent enterprises, thereby contributing to nontransparent and inefficient expenditures as well as the overpricing of goods and services sold to government. Given the implicit discount that inevitably accompanies these arrangements, they have also effectively operated as a rolling partial tax amnesty that has had an adverse impact on tax payment discipline. These schemes have also presented opportunities for corruption, and engender a general belief among taxpayers that the central government is incapable of enforcing statutory tax obligations.

59. **Other factors have contributed to weak tax administration in Russia. Large taxpayers routinely negotiate their tax payments, essentially independent of the statutory tax liability, and the audit and investigation functions of the tax authorities are weak.** Taxpayer compliance has also been eroded by complex and contradictory tax laws, high marginal tax rates (particularly on labor income), the growing problem of nonpayments throughout the economy, and endemic corruption among both taxpayers and tax collectors.

60. **A number of reforms have been attempted to address weaknesses in tax administration capacity**. In 1996, several measures were put in place, including the introduction of large taxpayer inspection units, limits on tax deferrals, and the elimination of import exemptions. However, these measures have had little impact on tax collections, owing to inadequate implementation as well as the more fundamental problems noted above. In the absence of improved taxpayer compliance, the elimination of a number of taxes—in an effort to simplify and enhance the efficiency of the tax system—contributed to

Box 2. Nonmonetary and Offset Arrangements in the Russian Federation

Nonmonetary or offset fiscal operations arose in Russia in the context of the need to settle mutual claims between the budget and taxpayers. Various offset or nonmonetary arrangements have evolved since 1994, with new forms typically following on commitments to cease previously existing mechanisms. In general, these schemes have (i) provided for discounts which effectively operate as a rolling partial tax amnesty that, in turn has had a serious adverse impact on taxpayer discipline, (ii) exacerbated the government's problems of meeting cash obligations in a timely manner, while distorting expenditure patterns, and (iii) led to overpricing of goods and services delivered to the government.

1994—The use of nonmonetary fiscal operations began in the fourth quarter of 1994 when the authorities attempted to close the budget year and clear large mutual tax and spending arrears with Treasury obligations—*kaznacheskie obyazatel'stva* or KOs. The instruments carried below-market interest rates, and the holder knew from the outset that they would be allowed to use them to pay taxes on maturity. On maturity, the holder was offered the choice of receiving cash or a *treasury tax offset* (KNO) which could be presented to the tax authorities to extinguish tax obligations. Two features encouraged holders of maturing KOs to accept KNOs: (i) cash was not always available; and (ii) the prospects of early redemption of KOs allowed for an implicit tax liability discount.

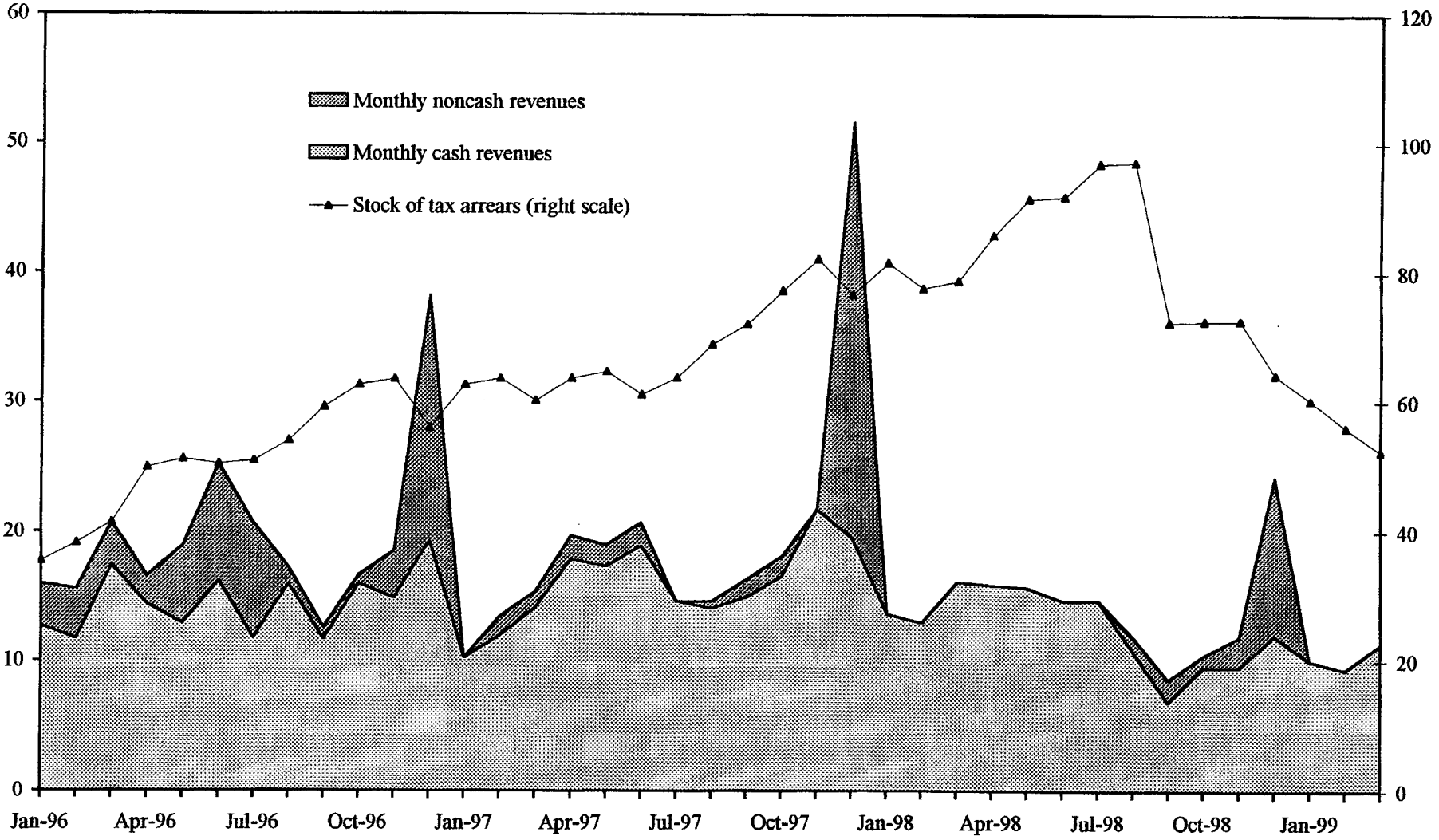
1995—KOs were slowly phased out in 1995. For the year as a whole, 1¼ percent of GDP in KOs were issued. Of the Rub 22 billion of KOs maturing during the year, Rub 15 billion in KNOs were issued to cover taxes.

1996—The government began to issue KNOs directly to pay for budgetary arrears. During 1996 Rub 44 billion in KNOs were issued and although the original intention was to use the KNOs to settle mutual arrears, firms were allowed to acquire tax arrears needed to participate in offset chains. The transaction costs of acquiring these tax arrears by firms which had a claim on the budget inevitably led to an overpricing of goods and services delivered to the budget. The use of KNOs was discontinued in September 1996, but in October, monetary offsets (MOs) were introduced whereby a commercial bank would lend money to a tax debtor who would use the funds to pay their tax arrears into a Treasury account held at that same bank. This money would be precommitted to make payments, through the same bank, for a budgetary arrear and the same money would then be used by the budget recipient to clear a chain of interenterprise arrears ending finally in payment to the tax debtor and repayment of the bank loan. Because this arrangement depended on a predetermined chain of offsets it had the effect of distorting government expenditure patterns, and limiting the ability of the government to meet other cash expenditures, such as wages. In the fourth quarter of the year Rub 26 billion of MOs were conducted to clear budgetary and tax arrears.

1997—During the first eight months of 1997 MOs continued. The low revenues of the third quarter led to the introduction of a new offset scheme in the fourth quarter—the so-called reverse monetary offsets (RMOs)—which were similar to the MOs except that the initiating transaction was a payment from the budget for its spending arrears rather than from the tax debtor. The government would establish a chain from budget arrears through a number of enterprises (each with arrears to the other) and finally to a tax debtor. From the end of 1997 to January 1998 Rub 58 billion of RMOs were conducted.

1998—Offset operations were resisted for the first half of 1998, bolstered by a Presidential Decree prohibiting all such noncash arrangements. In September "targeted financing" (TF) was introduced. In much the same way as RMOs, accounts were opened for all participants in an offset chain and monies were credited and debited from their accounts eliminating arrears as they went. The only difference, was that the accounts were opened under the auspices of the Federal Treasury. By year-end, Rub 25 billion in offsets were conducted, with the practice continuing in the first few months of 1999.

Figure 13. Russian Federation: Cash and Noncash Federal Revenues, January 1996-March 1999
(In billions of constant December 1995 rubles)



a reduction in revenue as a share of GDP in 1996.[13] In response to these developments, in October 1996, the government established the Emergency Tax Commission headed by the Prime Minister, which was intended to tackle the problem of large tax debtors, including by initiation of bankruptcy proceedings against the worst offenders. The Tax Commission again had only a limited effect on overall tax compliance, in part because actions against several large tax debtors, including bankruptcy and seizure of assets, did not have sufficient political support. More recently, additional steps have been taken to enhance tax administration, including improving collection enforcement of the VAT through the mandatory use of tax invoices; enhancing the effectiveness of tax audit operations by modernizing audit selection criteria and audit techniques; and increasing the effectiveness of alcohol excise taxation by improving legislation to strengthen licensing controls.

61. **An adequate commitment from the highest levels of government will play a critical role in any future undertaking to improve tax collections**. To demonstrate this commitment the Duma, in July 1999, passed a number of key amendments to Part I of the Tax Code. Among the changes are the following: increasing the powers of the tax authorities by eliminating the need for the Ministry of Taxation to use the already over-burdened court system and giving the authorities the ability to issue liens on bank accounts of delinquent taxpayers; introducing legal sanctions against tax agents who fail to deposit withheld taxes in a timely fashion; eliminating the ceiling on interest accruals on overdue taxes, as well as the ceiling on the interest rate; extending deadlines for collection orders; and introducing stronger penalties and sanctions for failures to file tax invoices, filing of false invoices or bookkeeping practices in violation of the law. Nevertheless, there is still a need to improve the management and organization of the tax authorities, strengthen the capacity to monitor and enforce collections from large taxpayers, and implement an appropriate tax identification system.

Federal government expenditures

62. **Federal government spending has declined dramatically from the high levels of the Soviet era**.[14] Reductions in noninterest expenditures have been particularly striking, with a decline from 26 percent of GDP in 1992 to 15 percent of GDP in 1996, and to 12 percent by 1998. These reductions were concentrated in spending on defense, subsidies to industry and agriculture, and net lending (mainly to Northern regions, agriculture and industry). A further rationalization of the structure of the federal government would require a comprehensive public expenditure review, which would allow for a prioritizing of spending and a reduction in the large number of federal employees. This would help prevent unplanned in-year

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[13]The taxes eliminated include the excess wage tax, VAT surcharge, and export duties on oil and gas.

[14] The information available on federal government expenditures is of poor quality and makes analysis extremely tentative; an example of this is the lack of an economic classification of the fiscal outturn or a concrete time series on expenditure commitments and budgetary arrears.

expenditure cuts via sequestration and across-the-board spending reductions. In recent times such practices have contributed to large expenditure arrears. While the expenditure reduction program begun in 1998 has gone some way toward addressing these shortcomings, implementation appears to have been far from complete.

63. **The lack of action in further rationalizing federal expenditures has been compounded by shortcomings in the Treasury system.** While the Federal Treasury has made progress in the past year in expanding its control over an increasing share of government activity, it still does not encompass the military (which accounts for ¼ of expenditures in the 1999 budget) and the Ministry of Finance does not yet have in place an effective mechanism for controlling (or even measuring) expenditure commitments.[15] Further, these problems have been exacerbated by the fact that suppliers, particularly in the energy sector, have not denied goods to those spending units that do not pay, and by the proliferation of nontransparent off-budget practices.[16]

64. **Less progress has been made in reducing government absorption than is suggested by cash spending estimates.** In 1996, arrears in federal transfers to the Pension Fund increased to ¾ percent of GDP, and significant delays on payments for goods and services were experienced. In addition, throughout the year, off-budget activities were conducted that were not captured by the Treasury reports on cash spending.[17] At the same time, interest payments increased rapidly from 2 percent of GDP in 1994 to an average of 5 percent of GDP in 1996–98.

65. **Attempts to reduce arrears and control expenditure commitments in 1997 met with mixed results.** The government was successful in early 1997, virtually eliminating federal wage and pensions arrears in the first half of the year. However, due to insufficient action in reducing government programs and in downsizing the defense and security ministries, arrears were building in these areas. Towards the end of the year, the government did begin taking significant steps to control expenditure commitments, and publicly announced

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[15]The 1999 budget law does, however, specify that contracts signed by spending units in excess of their budgetary limits will not be legal obligations of the federal government. In addition, the Treasury is working on a mechanism to pre-register contracts.

[16] For example, spending units used self-generated funds to finance their activities and the federal government undertook a number of government guarantees on commercial bank loans to suppliers that eventually had to be honored.

[17]The two clearest examples of this were expenditures financed by the issuance of guarantees against commercial bank borrowing—amounting to a further ½ percent of GDP by year-end—and spending funded by profits from oil exports executed under state contracts—which are estimated at ¼ percent of GDP.

Rub 40 billion in expenditure reductions to take place in 1998, including a reduction in civil service employment, and physical limits on energy consumption.

66. **Building on this plan, there were continued efforts in 1998 to reduce domestic absorption through an intensified focus on reducing spending commitments rather than on simply limiting cash expenditures**. In April, limits were placed on ministerial expenditures and each ministry was required to submit a plan to achieve these limits. To bolster the Ministry's control over spending units, the Treasury was expanded to cover all spending by nondefense ministries. For the first half of the year, some effect was felt from the expenditure reduction plan, as commitments declined.

67. **Immediately following the August crisis in 1998, the lack of financing caused a sharp decline in cash spending, which fell from an average of Rub 21 billion per month in the first half of the year to Rub 12 billion in August.** Consequently, federal spending arrears began to grow rapidly, increasing by Rub 22 billion or 3¼ percent of period GDP in the third quarter alone. In the final quarter of the year, civilian arrears stabilized and wage and defense arrears actually fell, financed primarily by recourse to borrowing from the CBR as well as with funds from the sale of Gazprom shares. The year ended with federal noninterest spending reaching 11½ percent of GDP. In the first quarter of 1999, federal noninterest spending was initially limited by the lack of an approved budget, but accelerated in March, ending the quarter at 11.4 percent of GDP, slightly lower than the same period of 1998.

The regional and local budgets

68. **The period since the transition process began has been characterized by a gradual shift of expenditure responsibilities to local and regional governments.** These included the shifting from the federal government of the payment of child allowances and some education expenditures, as well as a transfer from enterprises of the responsibility for the provision of housing and utilities and other divested "social assets." Increased expenditure assignments were initially accompanied by increased transfers, but later were shifted as unfunded mandates.

69. **The fiscal position of the regional and local budgets has slowly deteriorated along with the federal budget finances.** The consolidated fiscal balance of local and regional budgets, on a cash basis, gradually moved from a surplus of ½ percent of GDP in 1994 to a deficit of ¾ percent of GDP in 1997 and 1 percent of GDP in 1998 (Table 21).[18] These deficits were financed largely from the issuance of promissory notes ("*veksels*") and other local debt instruments although, in 1997, the deficit was also partially financed by loans extended to the regions from the federal budget. In the second quarter of 1997 some of the

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[18] Ministry of Finance data presented here capture only a partial picture of local budget activities. Many local budgets are characterized by a proliferation of off-budget and extrabudgetary funds that are not accounted for in official statistics.

more fiscally sound regions began to gain access to foreign capital markets and proceeded to issue Eurobonds to finance their budget expenditures.[19]

70. **This loosening of the financial constraints on some regional budgets, along with a substantial rise in regional and local revenues, allowed regional spending to rise in 1997.**[20] By the end of the year, however, access to foreign financing had dried up and regions were again constrained by the limited domestic financing that was available. However, the federal government made available Rub 19 billion (¾ percent of GDP) in loans to regions in order to clear local wage arrears which had become a sensitive political issue. By end-year, government wage arrears at both local and regional levels fell to almost zero although arrears on non-wage spending amounted to around 1 percent of GDP.

71. **The improvement in local and regional revenue was short-lived, however, and with a decline in federal transfers and in the absence of financing sources, cash spending fell across-the-board in 1998**. Cash sequestration caused an increase in arrears both on local government wages (which ended 1998 at 0.6 percent of GDP) and on goods and services (which totaled 2¾ percent of GDP by December 1998). This accumulation of arrears also reflected further shifting by the federal government of expenditure items to the local level without provision of commensurate revenues.[21]

Social extrabudgetary funds

72. **The four main social extrabudgetary funds have seen a deterioration in their financial position since 1992.** Revenues of these social funds, including transfers from the federal budget, declined from 11 percent of GDP in 1992 to a low of 8 percent of GDP in 1995–96 before rebounding somewhat; in 1998, revenues stood at 8.4 percent of GDP. (Table 22). Over the same period, the combined balance of the social funds fell from a financial surplus of 2½ percent of GDP to a deficit of 1 percent of GDP. This has left a benefit system that is nontransparent, poorly targeted, and increasingly unable to provide basic social support for the most exposed segments of Russian society. Moreover, despite real benefits being significantly reduced during the period, the dramatic decline in revenues has resulted in continued accumulation of arrears on pension payments.

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[19] In June, the Moscow city government issued a $500 million Eurobond followed in July by a $300 million issue by St. Petersburg and a $100 million issue by Nizhny Novgorod.

[20]It is not clear, however, the extent to which the improvement in revenue was a result of increased offset activity as opposed to a genuine improvement in cash collections.

[21]For example, the Ministry of Railways divested 115 secondary schools and 20 medical organizations to regional budgets in 1998 without any corresponding increase in funding.

73. **The Pension Fund suffers from a number of structural problems that have contributed to a worsening financial situation over 1996–98.**[22] These factors include a shrinking payroll tax base (as employers move toward non-wage forms of payment) and a steady decline in payroll tax compliance; an increase in the dependency ratio from 50 percent in 1993 to 58 percent in 1998; and insufficient transfers from the Federal budget to cover the costs of social pensions. Moreover, problems have been exacerbated by occasional Duma-mandated increases in pensions (for example in July 1997) that have not been accompanied by measures to improve the financial position of the Pension Fund.

74. **These financial difficulties have been manifested in the form of pension arrears rather than in a cash deficit, as the Pension Fund has been constrained in its ability to borrow from the banking system**. By end-1996, these arrears stood at Rub 16 billion (around 1½ months of benefits or ¾ percent of GDP). Arrears varied greatly by region, with those in some wealthier regions near zero while other regions had not been paid benefits for several months. During 1997, social pressures became acute and the federal budget transferred Rub 23 billion (0.9 percent of GDP) to the Pension Fund to clear arrears. This effort was successful and by mid-year the stock of arrears was eliminated. The Pension Fund ended the year with a small surplus on a cash basis and a ¾ percent of GDP surplus on a commitments basis.

75. **In 1998, the finances of the Pension Fund were adversely affected by benefit increases early in the year, and the economic crisis in August.**[23] In February 1998, a new formula was introduced for calculating pensions whereby pensioners could choose to either receive benefits based upon a statutory formula or have their benefits calculated on the basis of an "individual pension coefficient" that links their pension to their wage history and the increase in the economy-wide average wage. This change proved more costly than anticipated, despite a modification limiting indexation to the average wage implicit in the level of payroll tax collections.[24] In the first half of the year, payroll tax collections averaged a little over Rub 11 billion per month while, at the same time, pension benefits were nearer Rub 15 billion per month; by July, the Pension Fund had exhausted all its financing options (such as the drawdown of commercial bank deposits) and pension arrears rose to Rub 16 billion. In August and September, following the onset of the economic crisis, payroll taxes fell further to about Rub 10 billion and arrears doubled to over Rub 30 billion (or two months of benefits). This

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[22]Pension Fund benefits include an earnings related pension which is financed on a pay-as-you-go basis by payroll taxes that amount to 29 percent of employee wages. In addition, the Pension Fund makes payments for social, military, and disabled persons pensions that are financed through direct transfers from the federal budget.

[23] From 1998, the deficit of the Pension Fund is measured on a commitments basis.

[24] Initially, the increase in pensions was to be linked to the economy-wide average wage.

stock of arrears was reduced to Rub 26½ billion (or 1 percent of GDP) by year-end, in part due to Rub 6½ billion in transfers from the federal budget.

76. **In the first quarter of 1999, the Pension Fund ran a small surplus.** This was primarily due to the nonindexation of entitlements since the August 1998 crisis. As a result, the Pension Fund was able to reduce pension arrears from the end-December 1998 stock of Rub 26½ billion to Rub 18 billion at end-March 1999.

77. **The Social Insurance Fund, which provides birth, maternity, sickness and other benefits and some child allowances, appears to be a source of significant inefficiencies.** The Fund is financed by a payroll tax contribution of 5.4 percent, but its resources are highly decentralized, with the majority of the payroll taxes collected remaining within the enterprise to pay for benefits for those workers in the enterprise. As a result there is little transparency in the activities of this Fund—despite its accounting for resources in excess of 1 percent of GDP. A significant portion of the benefits paid by this Fund are not targeted to needy groups and amount to little more than non-wage benefits for workers.[25]

78. **The Employment Fund is limited in its ability to provide an effective social safety net for unemployed workers.** It is the smallest of the social extrabudgetary funds with spending and revenues of only ⅓ percent of GDP in 1997–98. The nature of the Employment Fund has changed markedly since the early 1990s with fewer of its resources devoted to labor subsidies to enterprises and more used to pay cash benefits to the unemployed. However, as noted (in Chapter II), only about one quarter of the unemployed (by ILO standards) are actually receiving benefits. In addition, benefit levels remain quite modest (only about 25 percent of the average wage), and are highly differentiated across region. Currently, 80 percent of Employment Fund revenues are retained in the regions; as a result, some regions do not have resources to pay benefits, while others have sufficient resources to engage in capital construction. The Employment Fund is entirely funded by a 1.5 percent payroll tax.

79. **In general, the social extrabudgetary funds do not meet the objectives for which they were designed.** The Pension Fund is continually forced to run pension arrears which results in inequities between regions and individuals. Further, while some pensioners receive relatively large benefits, others, particularly those retiring before 1992, receive only a minimum pension that covered about 35 percent of the subsistence level of consumption in early 1999. It is not clear to what extent the Social Insurance Fund and Employment Fund are meeting social needs and providing benefits that are sufficiently well-targeted to protect the most vulnerable of the population. In addition, the overall payroll tax of 36 percent, in particular when combined with the top marginal rate of personal income tax of 45 percent, leads to large distortions in the labor market and incentives for employers and employees to collaborate to evade taxes.

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[25] For example around 20 percent of the Fund's expenditures are for sanatoria vouchers.

Table 19. Russian Federation: Summary Operations of the Enlarged Government, 1992-98

	1992	1993	1994	1995	1996	1997	1998				1998
							Q1	Q2	Q3	Q4	
						(In billions of rubles)					
Enlarged government balance (deficit -) 1/	-3.5	-12.6	-63.6	-94.4	-190.4	-198.8	-56.2	-67.2	-70.4	-21.4	-215.2
Revenues 2/	7.5	62.1	211.5	515.8	708.2	917.8	169.7	201.3	184.2	294.9	850.2
Expenditures 2/	11.1	74.7	275.2	610.3	898.5	1,116.7	226.0	268.6	254.7	316.3	1,065.5
Federal government balance	-2.0	-11.2	-69.7	-88.5	-179.6	-179.8	-31.9	-42.8	-51.9	-31.9	-158.5
Revenues	3.2	23.5	72.1	198.1	268.1	310.4	59.0	64.8	53.8	110.3	287.9
Expenditures	5.2	34.7	141.8	286.7	447.7	490.2	90.9	107.6	105.7	142.2	446.3
Interest	0.1	3.4	12.0	54.7	126.8	118.0	27.6	34.4	31.8	28.6	122.4
Transfers to local govt.	0.3	4.4	25.1	29.2	51.1	49.9	8.0	11.4	4.2	21.7	45.2
Local government balance	0.3	1.1	3.1	-4.9	-8.1	-21.9	-18.5	-11.9	-5.2	2.9	-32.7
Revenues	2.6	28.6	110.0	231.8	326.7	429.8	67.2	97.1	83.4	145.0	392.7
of which: Federal transfers	0.3	4.4	25.1	29.2	51.1	49.9	8.0	11.4	4.2	21.7	45.2
Expenditures	2.3	27.5	106.8	236.7	334.9	451.7	85.8	109.0	88.6	142.1	425.3
Extrabudgetary funds balance	0.5	1.1	2.9	0.1	-2.7	2.9	-5.9	-12.6	-14.9	9.3	-24.1
Revenues	2.1	14.8	55.3	123.6	174.2	250.9	54.2	52.7	50.3	69.4	226.6
of which: Federal transfers	...	0.4	0.7	7.4	9.9	23.4	2.8	1.9	0.6	6.6	11.9
of which: Intra-EBF transfers	...	...	...	1.1	...	0.0					0.0
Expenditures	1.6	13.7	52.3	123.5	176.9	248.0	60.1	65.3	65.2	60.1	250.6
Unbudgeted import subsidies	2.3	3.6	...	...	...	...	...	...	...	...	...
Financing of the enlarged government	3.5	12.6	63.7	94.4	190.4	198.8	56.2	67.2	70.4	21.3	215.2
Net foreign financing	2.1	3.3	0.2	-3.2	14.5	40.3	6.8	26.7	31.3	-9.7	55.1
Foreign disbursements	2.3	4.5	5.4	11.0	28.8	50.7	10.2	33.2	40.7	9.7	93.9
Principal repayment	-0.2	-1.2	-5.3	-14.2	-14.3	-10.4	-3.4	-6.5	-9.5	-19.4	-38.8
Domestic financing	1.4	9.3	63.5	97.6	175.8	158.6	49.4	40.6	39.2	31.0	160.2
Domestic Banking system	1.0	8.7	54.3	79.4	157.6	43.9	24.9	1.0	-5.7	37.2	57.4
Monetary Authorities	1.7	10.1	49.4	25.6	48.8	30.4	7.1	5.0	62.6	10.2	84.9
Rest of the banking system	-0.7	-1.4	4.9	53.8	108.7	13.5	17.9	-4.1	-68.3	26.9	-27.5
Net credit from commercial banks	...	-2.0	-6.1	-0.2	170.7	-9.1	7.5	3.3	-1.9	33.6	42.4
Securities held by commercial banks	...	0.6	11.0	51.1	-61.9	22.6	10.4	-7.3	-66.3	-6.7	-69.9
Other financing	0.3	0.6	9.2	18.2	18.3	114.6	24.5	39.6	44.8	-6.1	102.7
Privatisation proceeds	0.1	0.4	0.7	4.7	2.7	23.5	1.0	1.5	0.7	14.6	17.8
Net proceeds from sale of gold, gems and precious metals	0.2	1.0	3.9	10.4	18.3	-2.2	0.1	1.3	3.0	1.8	6.2
Securities held by nonbank sector	...	-0.6	5.5	-1.1	-5.0	78.0	12.7	11.5	-10.5	-5.6	8.2
Domestic principal repayment	0.0	-0.4	-0.9	-0.6	-0.6	1.6	0.0	0.2	-0.2	0.0	0.0
Other	0.1	0.2	...	4.9	2.9	13.7	10.7	25.1	51.7	-16.9	70.6
						(In percent of GDP)					
Federal govt overall balance	-10.4	-6.5	-11.4	-5.7	-8.4	-7.0	-5.8	-7.1	-7.4	-3.8	-5.9
Federal govt primary balance	-9.7	-4.6	-9.4	-2.2	-2.5	-2.4	-0.8	-1.4	-2.9	-0.4	-1.3
Revenue	16.6	13.7	11.8	12.9	12.5	12.0	10.8	10.7	7.7	13.2	10.7
Expenditure	27.0	20.2	23.2	18.6	20.9	19.0	16.7	17.7	15.1	17.1	16.6
Local govt overall balance	1.5	0.6	0.5	-0.3	-0.4	-0.8	-3.4	-2.0	-0.7	0.3	-1.2
Revenue (including transfers)	13.5	16.7	18.0	15.0	15.2	16.6	12.3	16.0	11.9	17.4	14.6
Revenue (net of transfers)	11.9	14.1	13.9	13.2	12.8	14.7	10.9	14.1	11.3	14.8	12.9
Expenditure	12.0	16.1	17.5	15.4	15.6	17.5	15.7	18.0	12.7	17.0	15.8
Extrabudgetary funds overall balance	2.5	0.6	0.5	0.0	-0.1	0.1	-1.1	-2.1	-2.1	1.1	-0.9
Revenue (including transfers)	10.9	8.6	9.0	8.0	8.1	9.7	9.9	8.7	7.2	8.3	8.4
Revenue (net of transfers)	10.9	8.4	8.9	7.5	7.7	8.8	9.4	8.4	7.1	7.5	8.0
Expenditure	8.4	8.0	8.6	8.0	8.2	9.6	11.0	10.8	9.3	7.2	9.3
Enlarged govt overall balance	-18.4	-7.4	-10.4	-6.1	-8.9	-7.7	-10.3	-11.1	-10.1	-2.6	-8.0
Enlarged govt primary balance	-17.7	-5.4	-8.4	-2.6	-3.0	-3.1	-5.3	-5.4	-5.5	0.9	-3.5
Revenue	39.3	36.2	34.6	33.5	33.0	35.5	31.1	33.2	26.4	35.4	31.7
Expenditure	57.7	43.6	45.0	39.6	41.9	43.2	41.5	44.3	36.4	37.9	39.7
GDP (In billions of rubles)	19.2	171.5	611.0	1,540.5	2,145.7	2,586.4	545.2	606.6	698.9	833.9	2,684.5

Source: Ministry of Finance, CBR, Goskomstat, and IMF staff calculations.

1/ On a cash basis before 1996, includes wage and arrears in transfers to the Pension Fund in 1997, and accumulation of all federal spending arrears and local wage and pension arrears in 1998.

2/ Consolidated revenues and expenditures (excluding intragovernmental transfers) and including both cash and noncash items.

Table 20. Russian Federation: Federal Government Budget Execution, 1994-99

	1994	1995	1996	1997	1998				1998	1999
					Q1	Q2	Q3	Q4		Q1
					(In billions of rubles)					
Revenue 1/	72.1	198.1	268.1	310.4	59.0	64.8	53.8	110.3	287.9	89.5
Cash revenue	69.6	168.9	198.1	252.0	59.0	64.8	48.6	70.5	242.9	89.5
Noncash revenue 2/	2.5	29.3	70.0	58.5	0.0	0.0	5.2	39.8	45.0	0.0
VAT	31.4	78.0	115.4	117.9	23.4	23.6	21.1	36.7	104.7	33.9
Other taxes on goods and services	4.5	17.7	51.4	53.4	11.8	11.6	12.1	18.5	54.0	21.5
Nonenergy excise taxes	...	2.4	5.0	11.7	3.3	3.6	4.4	4.6	15.9	3.3
Energy excise taxes:	...	15.2	44.0	38.7	7.0	6.2	6.3	12.8	32.3	17.0
Profit taxes	17.1	41.0	34.8	33.1	4.9	11.0	7.3	11.7	34.9	8.4
Personal income taxes	0.1	3.3	5.1	1.7	0.0	0.0	0.0	0.0	0.1	0.0
Natural resources taxes	1.0	3.0	4.5	7.0	0.9	0.5	0.7	1.1	3.2	1.3
Taxes on trade	9.6	29.7	27.6	30.1	7.3	10.3	8.4	15.3	41.3	17.6
Export taxes	3.2	15.7	8.0	0.1	0.0	0.0	0.0	0.0	0.0	2.2
Import tariffs	2.7	8.5	14.8	26.6	6.5	7.1	5.7	8.1	27.4	9.7
Other (excl. gold transactions)	3.6	5.5	4.8	3.4	0.8	3.2	2.7	7.1	13.9	5.7
Budgetary funds	3.0	15.4	22.9	38.3	7.4	5.9	4.5	5.9	23.7	4.4
Other	5.4	10.0	6.4	28.8	3.3	1.8	1.2	19.6	26.0	1.5
Expenditure 1/	141.8	286.7	447.7	490.2	90.9	107.6	105.7	142.2	446.3	156.7
Non-interest expenditure	129.8	231.9	320.9	372.2	63.3	73.1	73.9	113.6	323.9	99.0
Government administration 3/	14.4	4.5	5.4	9.7	1.9	2.1	1.7	4.0	9.7	2.4
International activity	...	21.5	20.6	4.3	0.0	-0.8	-0.5	9.9	8.5	4.9
Defense	28.0	47.6	63.9	79.7	10.9	11.3	11.4	23.1	56.7	16.3
Law enforcement and public order	10.8	19.2	28.5	43.7	7.3	6.7	6.9	13.1	34.0	7.9
Science	...	4.8	6.6	9.5	1.8	1.0	0.4	2.0	5.2	1.5
Education	5.5	8.6	11.4	14.4	2.5	2.8	2.7	4.9	12.9	2.3
Health and emergency management	2.3	5.9	8.3	15.5	2.3	2.2	2.2	5.3	12.0	2.6
Social policy	1.0	3.8	9.9	22.7	7.5	7.3	5.5	16.2	36.5	10.9
Housing and municipal services	...	1.3	2.0	2.5	0.4	0.4	0.4	0.8	2.1	0.3
Culture and mass media	1.7	2.8	2.0	2.5	0.4	0.4	0.5	0.8	2.1	0.4
Industry, energy and construction	18.2	25.7	26.2	26.6	1.3	3.3	1.9	4.9	11.3	1.9
Agriculture and fishing	...	6.2	8.5	12.1	0.2	1.2	0.8	1.0	3.3	0.3
Transportation and communication	...	0.5	0.7	3.8	0.9	-0.7	0.5	0.3	1.0	0.1
Net lending	14.0	22.8	19.6	18.3	2.0	3.1	5.6	-1.2	9.5	9.6
Intergovernment Transfers	25.1	29.2	51.1	49.9	8.0	11.4	4.2	21.7	45.2	10.8
Budgetary funds	3.0	14.1	16.5	29.1	4.9	5.7	5.1	8.0	23.6	4.7
Other 4/	5.8	13.5	39.8	27.8	11.1	15.8	24.7	-1.2	50.4	22.1
o/w accumulation of arrears	...	...	...	10.4	2.5	8.0	22.0	-20.4	12.1	0.0
Interest Payments	12.0	54.7	126.8	118.0	27.6	34.4	31.8	28.6	122.4	57.7
External debt 5/	3.1	16.9	22.8	23.8	5.5	9.2	16.1	25.9	56.7	47.1
Treasury bills (GKO/OFZ)	1.4	28.5	89.7	86.2	21.2	22.6	17.1	0.0	60.9	0.0
Other domestic debt	7.5	9.3	14.3	8.0	0.9	2.7	-1.4	2.6	4.8	10.6
Overall Balance (deficit -)	-69.7	-88.5	-179.6	-179.8	-31.9	-42.8	-51.9	-31.9	-158.5	-67.2
					(In percent of GDP)					
Revenue	11.8	12.9	12.5	12.0	10.8	10.7	7.7	13.2	10.7	10.3
Cash	11.4	11.0	9.2	9.7	10.8	10.7	7.0	8.5	9.0	10.3
Noncash	0.4	1.9	3.3	2.3	0.0	0.0	0.7	4.8	1.7	0.0
Expenditure	23.2	18.6	20.9	19.0	16.7	17.7	15.1	17.1	16.6	18.1
Interest	2.0	3.6	5.9	4.6	5.1	5.7	4.6	3.4	4.6	6.7
Noninterest	21.2	15.1	15.0	14.4	11.6	12.1	10.6	13.6	12.1	11.4
Overall balance	-11.4	-5.7	-8.4	-7.0	-5.8	-7.1	-7.4	-3.8	-5.9	-7.8
Primary balance	-9.4	-2.2	-2.5	-2.4	-0.8	-1.4	-2.9	-0.4	-1.3	-1.1

Source: Ministry of Finance; and IMF staff estimates.

1/ Excludes budgetary funds (road and ecology funds) before 1994.
2/ Includes ruble offsets (decree 71) and tax offset in 1996, ruble offsets (decree 20) reverse monetary offsets in 1997, and targeted financing in 1998.
3/ From 1992-94 includes science and international activity.
4/ Includes unallocated noncash expenditures in 1996, accumulation of wage and arrears in transfers to the Pension Fund in 1997, and accumulation of all expenditure arrears in 1998.
5/ Measured on a commitments basis.

Table 21. Russian Federation: Regional and Local Government Operations, 1994-98

	1994	1995	1996	1997	1998				1998
					Q1	Q2	Q3	Q4	
				(In billions of rubles)					
Revenue	110.0	231.8	326.7	429.8	67.2	97.1	83.4	145.0	392.7
VAT	11.6	28.2	39.7	54.7	9.7	11.4	10.3	20.4	51.8
Profits taxes	31.7	75.8	64.1	69.0	10.6	16.8	12.4	21.7	61.5
Excises	3.0	6.5	8.2	12.4	0.0	0.0	0.0	0.0	0.0
Personal Income taxes	17.4	33.2	51.4	73.4	14.2	15.9	15.8	25.3	71.1
Natural resource payments	2.0	9.3	16.8	28.6	3.6	3.4	4.8	7.2	19.0
Property taxes	4.8	16.0	36.6	46.9	4.3	14.6	12.0	15.7	46.5
Federal transfers	25.1	26.9	60.2	78.6	9.4	12.3	5.2	20.6	47.4
Other	14.3	35.9	49.6	66.1	15.5	22.9	23.0	34.1	95.4
Expenditure	106.8	236.7	334.9	451.7	85.8	109.0	88.6	142.0	425.4
Education	22.0	47.8	72.4	94.5	14.7	24.1	17.0	28.3	84.1
Health	17.4	37.4	52.5	67.0	10.6	14.6	12.2	22.1	59.5
Housing & municipal services	33.9	61.3	89.5	107.5	15.9	22.0	19.8	38.0	95.6
Social security	6.5	16.9	26.9	32.4	5.6	7.3	5.6	9.6	28.0
Other 1/	27.0	73.2	93.6	150.4	38.9	40.9	34.1	44.1	158.1
Overall balance (- deficit)	3.1	-4.9	-8.1	-21.9	-18.5	-11.9	-5.2	3.0	-32.7
Financing	-3.1	4.9	8.1	21.9	18.5	11.9	5.2	-3.2	32.4
Foreign financing		0.0	0.0	5.2	0.6	3.4	0.0	0.0	4.0
Banking system	-3.8	-0.1	1.9	3.1	10.1	2.1	0.3	-3.2	9.3
of which: monetary authorities	-2.4	1.2	0.0	-1.5	1.2	0.1	0.7	-0.5	1.5
Nonbank	0.6	5.1	6.3	13.6	7.8	6.4	4.9	0.2	19.3
Privatisation	0.6	1.3	1.9	4.7	0.5	0.9	0.4	0.7	2.6
Other	...	3.8	4.4	8.9	7.3	5.5	4.4	-0.5	16.7
				(In percent of GDP)					
Revenue	18.0	15.0	15.2	16.6	12.3	16.0	11.9	17.4	14.6
VAT	1.9	1.8	1.8	2.1	1.8	1.9	1.5	2.4	1.9
Profits taxes	5.2	4.9	3.0	2.7	2.0	2.8	1.8	2.6	2.3
Excises	0.5	0.4	0.4	0.5	0.0	0.0	0.0	0.0	0.0
Personal Income taxes	2.8	2.2	2.4	2.8	2.6	2.6	2.3	3.0	2.6
Natural resource payments	0.3	0.6	0.8	1.1	0.7	0.6	0.7	0.9	0.7
Property taxes	0.8	1.0	1.7	1.8	0.8	2.4	1.7	1.9	1.7
Federal transfers	4.1	1.7	2.8	3.0	1.7	2.0	0.7	2.5	1.8
Other	2.3	2.3	2.3	2.6	2.8	3.8	3.3	4.1	3.6
Expenditure	17.5	15.4	15.6	17.5	15.7	18.0	12.7	17.0	15.8
Education	3.6	3.1	3.4	3.7	2.7	4.0	2.4	3.4	3.1
Health	2.8	2.4	2.4	2.6	1.9	2.4	1.7	2.6	2.2
Housing & municipal services	5.6	4.0	4.2	4.2	2.9	3.6	2.8	4.6	3.6
Social security	1.1	1.1	1.3	1.3	1.0	1.2	0.8	1.1	1.0
Other 1/	4.4	4.8	4.4	5.8	7.1	6.8	4.9	5.3	5.9
Overall balance (- deficit)	0.5	-0.3	-0.4	-0.8	-3.4	-2.0	-0.7	0.4	-1.2
Financing	-0.5	0.3	0.4	0.8	3.4	2.0	0.7	-0.4	1.2
Foreign financing	0.0	0.0	0.0	0.2	0.1	0.6	0.0	0.0	0.1
Banking system	-0.6	0.0	0.1	0.1	1.8	0.3	0.0	-0.4	0.3
of which: monetary authorities	-0.4	0.1	0.0	-0.1	0.2	0.0	0.1	-0.1	0.1
Nonbank	0.1	0.3	0.3	0.5	1.4	1.1	0.7	0.0	0.7
Privatisation	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Other	...	0.2	0.2	0.3	1.3	0.9	0.6	-0.1	0.6

Sources: Ministry of Finance, CBR and staff estimates.

1/ Including, in 1998, local wage arrears.

Table 22. Russian Federation: Extrabudgetary Fund Operations, 1994-98

	1994	1995	1996	1997	1998				1998
					Q1	Q2	Q3	Q4	
				(In billions of rubles)					
Revenue	55.3	123.6	174.2	250.9	54.2	52.7	50.3	69.4	226.6
Pension Fund	38.3	85.2	127.3	181.0	38.4	35.7	34.3	53.1	161.6
Employment Fund	3.0	6.2	6.9	8.8	1.9	2.2	1.9	2.1	8.0
Social Insurance Fund	7.5	17.6	25.4	31.5	7.5	7.7	7.4	7.4	30.0
Fed. Medical Insurance Fund	6.6	14.6	14.6	29.6	6.4	7.2	6.6	6.8	27.0
Expenditure	52.3	123.5	176.9	248.0	60.1	65.3	65.2	60.1	250.6
Pension Fund 1/	37.3	85.8	127.1	176.6	43.1	48.4	48.8	49.8	190.2
Employment Fund	2.4	6.4	7.1	8.8	1.9	2.0	1.9	2.1	8.0
Social Insurance Fund	6.6	16.6	24.8	30.4	6.6	7.7	7.7	8.0	30.0
Fed. Medical Insurance Fund	6.0	14.6	14.6	28.9	6.5	7.4	6.8	6.3	27.0
Float	0.0	0.2	3.3	3.3	1.8	-0.2	-0.1	-6.1	-4.5
Balance, total extrabudgetary funds	2.9	0.1	-2.7	2.9	-5.9	-12.6	-14.9	9.3	-24.1
Financing	-2.9	-0.1	2.6	-2.9	5.9	12.6	14.9	-9.3	24.1
of which: Monetary authorities	-1.6	0.3	-0.2	-2.2	1.7	0.5	-0.3	-2.5	-0.6
of which: pension arrears	...	...	...	...	1.2	11.9	17.4	-6.8	26.3
				(In percent of GDP)					
Revenue	9.0	8.0	8.1	9.7	9.9	8.7	7.2	8.3	8.4
Pension Fund	6.3	5.5	5.9	7.0	7.0	5.9	4.9	6.4	6.0
Employment Fund	0.5	0.4	0.3	0.3	0.3	0.4	0.3	0.2	0.3
Social Insurance Fund	1.2	1.1	1.2	1.2	1.4	1.3	1.1	0.9	1.1
Fed. Medical Insurance Fund	1.1	0.9	0.7	1.1	1.2	1.2	0.9	0.8	1.0
Expenditure	8.6	8.0	8.2	9.6	11.0	10.8	9.3	7.2	9.3
Pension Fund 1/	6.1	5.6	5.9	6.8	7.9	8.0	7.0	6.0	7.1
Employment Fund	0.4	0.4	0.3	0.3	0.4	0.3	0.3	0.3	0.3
Social Insurance Fund	1.1	1.1	1.2	1.2	1.2	1.3	1.1	1.0	1.1
Fed. Medical Insurance Fund	1.0	0.9	0.7	1.1	1.2	1.2	1.0	0.8	1.0
Float	0.0	0.0	0.2	0.1	0.3	0.0	0.0	-0.7	-0.2
Balance, total extrabudgetary funds	0.5	0.0	-0.1	0.1	-1.1	-2.1	-2.1	1.1	-0.9
Financing	-0.5	0.0	0.1	-0.1	1.1	2.1	2.1	-1.1	0.9
of which: Monetary authorities	-0.3	0.0	0.0	-0.1	0.3	0.1	0.0	-0.3	0.0
of which: pension arrears	...	...	...	...	0.2	2.0	2.5	-0.8	1.0

Source: Extrabudgetary funds and CBR.

1/ Measured on a cash basis 1992-7 and a commitment basis in 1998.

IV. MONETARY DEVELOPMENTS

A. Overview

80. **Starting in early 1995 and leading up to the period preceding the crisis in mid-1998, monetary policy was geared, first and foremost, at maintaining exchange rate stability.** This resolute policy stance of the CBR brought annual inflation down sharply, from over 215 percent in 1994 to about 6.5 percent by mid-1998. In maintaining the stability of the ruble, the CBR often intervened heavily in the foreign exchange market and showed a willingness to accept high real interest rates when necessary.

81. **Success at reigning in inflation in the presence of large fiscal imbalances was made possible by two crucial developments: the liberalization of the domestic treasury bill market and large external capital inflows during 1996–97.**[26] These enabled the government to reduce its reliance on central bank financing of the deficit and enabled the CBR to bear down on inflation without incurring unsustainable losses in external reserves.

82. **The sustained decline in inflation had a favorable impact on the monetization of the economy, although it remained at a very low level by international standards.** The increased scope for extension of credits resulting from the remonetization benefited, however, mainly the public sector; growth in ruble credit to the economy remained anemic as banking activity became very narrowly focused on the treasury bill market which expanded rapidly due to the large financing needs of the government.Credit extension to the real sector was further limited by structural problems, including insecure property rights and poor accounting standards, which made commercial lending inherently more risky.

83. **Following the decision in August 1998 to unilaterally restructure domestic government debt and allow the ruble to depreciate, much of the commercial banking system was left in a state of insolvency.** Further, the sharp depreciation of the ruble contributed to rapid inflation in the months immediately following the crisis. The authorities have subsequently succeeded in reigning in monetary expansion, and, as a result, inflation has begun to level off and the ruble to stabilize. (See Chapter I for a detailed discussion of events leading up to, and following, the August crisis.)

B. Institutional and Legal Structures

84. **The banking sector in Russia includes the CBR and about 1,400 banks at present.** The CBR is responsible for the exercise of monetary policy and conducts banking

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[26]Throughout this section, treasury bills refer to government debt instruments denominated in roubles—GKOs and OFZs. The term government securities, however, include government paper denominated in foreign currencies, such as MinFin Bonds.

supervision. The majority of the foreign reserves of Russia are held by the CBR; however, the government also holds some reserves and reserve-related liabilities.[27] There are a number of state-owned banks, notably Sberbank which holds the majority of household deposits, Vneshtorgbank (the Russian foreign trade bank) and Vnesheckonombank (which handles the external debt operations of the federal government). In addition, the CBR owns a number of commercial banks abroad.

85. **Until the crisis in mid-1998, treasury bills, spot and forward foreign exchange, and commodities were traded on numerous exchanges in Russia.** Interbank markets were active and the debt market—dominated by federal government debt instruments, including treasury bills, floating rate Federal savings bonds, and medium-term foreign-currency bonds—was highly liquid. Short-term debt instruments, including promissory notes (*veksels*) issued by banks, companies, and local governments were also widely issued and actively traded. The Russian equity market was one of the best emerging market performers in 1997.

86. **The financial crisis has led to a substantial downturn in financial market activities.** The organized interbank auctions for foreign exchange was segmented into two sessions—a restricted morning session and an open afternoon session.[28] Following the collapse of the banking sector, trading in the interbank market for ruble liquidity became very thin. As a result of the restructuring of treasury bills and a temporary freeze on secondary market trading (which has since been revoked), activity in the government debt market came to a complete halt during the second half of 1998. More recently, activity in this market has remained minimal, due in part to an administrative floor on prices. An informal market in the trading of commercial bank assets and liabilities has also recently sprung-up, in conjunction with the widespread spontaneous restructuring of banks' balance sheets.

C. Trends in Monetary and Exchange Rate Policies, 1995–99

The pre-crisis period

87. **The groundwork for the adoption of an exchange rate-based monetary policy was laid in 1995.** Early that year, the CBR significantly tightened its policy stance and monthly inflation declined to 8.5 percent by March, compared to over 16 percent in December 1994. In addition, the Central Bank Law passed in April 1995 provided independence in the formulation of monetary policy to the CBR and prohibited direct lending to the government. Finally, the CBR stopped providing directed credit to the banking system. These developments facilitated the adoption of an exchange rate band in July 1995.

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[27] The monetary authorities concept consolidates the operations of the CBR and the reserve-related operations of the federal government.

[28] The market was unified on June 29, 1999.

88. **Until mid-1998, despite occasional policy slippages, the CBR adhered to the monetary policy requirements of maintaining the ruble within some form of an exchange rate band** (See Box 3). During periods when demand for ruble assets increased substantially, market interest rates were allowed to fall and CBR gross reserves increased (Figure 14). In contrast, during periods when confidence ebbed, market interest rates soared and the CBR intervened heavily in the foreign exchange market to defend the ruble. Some remonetization of the economy occurred as velocity declined. Nevertheless, the impact on base money growth of the continued large external capital inflows, particularly to finance the budget, were in large part offset by sales of foreign exchange by the CBR. The exchange rate policy was, therefore, used to bear down on the inflationary impact of the persistent fiscal deficits (for a description of monetary policy instruments and procedures, see Box 4).

89. **Daily movements in the exchange rate remained very predictable as the ruble was, for the most part, maintained in the appreciated portion of the band.** The CBR also announced a more narrow daily intervention band each day within which it was prepared to let the ruble trade. This daily intervention band was actively managed to enhance the predictability of the exchange rate. For example, during the first half of 1998, a smooth depreciation of the midpoint of the daily band was maintained even while the ruble was under pressure and had been trading in the depreciated end of the band. Furthermore, the size of the daily band was often narrowed in the face of intensified foreign exchange market pressures in an attempt to influence market expectations regarding the stability of the exchange rate.

90. **The extension of domestic credit by the CBR was restrained and therefore did not exert significant pressures on the exchange rate**. The prohibition on direct lending to the government starting in 1995 implied that any increases in net credit to government from the monetary authorities came about through either the use of government holdings of NIR, which did not directly affect base money, or CBR purchases of treasury bills in the secondary market.[29] Recourse to the latter was limited, however, as other sources of credit were tapped by the government. The flow of net credit to the federal government from the CBR declined from about 350 percent of the stock of beginning-period base money in 1994 to about 20 percent in 1997. Meanwhile, commercial banks also increasingly relied on foreign sources of credit and the build-up in private sector deposits to finance lending activities, including to the government, so that net CBR credit to commercial banks also declined steadily during 1995–97.

91. **The decrease in central bank financing of the government budget occurred in tandem with the growth of the treasury bill market**. This market, which had its inception in 1993, took off in 1995. The stock of outstanding bills increased from about 1.2 percent of

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[29] The ruble counterpart, included under NDA of the monetary authorities, reflects changes in government holdings of international reserves. The use of the government's foreign currency reserves lead to a decrease in NIR and an increase in NDA.

Box 3. Exchange Rate Bands

In July 1995, with the aim of stabilizing market expectations about the exchange rate, the CBR introduced an exchange rate band—ranging from Rub 4,300 to 4,900 per US dollar— for the period until end-1995. Following a successful experience with this band, a new band of Rub 4,550–5,150 per U.S. dollar was set for the period January 1–July 1, 1996.

The corridor system was extended into the period July-December 1996, but with a sliding band in contrast to a flat corridor in previous periods, starting at Rub 5,000 to Rub 5,600 and ending at Rub 5,500 to Rub 6,100 per dollar at end-December, with an implied monthly depreciation of 1.5 percent. Within the wide band, the CBR announced a narrower daily band at which it would transact with market participants. In the event, the Ruble depreciated by less than the mid-point of the band, ending 1996 at Rub 5,560 per dollar.

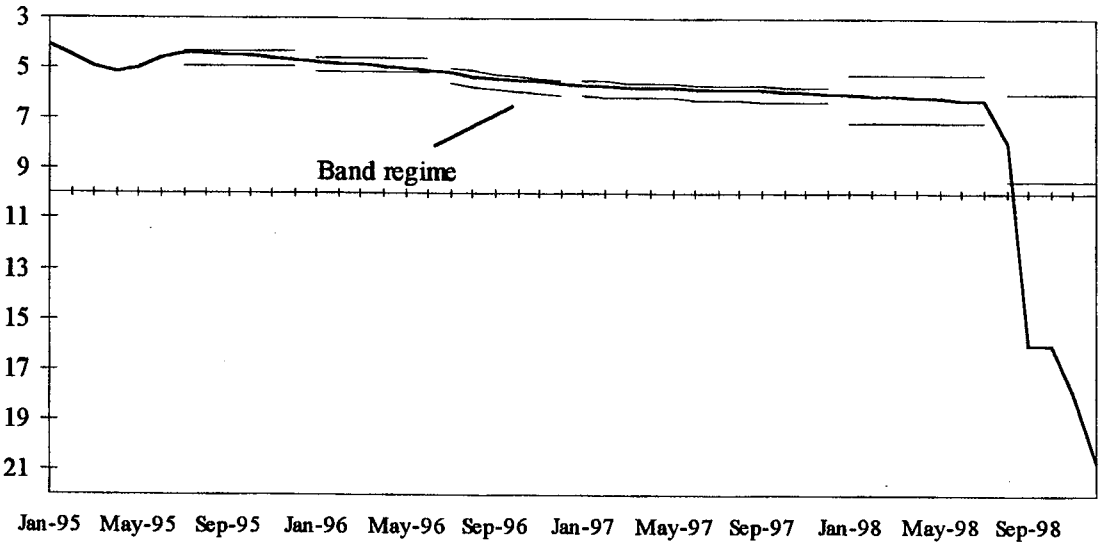
For 1997, the CBR retained a sliding band, beginning at Rub 5,500 to 6,100 and ending at Rub 5,750 to 6,350 at end-1997, implying a depreciation of 4 percent for the center of the band. The ruble, which began the year in the appreciated end of the band, depreciated by 6.7 percent over the course of the year.

In November of 1997, the authorities announced a new exchange rate regime for the period 1998–2000. The exchange rate of the rouble would be centered at 6.2 re-denominated rubles per U.S. dollar, with a margin of +/- 15 percent. At the same time, a narrower daily intervention band would remain in effect around an official mid-point rate for the day. In practice, the size of the daily intervention band varied substantially from day to day. Beginning with an average of +/- 0.5 percent around the mid-point rate in January, the band had narrowed to +/- 0.3 percent by April. The narrow daily band was progressively expanded over the course of the summer to +/- 0.7 percent before narrowing it down again to +/- 0.3 percent by August 14, 1998.

As part of the set of emergency measures announced on August 17, 1998, the wide exchange rate band was expanded, from the previous Rub 5.3–7.1 per US dollar to 6.0–9.5, and the announcement of the daily narrow band was eliminated.

On September 2, 1998 the authorities abolished the band system and let the exchange rate float.

Nominal Exchange Rate
(In rubles per U.S. dollar)



Box 4. Monetary Policy Instruments and Procedures

Until mid-1998, the primary instrument that the CBR used for regulating monetary conditions was the open market purchase and sale of treasury bills in the secondary market. In addition to open market operations and foreign exchange market interventions, the CBR used a number of instruments for liquidity management.

The **Lombard facility** was introduced in April 1996 through which the CBR provides refinance credit (collateralized by government securities) for periods of up to one month. Credit was initially available in weekly auctions subject to minimum interest rates, but subsequently provided on a continuous basis for banks in good standing with prudential requirements. As of mid-1998, the CBR extended Lombard credits through both a fixed-rate window and through credit auctions. Beginning in July 1998, however, Lombard credits were only extended through auctions, which are held twice a week. Lombard interest rates were lowered during 1996 and most of 1997, but were raised towards year-end. The CBR also has a facility for **repurchase agreements (repos)** with primary dealers (large banks that have undertaken to make markets in government securities). There is also an **end-of-day overnight settlement facility** for selected banks to ensure the smooth functioning of the payments system.

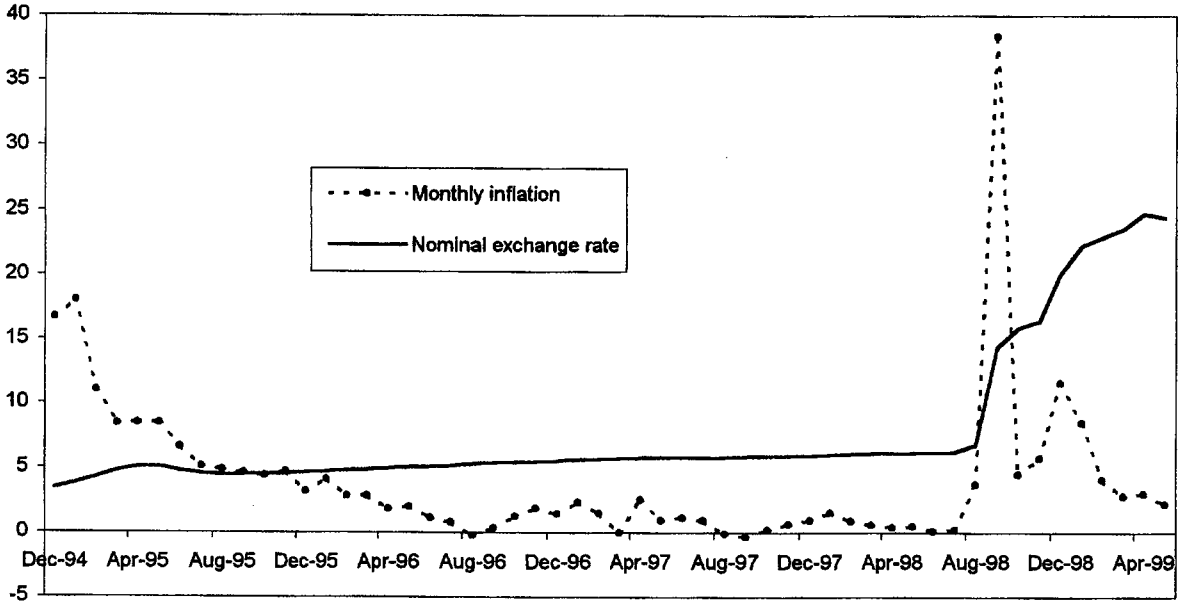
Following the banking crisis in 1998, the CBR created a special facility to extend **rehabilitation loans** to commercial banks. While not created with liquidity management in mind, significant resources have been provided to commercial banks through this facility. Loans are extended for periods upto one year at 20 percent interest per annum (compared to annualized inflation of over 100 percent at end-1998-early 1999) and in return the CBR retains 75 percent plus one share of the bank as collateral. Loans extended through this facility are subject to individual agreements with commercial banks and the full terms are not transparent. These loans are purportedly provided to banks to help in restructuring plans approved by the CBR.

Following the halt in trading of treasury bills in mid-1998, the CBR issued its own short-term paper. The amounts of these **CBR bills** issued remained small, and as their legal status was the subject of debate with the Securities Commission, the issuance of new bills was halted in late 1998. Amendments were recently enacted to the law, however, which will enable the CBR to resume their issuance. CBR bills are also expected to act as collateral in a new interbank repo market being set-up by the CBR and MICEX. The CBR also has a **deposit facility** available. Historically, there was little use of this instrument; deposits with maturities of only 1-2 days were offered; and, this facility was primarily used for very short-term liquidity management. Towards the end of 1998, however, this facility increased in importance; maturities were significantly lengthened and the deposit facility is actively used by commercial banks given the build-up in liquidity that has occurred recently.

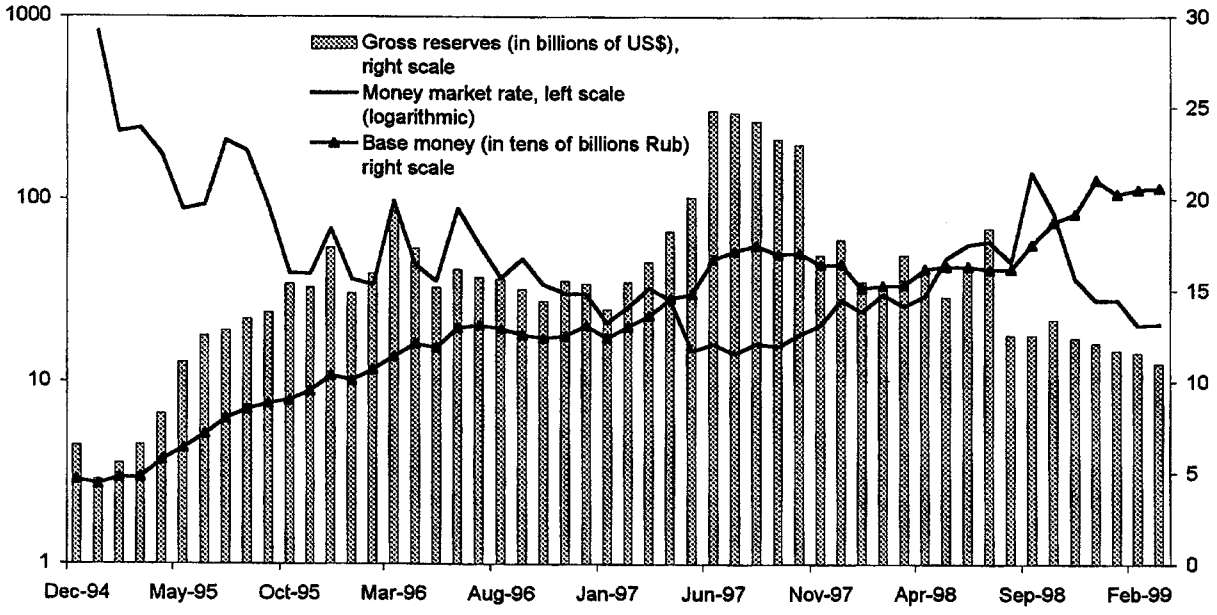
Reserve requirements have also been used as a front-line instrument of monetary policy. Starting in August 1998, the CBR reduced reserve requirements on a number of occasions. First, following the devaluation of the ruble, the exchange rate used for the calculation of reserve requirements on foreign currency deposits was frozen. Second, reserve requirements were uniformly reduced by 1 percentage point on August 24, 1998. Third, required reserves were reduced for selected banks—depending on the share of treasury bills in their portfolios—to between 5 and 7.5 percent on September 1, 1998. Fourth, banks' required reserves were reduced in connection with the CBR's attempts to clear the payments system on a number of occasions during September–November 1998, with the reduction in required reserves depending on individual banks' obligations with regard to outstanding payments on behalf of clients. By late 1998, the required reserve ratio, therefore, varied considerably between different banks. Effective, December 31, 1998 the CBR unified reserve requirements on both ruble deposits and foreign currency deposits at 5 percent and required that current exchange rates be used for calculating reserves on foreign currency deposits. In 1999, reserve requirements have been increased twice to mop up liquidity and a differentiation of rates, depending on currency and type of deposits, has been reintroduced.

Figure 14. Russian Federation: Monetary Developments, December 1994-May 1999

Inflation and Exchange Rate



Foreign Reserves, Base Money and Interest Rates



Sources: Russian authorities and Fund staff estimates.

GDP at end-1994 to over 12 percent of GDP at end-1997 (Figure 15). Nominal yields on treasury bills fell during 1995–97, despite considerable volatility, as success was achieved in reducing inflation. However, yields adjusted for inflation and the depreciation of the ruble remained high, reflecting the risk premium on lending to the Russian government (Figure 15).

92. **Changes in legislation governing treasury bill purchases by nonresidents, coupled with a growing appetite for emerging market issues in international financial markets ensured that market demand for these instruments remained high** (see Box 5). The fixed exchange rate policy conferred an implicit exchange rate risk guarantee on these investments, further encouraging purchases by nonresidents. Domestic commercial banks also found investment in treasury bills more lucrative than other forms of credit extension, and the increase in ruble deposits was diverted to the treasury bill market. The large need for government financing, however, ensured an ever-increasing supply of treasury bills.

93. **Base money growth remained moderate over the period without excessive losses of external reserves.** (For a review of CBR management of international reserves, see Box 6.) The CBR's restrained credit policy stance, large capital inflows, and a willingness to sell significant amounts of foreign exchange in the market contributed to a slowing in the growth of base money from over 225 percent in 1994 to 26 percent in 1996–97 (Table 23), and a steady decline in inflation despite the persistence of large fiscal deficits. Owing to these developments, the CBR was able to successfully weather temporary reversals in market sentiments, for example against the backdrop of political uncertainties associated with the Presidential election in 1996, and in the process further bolster public confidence in the stability of the ruble.

94. **Following the presidential election and through late 1997, a surge in capital inflows and a favorable external environment masked the continued inconsistencies between fiscal policy and monetary and exchange rate policies.** Eurobond placements by the federal government began with the issuance of $1 billion in late 1996 and amounted to an additional $3.5 billion during the course of 1997. Increasingly, regional and local governments as well as Russian commercial banks made successful placements of Eurobonds (see Chapter V for further details). As a result, the need for monetary financing of the government budget was further reduced, gross reserves increased by about $9 billion between mid-1996 and mid-1997, and average monthly inflation came down to about 1 percent.

95. **Russia had, however, become increasingly vulnerable to a sudden and sustained turnaround in investor confidence.** A major vulnerability arose from the government's accumulation of short-term ruble-denominated debt. Increased participation by nonresidents in the treasury bill market explained, in large measure, the ever-increasing outstanding stock of treasury bills. Nevertheless, by early 1997, demands on the government to issue new treasury bills simply to keep pace with maturing issues and meet interest payments had become severe due to the short-term nature of the bonds and the high interest costs. As a result, while issuance of new bills continued unabated, net financing (after debt-service costs) declined

Box 5. Nonresidents and the Treasury Bill Market

Nonresident access to the GKO market was not officially permitted until early 1996, when a scheme was introduced to allow nonresidents to purchase securities in primary auctions and hold them to maturity. The investor received a predetermined dollar yield of 25 percent through an effective CBR foreign exchange forward contract, which was subsequently reduced to 19 percent in April 1996.

A modified scheme introduced in August 1996 allowed nonresidents to participate in the primary and secondary markets in the same way as residents and to keep all the ruble proceeds, except that repatriation of the balances held in "S" accounts at commercial banks could not occur until the investor had purchased and held until maturity a three- to six-month forward foreign exchange contract on the balance in these accounts. These forward contracts were provided by commercial banks which were required to enter into contracts with the CBR for 90 percent of the amount to be repatriated; the contracts continued to yield a 19 percent return on the CBR component, with the banks covering the remainder of the contract. The effective dollar yield for nonresident investors was cut in stages to 9 percent by September1997, by which time the proportion of the forward contract provided by the CBR had been reduced to 25 percent.

The CBR announced in February 1997 that all restrictions on capital outflows would be removed by end-1997. Starting in 1998, the CBR withdrew completely from the forward contracts market. Nonresidents, however, continued to hedge their exposures through forward contracts with large Russian commercial banks. These banks, in turn, hedged with other domestic banks. It was widely perceived, however, that the quality of the hedges by Russian banks was questionable and that some of these were engaged in purely to meet prudential requirements, which in turn were lax.

Box 6. The CBR Management of International Reserves

There has been public controversy surrounding the international reserves management practices employed by the CBR during 1993 to 1996—in particular, as it involved the use of an off-shore company, the Financial Management Company (FIMACO) Limited. With the development of its own capacity to manage reserves, however, CBR reserve management has been following best international practice in recent years.

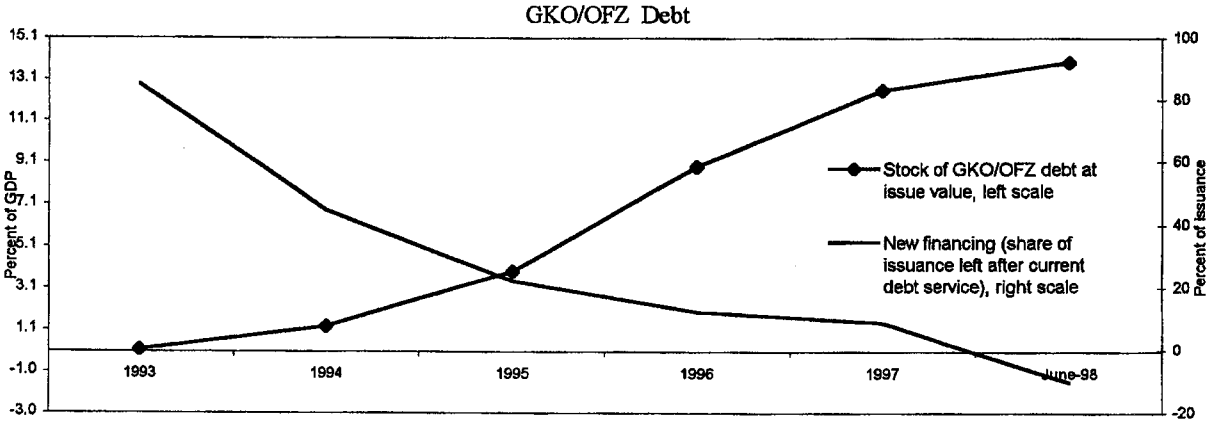
Foreign currency reserves. The operations in managing and placing foreign currency reserves are regulated by the CBR board-approved guidelines of reserves management which became effective in mid-1996. The guidelines set out definitions for eligible assets, the methods of evaluating various risks, the calculation of yields, the currency and maturity structure, asset quality, and counterpart quality. They also prescribe the delegation of authority within the CBR with regard to decision making on reserves and provide that the performance of investments be evaluated against benchmark portfolios. The CBR maintains some foreign currency reserves at CBR-owned banks abroad which are not actively managed and not covered by the general guidelines.

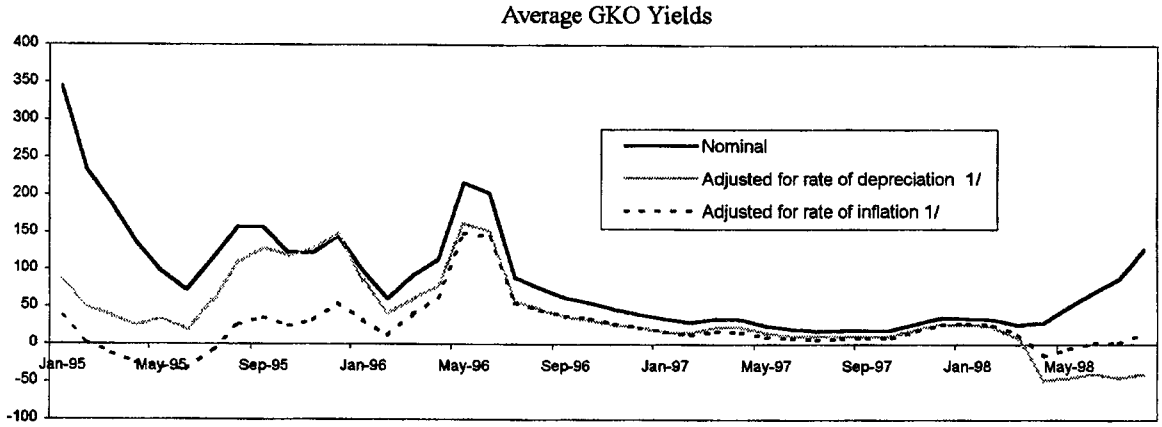
The CBR distinguishes between two different types of portfolios, the operational portfolio and the investment portfolio. The ***operational portfolio*** is intended to provide ready-funds for day-to-day interventions in the domestic foreign currency market. The portfolio has no fixed currency structure, but assets are mostly invested in highly liquid U.S. dollar instruments, as most turnover in Russia's currency markets is in U.S. dollars. The ***investment portfolio*** has a fixed currency structure. Until mid-1998, assets were to be invested in U.S. dollar and DEM assets only. However, following the purchase of SDRs from the IMF in July 1998, the revised benchmark portfolio now resembles the SDR basket of currencies for the size of the tranche. For assets in excess of the Fund tranche, the original benchmark portfolio continues to be applicable.

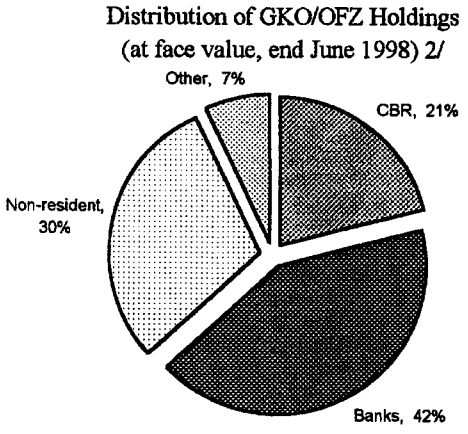
Any ***assets*** in which the CBR invests must be highly rated by the major rating agencies. ***Counterparties*** need to be of high-quality and explicit limits are assigned. For unsecured transactions, for example foreign currency transactions and deposits, there is a specific list of permissible counterparties, with specific counterparty limits and country limits. These limits apply combined for foreign currency and gold transactions and placements. For secured, i.e., collateralized transactions, for example repos, more generous limits apply. And for delivery-versus-payments transactions with primary dealers in the United States and Germany, no quantitative limits are set. As a general rule, the CBR does not take any speculative positions nor can positions be leveraged.

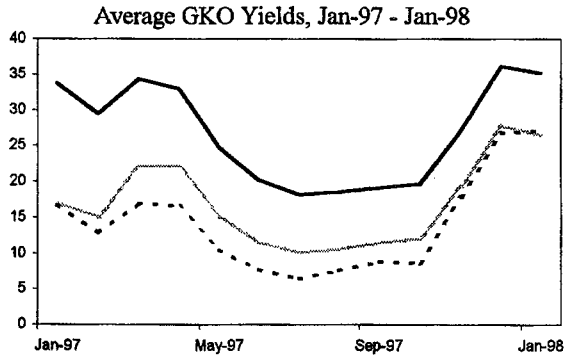
Gold reserves. The practices employed are conservative and only three different instruments are currently being used for placing gold reserves: gold placement in CBR vaults, deposits in allocated gold accounts, and deposits in unallocated gold accounts. The CBR only places gold on deposit and does not perform any swaps or other transactions with gold.

Figure 15. Russian Federation: Treasury Bill Market, 1993-August 1998









Sources: Russian authorities, Bloomberg and Fund staff estimates.

1/ Using exchange rate and inflation developments from the preceding 6 months and the following six months.

2/ Non-residents were legally allowed participation only in early 1996.

continuously, from more than 85 percent of new issuance in 1993 to less than 10 percent in 1997 (Figure 15).

The onset of the crisis

96. **The underlying tensions in economic fundamentals abruptly came to the fore in late 1997 in the aftermath of the financial crisis in Asia and in the context of a precipitous decline in export prices.** The CBR successfully weathered the first bout of instability in late 1997, but at a cost that indicated the extent to which the exchange regime had become vulnerable to a turn-around in investor confidence. Sales of foreign exchange in November alone amounted to $6 billion (over one quarter of gross reserves), while the rise in interest rates necessary to defend the exchange rate weakened commercial banks, in whose portfolios the share of federal government securities had increased to almost three quarters of ruble deposit liabilities at end-1997.

97. **Large scale capital outflows resumed in May 1998 as investors became increasingly unwilling to roll over maturing short-term treasury bills while the CBR continued to defend the exchange rate.** Market turbulence intensified in the face of political uncertainties associated with the dismissal of the government of Prime Minister Chernomyrdhin and the prolonged stalemate over the formation of a new cabinet. The growing perception that the fiscal position was unsustainable encouraged larger outflows, necessitating further foreign exchange market intervention by the CBR and increases in interest rates; the latter crippled commercial banks which relied on their portfolios of treasury bills to manage liquidity. Finally, large-scale support by the CBR to both banks and the government intensified pressure on the ruble, completing the vicious cycle.[30] Yields on short-term treasury bills at one point exceeded 300 percent and CBR intervention from April to mid-August amounted to $10.5 billion, or 40 percent of end-July base money.

98. **Faced with an unsustainable financial regime, the government on August 17 announced a set of emergency measures.** These included, in particular, a change in the wide exchange rate band and the elimination of the daily narrow band, and the unilateral conversion of all ruble treasury bills maturing before end-1999 into longer-term paper (see Chapter I). In the wake of the announcement, financial turmoil intensified and the ruble depreciated sharply despite large-scale intervention by the CBR. Foreign exchange trading was brought to a virtual halt on August 26 when the CBR terminated the fixing of the exchange rate in the MICEX auctions. On September 2, the authorities abolished the exchange rate band and let the ruble float.

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[30]Due to the prohibition in direct lending to the government, the CBR provided overdrafts to the government while redeeming maturing treasury bills from the market in its capacity as agent for the government.

Developments since the crisis

99. **Following the events of August 17, financial market activity ceased completely and the payment system came to a virtual halt due to a breakdown in trust between banks, while a run on deposits ensued.** In the first instance, the authorities responded to the banking crisis by injecting liquidity into the system, including through a freeing-up of commercial banks' required reserves. While these liquidity injections and a shift in household deposits to Sberbank brought about some return to banking and payments system activity, commercial banks' free reserves at the CBR increased rapidly as a flight to quality ensued.

100. **Monetary policy was largely reactive to the crisis through end-1998**. The CBR's credit policy became circumscribed by the financing needs of the government and the decision to provide credit to ailing individual commercial banks on a case-by-case basis. Together, CBR net credit to the government and gross credit to banks amounted to Rub 81 billion, or 46 percent of base money during the fourth quarter of 1998. However, the effects of this expansionary credit policy on inflation and the exchange rate were, to some extent, neutralized by the deflationary impact of the banking crisis and the introduction of foreign exchange market restrictions such as a prohibition on the increase of commercial banks' net long foreign currency positions. Nevertheless, monthly inflation at year-end had picked up to 11½ percent compared to 4½ percent in October.

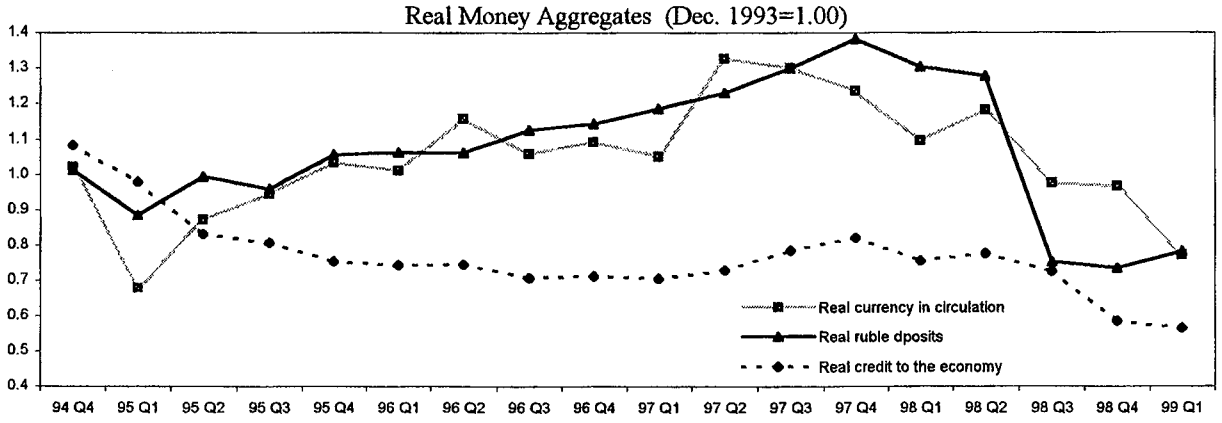
101. **Monetary policy was significantly tightened during the first few months of 1999, monthly inflation declined to about 2 percent and the rate of depreciation of the ruble decelerated**. Ruble credit to the government and banks was reduced while the external debt service payments of the government were financed largely through draw-downs of reserves. The CBR also increased reserve requirements for commercial banks, partly offsetting the relaxation in the immediate aftermath of the crisis. Nevertheless, the stability achieved remains precarious as even small injections of liquidity have required immediate sterilizations to eliminate the emergence of renewed pressures in the foreign exchange market.

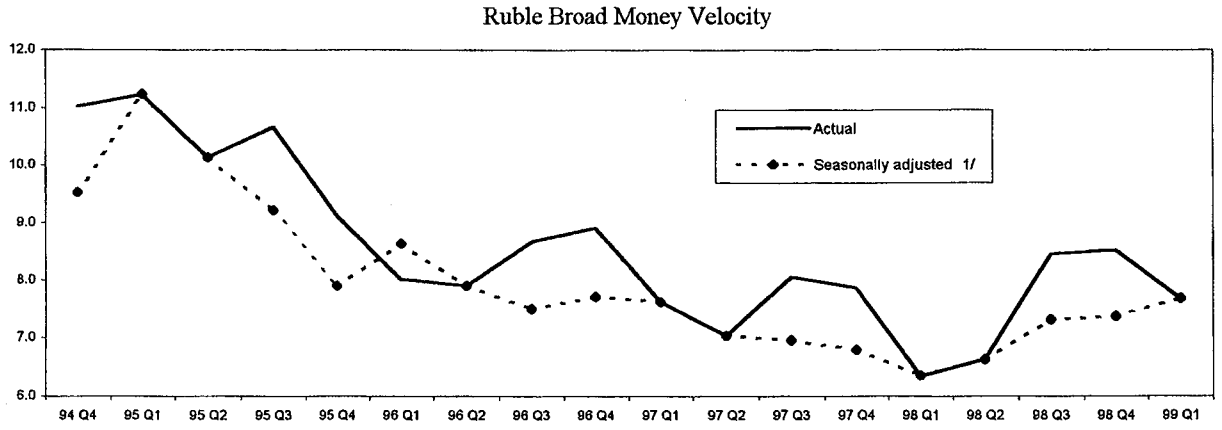
D. Commercial Banking and Broad Money Developments, 1995–99

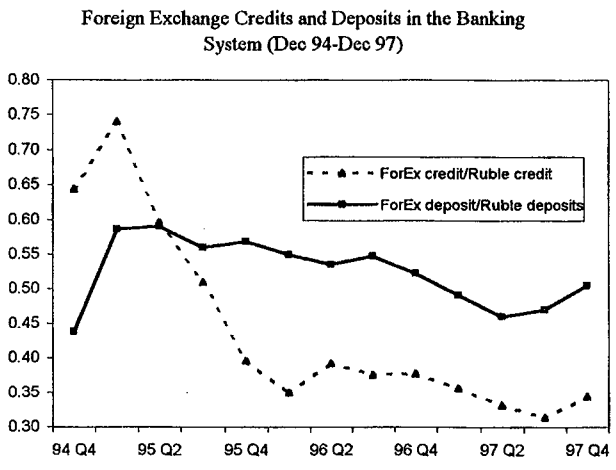
Broad money and credit developments

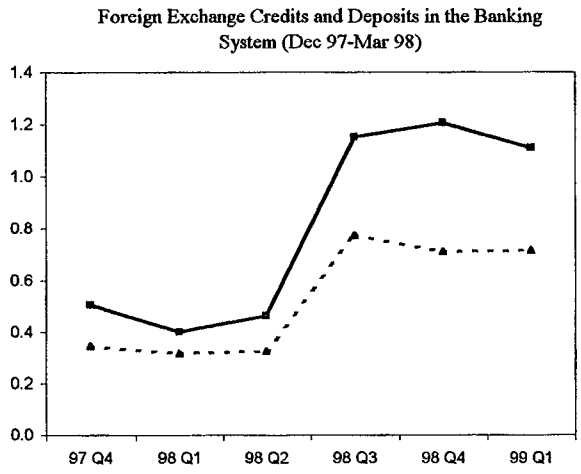
102. **The success until mid-1998 in reducing inflation had a significant positive impact on monetization and the demand for money.** Ruble broad money velocity steadily declined for the most part during 1996–97 and ruble broad money increased by almost 23 percent, in real terms, between end-1994 and June 1998. In addition, real ruble deposits increased by 27 percent compared with a rise of 16 percent in currency in circulation, suggesting an enhanced financial intermediation function of commercial banks. This function, however, became increasingly directed towards channeling private sector deposits to finance the budget deficit (Figures 16 and 17). The stability of the ruble also decreased the

Figure 16.
Russian Federation: Monetary and Credit Developments, December 1994-March 1999







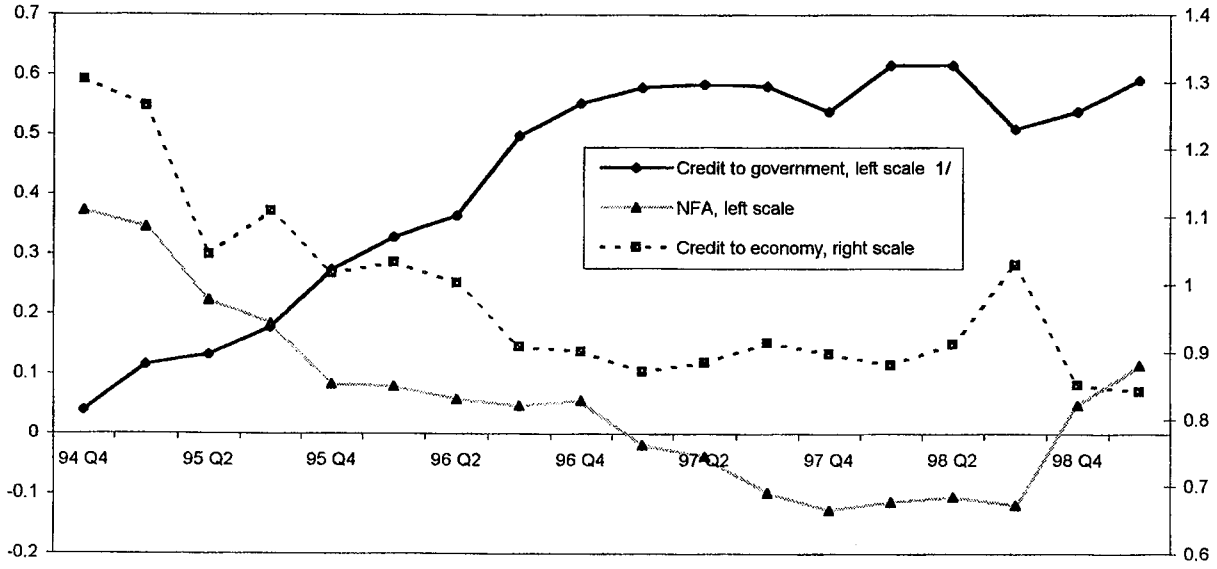


Sources: Russian authorities and Fund staff estimates.

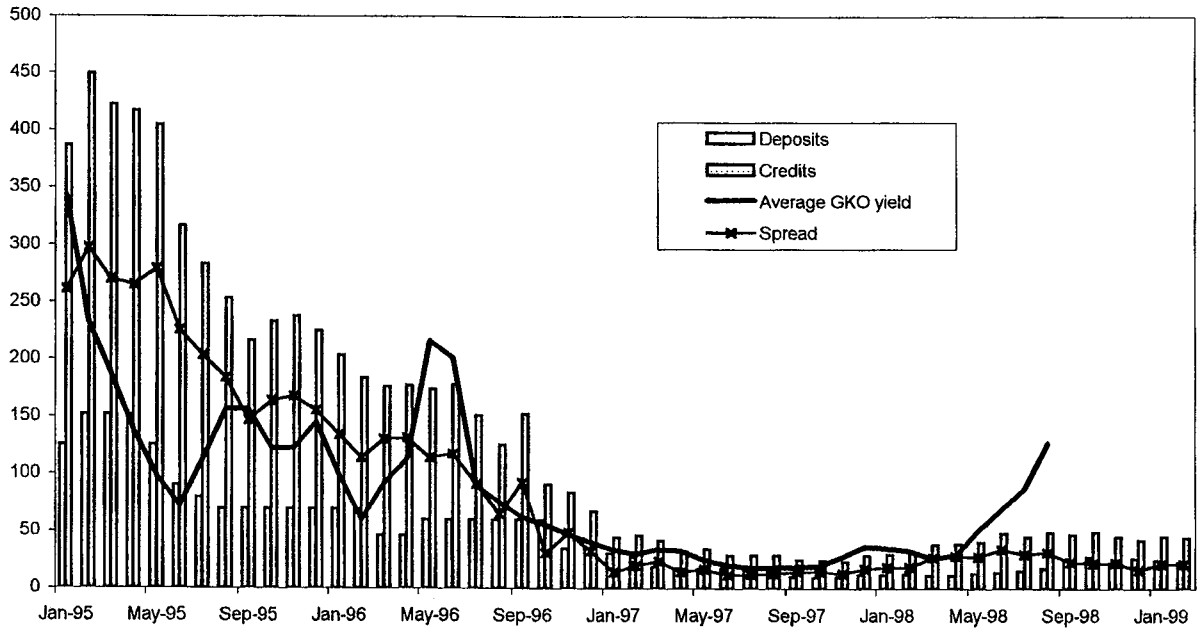
1/ Seasonal adjustment normalized to equal actual velocity during the second quarter.

Figure 17. Russian Federation: Commercial Banks: Credit and Interest Rates, January 1995- March 1999

Commercial Banks' Credit and Net Foreign Assets Ratio to Total Deposits



Nominal Interest Rates



Sources: Russian authorities and Fund staff estimates.

1/ Including amounts on-lent from the CBR.

dollarization of banking services; the ratio of foreign currency deposits to ruble deposits declined by 56 percent, from a high of 0.74 in March 1995 to 0.33 in June 1998 (Figure 16), while the share of banking sector credit denominated in foreign currency declined by 14 percent.[31] The smaller change in currency composition of credits reflects the fact that the favorable external environment enabled commercial banks to obtain foreign loans, which were on-lent to domestic clients. Reflecting this, the net foreign asset position of commercial banks deteriorated markedly during 1997 as on-balance sheet foreign liabilities almost doubled to $18.4 billion by year-end.

103. **Despite gains in remonetizing the economy and the access to foreign capital by Russian banks, commercial banks did not play a major role in meeting the credit needs of the real economy.** The real stock of credit to the nongovernment sector declined sharply in 1995 and by and large remained at that level until mid-1997 when a rise in foreign-currency denominated credit occurred in conjunction with increases in commercial banks' foreign liabilities. Nevertheless, the real stock of credit to the economy at end-1997 stood substantially below the level at end-1994. Commercial bank credit to the private sector declined further in 1998, reflecting the lackluster growth in monetary aggregates during the first half of the year and the wholesale collapse of the banking system after August; credit denominated in rubles declined by 11.5 percent during the second half of the year. In the aftermath of the banking crisis, loans in foreign currency were also either called in or not rolled-over and consequently declined by one-third during August-December to $10 billion by year-end and a further $9.3 billion by March 1999.[32]

104. **Commercial bank deposit and lending rates on credit to the private sector fell steadily from January 1995 to end-1997, although effective real rates initially remained very high as inflationary expectations adjusted slowly** (Figure 17). Nominal deposit rates were substantially below lending rates in early 1995 and the spread, while narrowing markedly, still averaged about 14 percent during 1997. The persistence of a large spread can be attributed, in part, to the low penetration of banks in the economy, particularly at the regional level, leading to a lack of competition in attracting household deposits, while the high lending rates reflected the attractive yields offered by investment in government debt and the real risks of lending in an environment with unclear property rights, poor accounting, and lax regulations. Deposit and lending rates, as well as the spread, started to move upwards again toward the end of 1997, preceded by a rise in the interbank rate, as commercial banks began to feel the credit squeeze associated with the CBR's efforts to defend the ruble.

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[31] These data exclude deposits and loans to the government.

[32] Reflecting the impact of the devaluation, the share of credit and deposits denominated in foreign exchange increased substantially during the third quarter of 1998, despite declines in dollar terms (Tables 24-25 and Figure 16). This also accounts for what appears to be a pick-up in total credit (Tables 24-25 and Figure 17).

105. **From the first quarter of 1994 through 1997, credit to government from commercial banks increasingly crowded out credit to the economy**. While at end-1993 commercial banks had a net liability position vis-à-vis government, the stock of government securities started increasing steadily in commercial banks' portfolios thereafter. By August 1998, the nominal value of government securities in banks' portfolios had increased by about 250 times while the real value had experienced a staggering twenty three-fold increase over end-1993.

106. **The growing concentration of commercial banks' activities increased the risks to the stability of the banking system from any volatility in the price of government debt or the exchange rate.** By mid-1998 the balance sheet positions of a number of large banks were already critical due to the persistently high interest rates needed to defend the ruble and the poor quality of their foreign-currency-denominated credit to the private sector. Money demand remained stagnant during the first half of 1998, reflecting decreased confidence in the ruble as well as perceived weaknesses of the banking system. Ruble deposits had, by mid-1998 declined in nominal terms compared to end-1997, as broad money velocity was already on an increasing path; velocity declined in June 1998 by less than 6 percent compared to a year earlier whereas the comparable figure for end-1997 had been 12 percent.

107. **The liquidity crisis during the first half of 1998 associated with skyrocketing interest rates and falling prices of government debt quickly turned into a system-wide insolvency problem with the devaluation and unilateral restructuring of treasury bills.** The payments system collapsed, activity in the interbank market came to a virtual halt, and banks froze their clients' deposits in the wake of a bank run; by end-August ruble deposits in the banking system had fallen by over 12 percent from levels two months earlier while foreign currency deposits declined by over 18 percent in dollar terms during the third quarter.

108. **In response to the crisis the authorities transferred household deposits from a number of large private banks to Sberbank—where deposits were guaranteed by the government.** In addition, the CBR freed up commercial banks' required reserves in the context of a mutual clearing of interbank settlements; extended liquidity and longer-term stabilization credit to banks, often in an ad-hoc manner; and purchased frozen treasury bills from banks. The use of required reserves to clear the payments system had a stabilizing effect as payments transactions, which had declined by about 40 percent following the devaluation, subsequently recovered—albeit to a point below the pre-crisis level, reflecting the decline in economic activity.

109. **The large liquidity injections resulted in a sharp rise in currency and in banks' free reserves during the fourth quarter of 1998, while ruble broad money velocity increased further.** The rise in base money accommodated, to some extent, the need for currency for transactions following the sharp decline in the real value of ruble balances after the devaluation and the increase in the price of imports, and offset some of the impact of the freezing of household deposits. Deposits transferred to Sberbank were, for the most part, not

made available for withdrawal until year-end and numerous banks either did not allow withdrawals or placed restrictions on amounts or required advance notices. The frozen deposits in the banking system also help to explain the relatively small increase in measured velocity, which at year-end had increased by only about 8½ percent compared to a year earlier despite the scale of the financial crisis.[33] The contraction in effective money supply resulting from the nonavailability of deposits for withdrawals, coupled with restrictions in the foreign exchange market, also contributed to a slowing of inflation during October–November, 1998.

110. **The collapse of the interbank market, the halt in trading of government securities and restrictions on increasing foreign currency positions, led to a large build-up in commercial banks' free reserves at the CBR during the final months of 1998.**[34] While this liquidity reflected, to some extent, a change in liquidity management practices by banks who could no longer rely on liquid government paper, on other banks, or on foreign sources for raising funds, it also reflected a genuine breakdown of all credit market activity and the flight to security by commercial banks. Banks were even less willing than earlier to extend new loans to the private sector and the market for government debt was nonexistent.[35] The breakdown of financial markets resulted in a segmentation of the banking sector, with some banks highly liquid following the CBR's extension of support in the aftermath of the crisis and others starved for liquidity. In the aggregate, however, commercial banks' correspondent accounts at the CBR had, by year-end, quadrupled compared to end-August.

111. **In early 1999, a lack of progress in bank restructuring ensured a continuation of the trends evident at end-1998.** Velocity continued to increase and real credit declined while banks' free reserves at the CBR increased further. The net foreign asset position of the commercial banking sector improved, however, as some banks successfully made payments on

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[33] As inflation, as measured by the CPI, has been notably higher than that measured by the GDP deflator, the decrease in real money balances as measured using the CPI has been substantially more than would be indicated by velocity developments (Figure 16).

[34]Secondary market trading of all treasury bills were halted until end-1998. The government issued some new notes but these were earmarked for purchases by the CBR through Sberbank.

[35]The expansion of credit to government from commercial banks starting in the fourth quarter of 1998 (Table 24 and 25) reflected earmarked on-lending of foreign exchange from the CBR to the government through state-owned commercial banks for making external debt payments. With loss of access to foreign markets, the government had to rely on the foreign currency reserves of the CBR for making external debt service payments. As the CBR was prohibited from lending directly to the government, an arrangement was put in place whereby the CBR provided the necessary funds to Vneshekonombank which in turn recorded these as its own claims on the government.

their external debt obligations while new foreign credit to the banking sector had virtually dried up.

Developments in the commercial banking sector

112. **Despite an explosive growth in the number of commercial banks, from fewer than 100 in 1988 to about 1,500 a decade later, the Russian banking sector is highly concentrated**. At end-1997, the top five banks accounted for 36 percent of total assets and the top 50 for 71 percent.[36] Private sector deposits were similarly concentrated; at end-1997 about three-quarters of all household deposits were maintained with Sberbank and the figure has since increased substantially. Including enterprise deposits, at end-1997 five banks accounted for 58 percent of ruble deposits and 50 banks for 65 percent.[37] The number of banks has been reduced from a high of about 2,400 in 1994, including through license withdrawals of nonviable banks. Most banks remain small in terms of the size of operations, with only a quarter of them authorized to have capital above Rub 20 million ($1 million) at end-1998.

113. **Despite the large number of banks, Russia's banking sector accounts for a small portion of economic activity by international standards.** In mid-1998, total commercial bank assets amounted to about 30 percent of GDP while nongovernment deposits accounted for some 12 percent of GDP. This compares, for example, to a deposit base of 33 percent of GDP in Poland and 64 percent of GDP in the Czech Republic at end-1997.

114. **The banking system is dominated by Sberbank, which accounted for almost a quarter of all assets at end-1997**. The remainder of the banking system can be grouped into four broad categories: (i) large banks with extensive branch networks and significant retail-banking based businesses; (ii) large banks with limited retail banking activities; (iii) subsidiaries of foreign banks licensed to operate in Russia; and (iv) small and primarily regional banks. Banks of types (i)–(iii) are primarily based in Moscow; at end-1997 all but four of the top 50 banks (in terms of assets) were based in Moscow and three in St. Petersburg. Very few banks, outside of Sberbank, can be characterized as having a significant retail banking business; at end-1998, despite the sheer geographical size of Russia, there were only about 4,500 bank branches in the country, with Sberbank alone accounting for close to half and SBS-Agro Bank for another third.[38] Most of the large Moscow banks' client base derives from enterprises within the financial-industrial group (FIG) that also includes the

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[36]Due to the dramatic changes in asset and liability valuations of individual banks in mid-1998, the analysis of more recent data is not very meaningful.

[37]Data for individual banks are from Interfax, may not be directly comparable with the banking system aggregate data, as reported to *IFS*, due to different accounting methodologies.

[38] This excludes over 30,000 sub-branches of Sberbank.

bank. Apart from servicing the banking needs of these clients, these banks' activities primarily focused on trading in government securities and conducting trade-related and other financial transactions.

115. **The pattern of holdings and cross-holdings between industrial enterprises and commercial banks within a financial industrial group make the ownership structure of the Russian banking sector extremely opaque.** The lack of consolidated information about FIGs poses difficulties in assessing risk from the point of view of creditors and regulators and renders any analysis of exposure from connected lending difficult to assess. The CBR has recently required consolidated reporting of accounts, including of banking subsidiaries, for bank supervision purposes; however, legal impediments still stand in the way of requiring consolidation of all subsidiaries. Russian accounting standards differ from international standards and calculations of prudential norms, such as capital adequacy, vary considerably, further complicating the task of assessing banking sector soundness.

116. **Nevertheless, by 1997 it was already evident that the Russian banking system was significantly exposed to exchange rate and interest rate risks.** Due to the concentration of government securities in the assets of the large Moscow based banks, any decline in the values of these portfolios threatened the solvency of the banks. Furthermore, banks relied on government securities with short maturities to manage their day-to-day liquidity needs. The tight liquidity conditions necessary to defend the ruble in late 1997 and early 1998 and the persistence of high interest rates forced many banks to realize losses by unloading government paper to meet liquidity needs.

117. **Russian banks were also significantly exposed to external and foreign-currency risks.** Data from early 1998 indicated that the maturity structure of foreign assets and liabilities was mismatched, with liabilities to nonresidents denominated in foreign exchange of under one year of $11.8 billion offset by similar assets of only $5.9 billion.[39] This reflected, in part, the use of short-term foreign loans from nonresidents to extend credit denominated in foreign currency to resident enterprises. In terms of currency exposure, although balance sheet assets of the commercial banking sector denominated in foreign currency exceeded liabilities, the quality of the assets was extremely poor due in large part to loans of dubious quality extended in foreign currency to domestic enterprises. Furthermore, the gross foreign currency exposure of the banking system as a whole was substantial, with assets and liabilities denominated in foreign currency exceeding $40 billion. The short-run position of the commercial banking system appeared particularly vulnerable to any deterioration of asset quality, as about 26 percent of foreign-currency liabilities had maturities of under one month.

118. **Commercial banks in Russia also had an extensive off-balance sheet exposure to foreign currency risks.** Following changes in the rules governing nonresidents' access to the treasury bill market and in conjunction with the inflow of foreign capital into the Russian

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[39] Figures from end-May 1998.

stock market, commercial banks engaged in heavy trading of foreign currency derivatives. Given the stability of the ruble and weak prudential supervision, banks did not, however, ensure that their own exposures were adequately hedged. While the volume of forward foreign currency operations declined somewhat in early 1998, commercial banks' off-balance sheet forward foreign currency claims on residents and nonresidents still stood at a staggering $93 billion at end-May 1998, with such obligations amounting to $83 billion.[40] Furthermore, reflecting the volume of contracts with nonresident investors participating in the market for short-term government debt paper, the short-term gross position of the banking sector was very vulnerable, as forward operations of under 90 days accounted for 38 percent of the total and the quality of Russian banks' own claims on smaller banks and enterprises for delivery of foreign exchange was highly questionable.

119. **Given the exposure of the Russian banking system, three sources of risk arising from a devaluation of the currency existed.** First, a substantial portion of lending was denominated in foreign currency and made to clients without foreign currency earnings, while on-balance sheet liabilities had short maturities requiring rollovers of existing credit lines or the continuation of access to foreign capital markets. Second, there was a danger of an unfolding chain of defaults in off-balance sheet contracts, as nonresidents typically purchased forward foreign currency contracts and options from larger banks, which in turn did their hedging with smaller, weaker banks. This risk was exacerbated by the difficulty of enforcing off-balance sheet contracts under Russian law. Third, prudential requirements for coverage of foreign currency positions were inadequate, and the quality of banks' hedges of foreign currency risk was highly questionable.

120. **The August crisis dealt two death-blows to a large number of commercial banks—particularly the large Moscow-based banks.** First, banks' substantial foreign currency loans, which were already of extremely poor quality, became uncollectible as often such loans represented claims on parties without foreign currency earnings. While some commercial banks reached bilateral agreements with their counterparts for settling forward claims at rates substantially below the new value of the ruble, many of the forward claims in the banking system still have not been settled. Exacerbating the problem, external credit lines were curtailed or withdrawn and some banks subsequently defaulted on their external debt while others initiated negotiations with their creditors for restructuring their debts.[41] Second, given the short-term nature of treasury bills, most of the commercial banks' portfolios of government paper became subject to the restructuring—effectively at a fraction of the face value of the instruments. The bulk of the Russian banking system in terms of asset size became

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[40] These figures are to be interpreted as being indicative of the size of the problem as they represent aggregate numbers that do not distinguish between different sorts of foreign currency derivatives and different terms underlying the contracts.

[41] The three-month moratorium on external debt service by banks and enterprises introduced as part of the August 17 measures, expired in mid-November.

insolvent, reflecting the relative size and nature of banking activities of the Moscow-based banks. Regional banks, however, fared significantly better given their lower exposure to external and currency risks and the lower share of their assets invested in government paper.

121. **The Russian banking system lay in a state of semi-paralysis.** In the aftermath of the crisis, the authorities delayed moving decisively to close the large insolvent banks and extended ad hoc support to a number of banks in the form of "rehabilitation credits." While this support enabled banks to continue functioning in some fashion, the fundamental problems remained to be addressed. There were wide-spread reports of asset-stripping, of banks shifting assets to shell entities, and the initiation of unilateral restructuring of their own balance sheets. Legal impediments had, to some extent, prevented the authorities from intervening; however, in the case of banks receiving rehabilitation credits—where the CBR held 75 percent of shares as collateral—the lack of legal intervention powers can not fully explain the lack of early decisive actions.

122. **More recently, the authorities have begun to accelerate the process of bank restructuring. The strategy is aimed at rehabilitating a core group of banks while liquidating a large number of nonviable banks.** The first priority was to lay the legal and technical groundwork necessary for a program of bank restructuring. The Bank Bankruptcy Law, which, inter alia, strengthens the CBR's intervention powers, was ratified by parliament in early 1999. The authorities also conducted a due diligence analysis of the soundness of a number of individual large Moscow-based banks and identified the size of the capital hole in the system and set-up a bank restructuring agency (ARCO). The adoption of a stand-alone Bank Restructuring Law in June 1999 gives sole responsibility for restructuring banks to ARCO, allows for the transfer of banks to ARCO only by CBR directive issued on the basis of specific criteria, provides for an equitable and transparent mechanism for shareholder writedowns, and empowers ARCO to undo transactions made with intent to defraud depositors and creditors of insolvent banks. The CBR has decided to adopt a policy of limiting liquidity support to solvent banks or those implementing ARCO-approved restructuring plans, and only though regular facilities with full collateralization. The CBR revoked the licenses of four large Moscow banks in late June, bringing the total number of such banks who have had their licenses revoked to six. Nevertheless, much remains to be done and the large scale restructuring of the banking sector, aimed at setting up a sound and competitive system that can engage in effective financial intermediation and in allocating credit efficiently while providing banking services to households, remains a key priority.

Table 23. Russian Federation: Monetary Authorities' Accounts, 1995-99
(In billions of new rubles, unless otherwise indicated) 1/

	1995	1996	1997	1998					1999
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Dec revalued.	Mar
Base money	103.7	130.9	164.5	152.9	163.2	175.2	210.4	210.4	205.9
Currency issued	83.4	108.6	137.0	127.2	137.7	161.8	197.9	197.9	186.5
Required reserves on ruble deposits	20.4	22.3	27.5	25.7	25.5	13.4	12.5	12.5	19.4
Net international reserves (NIR) 2/	35.7	9.6	22.3	14.4	9.5	-107.4	-134.0	-148.6	-188.8
(US$)	7.7	1.7	3.7	2.4	1.5	-6.7	-6.5	-7.2	-7.8
Net domestic assets (NDA)	68.0	121.3	142.2	138.5	153.8	282.6	344.4	359.0	394.7
Net credit to enlarged government	99.8	157.2	191.1	192.4	183.1	228.1	238.3	238.3	233.7
Net credit to federal government	104.1	161.5	199.2	197.9	187.9	232.5	245.7	245.7	245.0
CBR net credit to the federal government 3/ 4/	73.4	107.1	134.0	131.7	122.3	155.8	179.9	179.9	197.0
o/w securities	32.5	60.0	146.9	148.8	138.0	163.6	208.7	208.7	215.6
Ruble counterpart 5/	30.8	54.4	65.2	66.2	65.6	76.7	65.8	65.8	48.0
CBR net credit to local government 4/	-2.1	-2.1	-3.6	-3.2	-2.9	-2.0	-2.9	-2.9	-5.6
CBR net credit to extrabudgetary funds 4/	-2.2	-2.3	-4.5	-2.3	-1.9	-2.4	-4.5	-4.5	-5.7
Net credit to banks	-6.1	-17.8	-20.7	-13.8	-2.2	-5.5	29.9	29.9	66.5
Gross credit to banks 6/	17.5	11.4	11.1	5.8	12.0	17.9	75.0	75.0	134.7
Gross liabilities to banks and deposits	23.6	29.2	31.8	19.6	14.2	23.4	45.1	45.1	68.2
OIN	-25.7	-18.1	-28.2	-40.1	-27.0	60.0	76.2	90.8	94.6
o/w required reserves on foreign currency deposits	-1.2	-3.6	-8.9	-12.7	-12.6	-6.8	-8.3	-8.3	-15.7
o/w other items	-24.5	-14.5	-19.3	-27.4	-14.4	66.8	84.5	99.0	110.2
Demand deposits at CBR	-1.1	-1.3	-5.2	-4.2	-3.7	-3.4	-5.5	-5.5	-6.8
Time and forex deposits at CBR	0.0	0.0	-0.2	-0.8	-2.3	-1.1	-1.8	-1.8	-2.2
Memorandum:									
Exchange rate (official, end-period)	4.64	5.56	5.96	6.11	6.20	16.06	20.65	20.65	24.18
Gross reserves (US$) 7/	17.3	15.4	17.8	17.0	16.2	12.6	12.1	12.2	10.9
o/w gold	2.9	4.1	4.9	4.9	5.0	3.9	4.4	4.4	4.1
CBR	15.0	14.8	17.2	16.0	15.0	12.4	12.0	12.1	10.6
MinFin	2.3	0.5	0.6	1.0	1.2	0.1	0.2	0.2	0.3
Reserve Liabilities (US$)	9.6	13.6	14.0	14.6	14.7	19.2	18.6	19.4	18.7
CBR	0.0	1.1	0.0	0.0	0.0	3.8	3.8	4.0	4.1
MinFin	9.6	12.5	14.0	14.6	14.7	15.4	14.8	15.4	14.7

1/ Data (except for external reserves and the ruble counterpart) are compiled according to IFS definitions, which differ from program definitions. Due to the adoption of a new chart of accounts in 1998, data not strictly comparable to earlier periods.
2/ At end-of-period Ruble/US$ exchange rates. US$ amounts based on end-1997 cross rates for 1998 and end-1998 cross rates for Dec 1998 revalued onwards.
3/ Includes valuation losses in government securities portfolio which, in 1998 amounted to about Rub 35 billion. Excludes US$ 2.3 billion in U.S. dollar directed credit to the federal government in 1998 and US$ 2 billion during Q1, 1999 through Vneshekonombank for external debt service of the federal government.
4/ Definitions of "federal government", "local government" and "extrabudgetary funds" do not fully coincide with program definitions.
5/ Represents the government's use of NIR resources and calculated in flow Ruble terms using the exchange rate in effect at the time of the transaction.
6/ Includes US$ 2.3 billion in U.S. dollar directed credit to the federal government in 1998 and US$ 2 billion during Q1, 1999 through Vneshekonombank for external debt service.
7/ Include amounts held with domestic banks and by CBR-owned banks abroad. Change in gross reserves during the first quarter of 1999 differs from the BOP presentation as the latter excludes .

Table 24. Russian Federation: Monetary Survey, 1995-99 1/
(In billions of new rubles, unless otherwise indicated)

	1995	1996	1997	1998					1999
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Dec revalued.	Mar
Net foreign assets 2/	51.9	23.6	-19.1	-21.2	-23.3	-151.8	-112.4	-126.9	-130.2
NIR of monetary authorities	35.7	9.6	22.3	14.4	9.5	-107.4	-134.0	-148.6	-188.8
NFA of commercial banks	16.2	14.0	-41.4	-35.6	-32.7	-44.4	21.7	21.7	58.6
NDA	223.8	333.7	478.3	457.5	469.4	681.2	752.8	767.4	818.0
Domestic credit	349.5	523.3	655.5	660.4	660.6	800.3	859.2	859.2	959.1
Net credit to general government	152.7	296.3	365.3	385.0	375.7	417.6	478.8	478.8	532.8
Net credit to federal government 3/	163.2	301.8	369.7	375.1	363.7	405.7	474.5	474.5	532.6
Net credit from the monetary authorities 4/	104.1	161.5	199.2	197.9	187.9	232.5	245.7	245.7	245.0
Net credit from com. Banks 4/	59.1	140.3	170.5	177.2	175.7	173.2	228.9	228.9	287.6
Ruble credit	...	124.1	147.8	156.6	150.8	83.8	76.7	76.7	64.5
Forex credit	...	16.2	22.7	20.6	24.9	89.4	152.2	152.2	223.1
Net credit to local government and EBFs 4/	-10.5	-5.5	-4.4	9.9	12.0	12.0	4.3	4.3	0.2
Net credit from monetary authorities	-4.3	-4.3	-8.1	-5.5	-4.9	-4.4	-7.4	-7.4	-11.3
Net credit from com. banks	-6.2	-1.1	3.7	15.4	16.9	16.4	11.7	11.7	11.6
Credit to the economy	196.8	227.0	290.2	275.3	284.9	382.6	380.3	380.3	426.3
Loans in foreign currency 2/	71.3	77.9	97.4	78.7	90.3	204.8	207.9	207.9	224.1
(in U.S. dollar)	15.4	14.0	16.3	12.9	14.6	12.7	10.1	10.1	9.3
Other loans	125.5	149.1	192.8	196.7	194.6	177.8	172.4	172.4	202.2
Other items (net)	-125.6	-189.6	-177.2	-202.8	-191.2	-119.1	-106.3	-91.7	-141.1
Broad money	275.8	357.3	459.2	436.3	446.1	529.4	640.5	640.5	687.8
Ruble broad money	220.5	287.9	374.2	360.4	368.6	365.8	452.5	452.5	473.7
Currency in circulation	80.8	103.8	130.5	119.1	129.8	154.2	187.8	187.8	174.2
Ruble deposits 5/	139.7	184.0	243.7	241.3	238.8	211.6	264.7	264.7	299.5
Forex deposits 2/	55.3	69.4	85.0	75.9	77.5	163.6	188.0	188.0	214.0
(in U.S. dollar)	11.9	12.5	14.3	12.4	12.5	10.2	9.1	9.1	8.9

1/ Data largely presented according to IFS definitions and methodologies, which differ from program definitions. Due to the adoption of a new chart of accounts in 1998, data not strictly comparable to earlier periods.

2/ At end-period Ruble/US$ exchange rates. NIR of the monetary authorities in US dollars calculated using end-1997 cross rates for 1998 and end-1998 cross rates from Dec 1998 revalued onwards.

3/ Inclusive of valuation gains and losses on holdings of government securities. Directed credit in foreign exchange from the CBR to the government through Vneshekonombank included as credit from commercial banks and not from the monetary authorities.

4/ Definitions of "federal government", "local governments" and "extrabudgetary funds" do not fully coincide program definitions.

Table 25. Russian Federation: Key Monetary Indicators, 1995-99

	1995	1996	1997	1998					1999
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Dec rev.	Mar
Velocity									
Ruble broad money velocity (seasonally adj.) 1/	7.9	7.7	6.8	6.3	6.6	7.3	7.4	7.4	7.7
Ruble money multiplier	2.13	2.20	2.27	2.36	2.26	2.09	2.15	2.15	2.30
Currency-to-deposit	0.58	0.56	0.54	0.49	0.54	0.73	0.71	0.71	0.58
Reserves -to-deposits	0.15	0.12	0.11	0.11	0.11	0.06	0.05	0.05	0.06
Currency held by banks to deposits	0.02	0.03	0.03	0.03	0.03	0.04	0.04	0.04	0.04
Currency ratios									
Forex deposits/ruble deposits	0.40	0.38	0.36	0.32	0.33	0.79	0.73	0.73	0.73
Forex credit/ruble credit	0.57	0.52	0.51	0.40	0.46	1.15	1.21	1.21	1.11
Real measures of monetary aggregates									
Real currency in circulation 2/	1.03	1.09	1.24	1.10	1.18	0.98	0.96	0.96	0.77
Real ruble deposits 2/	1.06	1.14	1.36	1.31	1.28	0.79	0.80	0.80	0.78
Real ruble broad money 2/	1.05	1.12	1.32	1.23	1.25	0.86	0.86	0.86	0.78
Real forex deposits 2/	0.63	0.65	0.72	0.62	0.63	0.92	0.86	0.86	0.84
Real credit (incl. Forex) to the economy 2/	0.75	0.71	0.82	0.76	0.78	0.73	0.58	0.58	0.56
Real ruble credit to the economy 2/	0.56	0.55	0.64	0.63	0.62	0.39	0.31	0.31	0.31
Contributions to monetary growth									
1. Monetary authorities 3/									
Base money growth	123.9	26.2	25.7	-7.1	6.8	7.3	20.1	...	-2.2
NDA	64.3	51.4	16.0	-2.3	10.0	78.9	35.3	...	17.0
Credit to government	84.8	55.3	25.9	0.8	-6.1	27.6	5.8	...	-2.2
NIR	59.6	-25.2	9.7	-4.8	-3.2	-71.6	-15.2	...	-19.1
2. Banking system 4/									
Broad money	112.6	29.6	28.5	-5.0	2.3	18.7	21.0	...	7.4
NDA	105.7	39.8	40.5	-4.5	2.7	47.5	13.5	...	7.9
Credit to government	68.2	52.1	19.3	4.3	-2.2	9.4	11.6	...	8.4
NFA	6.9	-10.3	-12.0	-0.5	-0.5	-28.8	7.5	...	-0.5
Growth in credit 5/									
Total credit to the economy	4.8	1.4	2.5	-2.7	1.6	14.0	-0.3	-0.3	5.3
Ruble-denominated credit to the economy	2.6	1.1	1.7	0.7	-0.3	-2.4	-0.7	-0.7	3.5
Credit to government from commercial banks	3.2	4.0	1.4	3.4	0.0	-0.4	6.1	6.1	6.8
Prices									
Inflation from end of previous year	131.3	21.8	11.0	8.5	6.4	52.2	84.4	84.4	16.1

1/ Based on annualized end-period monthly GDP. Seasonal adjustment normalized to June level.

2/ End-1993 = 1.00. Deflated by the CPI, stocks of foreign currency-denominated items converted into rubles at prevailing exchange rates.

3/ Change as a percent of the previous period stock of base money. Changes in NIR include valuation effects arising from exchange rate movements

4/ Change as a percent of the previous period stock of broad money (including foreign exchange deposits). Changes in NFA include valuation changes arising from exchange rate movements.

5/ Change as a percent of period GDP (annual 1994-97 and quarterly thereafter). Includes valuation effects in banks' portfolios of government debt.

V. External Sector Developments

123. **The balance of payments has been heavily influenced by the pattern of Russia's access to international capital markets, which peaked in 1997 before a progressive decline and eventually abrupt shutoff in 1998**. (See text table, below and Table 26). In 1997, heavy net government borrowing from private and official external sources more than offset continued net private outflows and Russia's first annual current account deficit since the breakup of the Soviet Union, permitting a buildup of $1½ billion in net international reserves (NIR) without compromising exchange rate stability. In 1998, by contrast, the curtailment of government borrowing from private external sources, accompanied by an acceleration of capital flight, resulted in a swing in the capital account of some $16 billion. This was reflected in the forced abandonment of the exchange rate band, a sharp import compression that brought the current account back into surplus, a rundown in NIR of about $10 billion, and an accumulation of external official and private sector arrears. The post-August 1998 pattern of capital outflows driving an overall balance of payments deficit and forcing reserve losses and an accumulation of official external arrears continued until the first quarter of 1999, when the tightening of monetary policy, possibly reinforced by the imposition of a number of capital controls, was reflected in a reduction in net private capital outflows and a stabilization in reserves.[42]

124. **These dramatic developments overshadowed the government's efforts, until the August crisis, to liberalize the exchange and trade regimes.** After accepting the obligations of Article VIII of the IMF's Articles in June 1996, Russia had progressed toward an exchange system that was largely free of restrictions on both current and capital transactions. In the wake of the August crisis, however, a number of measures—some short-lived, others still in place—were taken to bolster reserves and stem capital outflows. Similarly, while Russia continued to advance the development of the regional customs union and to seek accession to the WTO, a number of trade-hindering measures were taken after August 1998.

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[42]While balance of payments data for the second quarter of 1999 are not available, the reserve losses have recently been reversed somewhat as the CBR has made significant purchases from the market.

Summary Balance of Payments, 1995–99

	1995	1996	1997	1998 1st half	1998 2nd half	1998 Year	1999 1st quarter
	(In billions of U.S. dollars)						
Current account	**4.8**	**3.9**	**-3.0**	**-6.9**	**9.2**	**2.3**	**3.3**
Trade balance	18.7	17.8	11.6	1.8	16.1	17.9	6.5
Exports	82.7	90.6	89.0	37.5	37.3	74.8	15.3
Imports	-64.0	-72.8	-77.4	-35.7	-21.2	-56.8	-8.8
Other current account transactions	-13.8	-13.8	-14.6	-8.7	-6.9	-15.7	-3.3
Capital account	**-4.2**	**-10.9**	**6.3**	**7.4**	**-17.1**	**-9.7**	**-3.5**
Capital flows relating to the federal government	-9.7	1.7	15.1	7.3	0.4	7.7	-0.4
Inflows 1/	2.5	11.4	19.7	9.3	3.0	12.2	0.4
Amortization	-12.6	-10.9	-4.6	-1.8	-2.3	-4.1	-0.7
Other capital flows	5.4	-12.6	-8.7	0.2	-17.5	-17.4	-3.0
of which: foreign direct investment, net	1.7	1.7	3.6	1.1	0.1	1.2	0.2
Errors and omissions, net	**-7.9**	**-8.6**	**-7.8**	**-4.4**	**-3.5**	**-7.9**	**-1.6**
Overall balance	**-7.3**	**-15.6**	**-4.5**	**-3.9**	**-11.4**	**-15.3**	**-1.8**
Net international reserves (- = increase) 2/	-5.4	4.6	-1.4	2.3	7.8	10.2	0.2
Exceptional financing	12.8	11.0	5.9	1.6	3.6	5.2	1.6

Sources: Data provided by the Russian authorities, and Fund staff estimates.

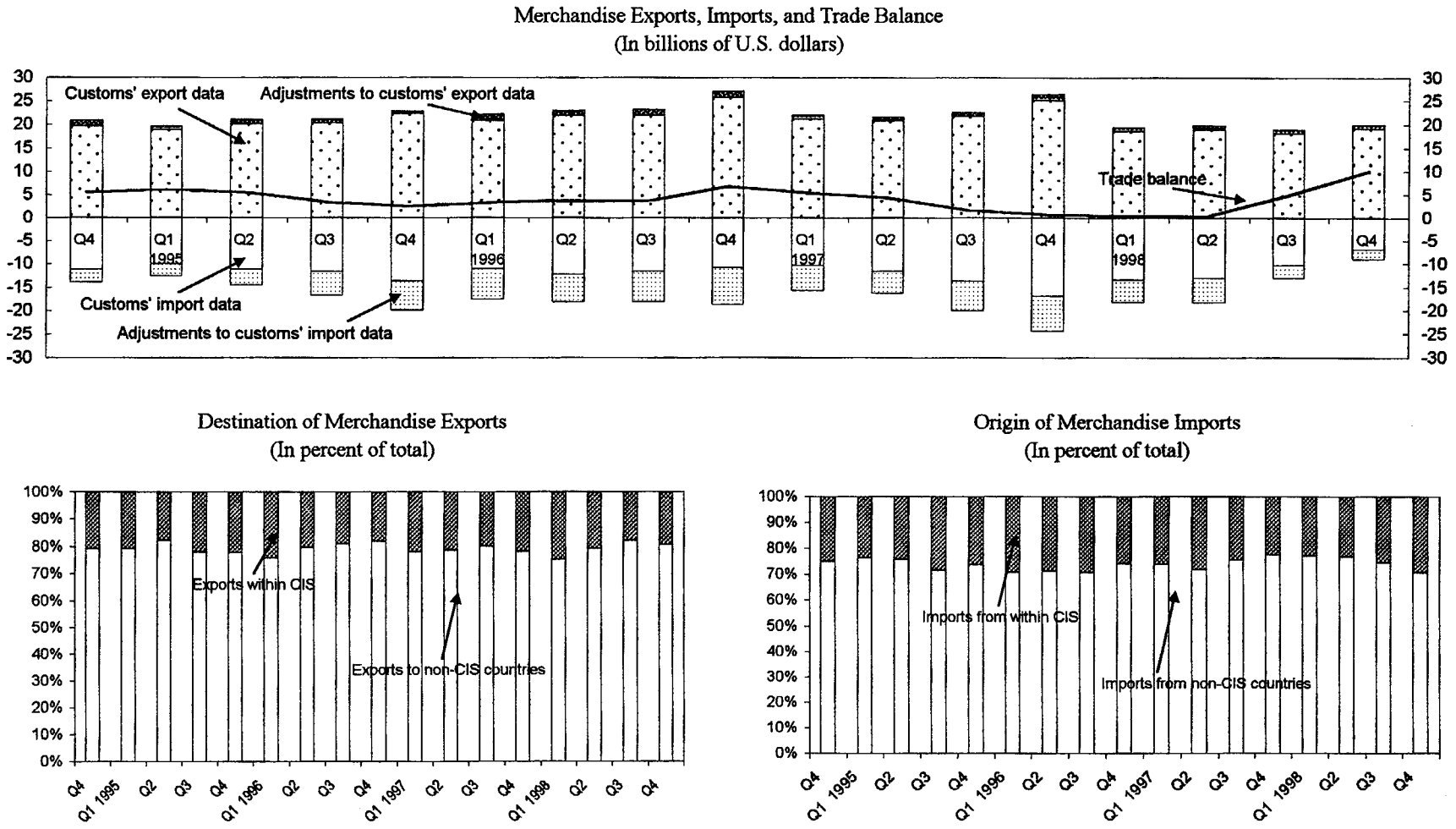
1/ Loan disbursements and net purchases of government securities.

2/ The definition of NIR differs from that used in the monetary accounts due to differences in cross exchange rates and treatment of gold.

A. Current Account

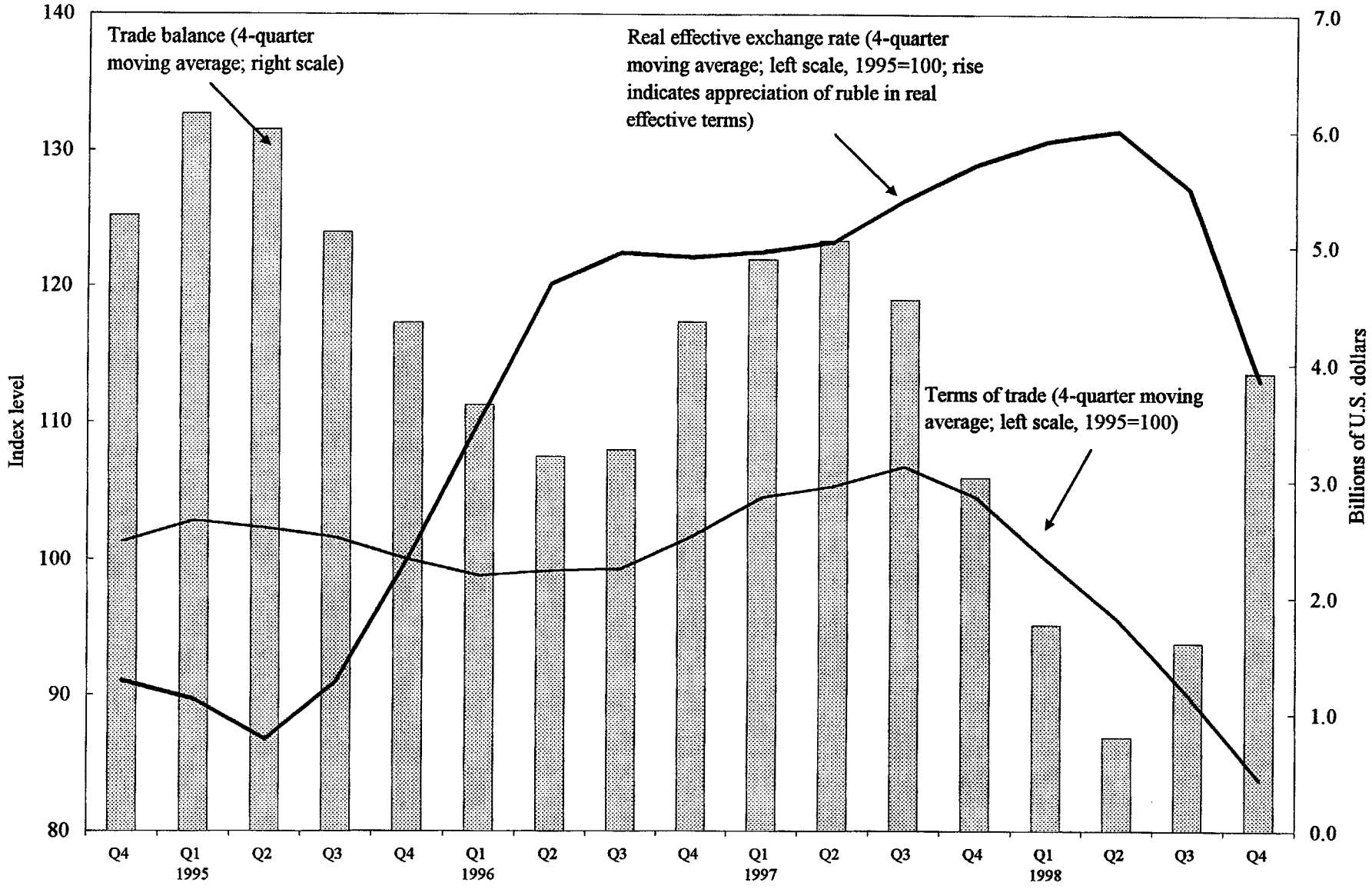
125. **Beginning in 1994, and continuing through mid-1998, Russia's current account position showed a trend deterioration, driven by a decline in the merchandise trade surplus**. (Table 26, Figure 18). Despite the still-depressed level of domestic demand, by the second quarter of 1997 the current account had swung into deficit, and did not move decisively back into surplus until after the August 1998 crisis. This trend, although masked for a time by an improvement in the terms of trade, was broadly coincident with the continuing appreciation of the ruble in real effective terms through July 1998 (Figure 19). From the point in 1997 when the terms of trade began to deteriorate, until the collapse of the ruble in August 1998, the shrinkage of the trade surplus accelerated, reversing itself only when the sudden plunge in the real effective exchange rate (and the disruption of the payments system in

Figure 18. Russian Federation: Quarterly Merchandise Trade, 1994-98



Sources: Data provided by the Russian authorities; and Fund staff estimates.

Figure 19. Russian Federation: Merchandise Trade Balance, Terms of Trade, and Real Effective Exchange Rate, 1994-98



August–September 1998) resulted in a severe compression of imports. Exports were also initially hit in the chaotic economic and financial environment after August 17, delaying the response to the sharp depreciation of the ruble. On a seasonally adjusted basis, however, export volumes did begin to improve from December 1998 onwards, and dollar export values picked up markedly from the beginning of the second quarter of 1999 in tandem with the strong recovery in oil prices. With the gradual return of stability, imports have been rising in 1999, although from very depressed levels: for the first four months of the year they remained at just over half the level of the corresponding period of 1998.

Merchandise trade

126. **The erosion of the trade surplus in the four years through mid-1998 was a function of the continued rapid growth in imports, despite a large decline in real GDP over that period, combined with sluggish and slowing increases in export volumes** (Figure 19). Fluctuations of the trade surplus around that declining trend were driven largely by oscillations in export prices, especially oil and gas prices. The trends in the trade account, as well as the sharp exchange rate correction in which they culminated, appear to have reflected an increasing degree of overvaluation of the ruble (see Box 7).

Exports

127. **After the marked shift in the destination of exports toward non-CIS countries in the first two years of transition, driven by the dismantling of the Soviet economic system and the removal of barriers to trade with the West, there has been relatively little change in the ratio of total exports going to non-CIS countries since 1994** (Table 27).[43] Within the CIS, the 1997–98 period showed some evidence of a shift in exports toward Russia's customs union partners (Belarus, Kazakhstan, and the Kyrgyz Republic). Among non-CIS trading partners, the most marked change in the destination of Russian exports was the fall in the share of Asian countries, from 14 percent in 1996 to under 12 percent in 1998, reflecting the slowdown in demand in that region arising from the economic crises in mid-1997.

128. **Through the first half of 1998, Russia's exports showed a tendency to become increasingly dominated by primary commodities**. Exports of fuel products, base and precious metals, forest products and precious stones accounted for about 77 percent of total exports in the period January 1997–June 1998, up from slightly over 70 percent in 1995 (Table 28). Over the same period, exports of other commodity groups like textiles and clothing stagnated or declined in dollar terms. The pronounced natural-resource orientation of Russian exports has tended to make overall exports sensitive to changes in world demand and the attendant swings in commodity prices.

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[43]Data on exports and imports include adjustments made to the State Customs Commission trade data to account for unrecorded trade.

Box 7. Real Exchange Rate Trends

Since the collapse of the Soviet Union, the ruble has seen huge swings in its purchasing power vis-à-vis the US dollar and other major world currencies. Given the major structural change inherent in the process of transition to a market economy and the large associated shifts in relative prices, the path of the fundamental equilibrium exchange rate has been particularly hard to identify. Nonetheless, by early 1998 a number of signs suggested that the ruble had become overvalued:

- The real effective (CPI-based) exchange rate index rose seven-fold from its low point just after the collapse of the Soviet Union at the end of 1991 to a high that was broadly maintained from July 1997 to July 1998. Qualitatively, this was not atypical: most transition economies have experienced a pattern of sharp initial real depreciation of the currency followed by steady real appreciation (especially of CPI-based real exchange rate indices), reflecting initial dislocation and a subsequent catchup in labor productivity vis-à-vis advanced non-transition economies, and corrective changes in the relative price of nontradeables. The pace and degree of appreciation of the ruble in real effective terms, however, were unusual even by the standards of other transition economies, including other former Soviet republics (see Figure 5).

- The path of average monthly dollar wages tell a similar story. In 1990 dollar wages in the Soviet Union were about $100 a month, although the existence of numerous trade and exchange barriers make it difficult to infer what their equilibrium level would have been in the absence of such controls. From an obviously distorted level of only about $10 a month in early 1992, dollar wages rose to $50 a month by mid-1993, and $100 a month by mid-1994. At that point, monthly dollar wages in Russia were broadly in line with other newly independent transition economies. With the nominal exchange rate stability that was imposed from early 1995 onward combined with inertial wage inflation, however, monthly dollar wages continued to rise rapidly, reaching $150 at the end of 1995. They continued to climb, to over $200 a month, by December 1997.

- The rise in dollar wages was not matched by increases in labor productivity or in the dollar prices of traded goods, so that the profitability of firms in the tradeables sector was increasingly under stress. Over the period 1995 to mid-1998 the unit labor cost-based measure of the real exchange rate rose even more rapidly than the CPI-based measure, while the dollar price of exports and the producer price index in dollar terms showed little cumulative change.

- Although for much of the period 1993-96 the terms of trade were relatively stable, they registered a substantial deterioration from early 1997 through 1998.

- From 1994 through mid-1998, imports continued to rise despite a cumulative fall in real incomes over the same period, while exports stagnated and the trade and current account balances deteriorated by about 7 percentage points of GDP.

- There was a growing awareness in pre-crisis months of the difficulties in the banking system and public finances, which led international capital markets to lower their assessment of Russia's creditworthiness and raise the risk premium on Russian financial assets, worsening the underlying balance of payments position.

The stability of the nominal exchange rate was ended, suddenly and dramatically, in August 1998. By January 1999 the ruble had declined in real effective terms by more than 45 percent from its July 1998 level, reversing all of the rise since early 1995. Over the same period, average monthly dollar wages are estimated to have fallen even more, by some 70 percent. The response was an immediate and sharp improvement in the current account balance, mainly on account of import compression. The nominal effective exchange rate broadly stabilized between January and June 1999, while gross reserve losses slowed and then were reversed.

Imports

129. **As with exports, there was no marked trend in the share of CIS countries in Russia's total imports, at least until the fourth quarter of 1998** (Table 29 and Figure 18). After the August crisis, there were signs that imports from other CIS countries—whose currencies had appreciated against the ruble by less than had the U.S. dollar[44]—were holding up better than imports from non-CIS countries.

130. **Through mid-1998, much of the growth of imports was attributable to unregistered or "shuttle" imports.**[45] These imports peaked in late 1996 at about 35 percent of total imports, remaining high until the onset of the full-blown crisis; in the fourth quarter of 1998 they had fallen to about 20 proportion of total imports (Figure 19 shows the proportion of total imports accounted for by all adjustments to customs data, including for shuttle trade.) There are indications that demand for consumer goods, which is the essence of shuttle trade, was particularly hard-hit by the sharp depreciation of the ruble.

131. **During 1997–98, the composition of Russia's imports remained broadly unchanged** (Table 30). The most notable shift was the substantial drop in the relative share of food and agricultural commodities in total imports in the aftermath of the August crisis.

Services, net income and transfers

132. **Russia has traditionally had a deficit in services, owing mainly to sizable interest payments on Federal government debt.** This pattern continued through 1997–98, with the services account registering deficits averaging about $15 billion (4 percent of GDP). With the growing interest payments on government debt, the deficit on income rose from $7.6 billion in 1996 to close to $12 billion in 1998. Nonfactor services (net), on the other hand, have been improving during the same period, due in part to falling outflows related to travel and tourism. There continued to be a small net inflow of transfers, reflecting primarily funds remitted to Russia by nonresident nationals.

B. Capital Account

133. **The developments in Russia's capital account since the last Article IV consultation closely mirror the country's economic and financial fortunes**. Overall, Russia's capital account balance swung from a deficit of $10.9 billion to a surplus of $6.3 billion in 1997 and back to a deficit of $9.7 billion in 1998 (Table 26). Improvements in Russia's economic policy environment and financial position, together with successful

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[44]Indeed, in the second half of 1998 the Belarussian rubel actually depreciated vis-à-vis the ruble by more than 40 percent.

[45] See SM/97/113 for a discussion of the phenomenon of shuttle imports.

rescheduling agreements with Paris and London Club creditors, in 1996 and 1997 respectively, encouraged sharp improvements in Russia's access to global capital markets, which were reflected in large inflows. In the first half of 1997, these inflows induced the CBR to purchase foreign exchange, while slowing the pace of the crawl of the ruble within its "sliding corridor." However, as much of these inflows were directed to short-term investments in government securities and equities, Russia became increasingly vulnerable to shifts in market sentiment, a weakness that manifested itself forcefully in the form of large capital outflows after the onset of the Asian crisis in the third quarter of 1997. The decline in investor confidence in emerging markets, adverse terms-of-trade developments, and unresolved structural and fiscal weaknesses encouraged a revision of investors' assessments of Russia's financial position and prospects, thereby inducing accumulating financial pressures that culminated in the crisis of August 1998.

Capital flows to the federal government

134. **The federal government was a major beneficiary of the improved financial environment from 1996 through late-1997, as it gained extensive access to the global capital markets**. Net inflows to the federal government soared from less than $2 billion in 1996 to a peak of $15 billion in 1997, before declining to $7.7 billion in 1998 (Table 26). After an initial $1 billion Eurobond placement in November 1996, the Russian government successfully issued another three bonds for $3.6 billion in 1997.[46] With the relaxation of restrictions on nonresidents' holdings of short-term zero-coupon GKOs and longer-term OFZs that occurred in 1996, foreign investors in 1997 purchased, on a net basis, about $11 billion of the government's local-currency instruments, up from $6 billion in 1996. In addition to market borrowing, the government received close to $6 billion in loans from official bilateral and multilateral sources. In 1998, however, excluding disbursements from the Fund, inflows to the budget fell from $19.7 billion in 1997 to $12.2 billion (Tables 26 and 31, Figure 20).[47]

135. **The fall in inflows in 1998 primarily reflects the experience in the second half of the year; in the year to mid-1998, despite adverse developments in emerging markets, Russia continued to receive substantial inflows from abroad, albeit on increasingly expensive terms.** From total inflows of $12.2 billion in 1998, all but $0.9 billion came during January–August, as access to capital markets virtually dried up after the August crisis.

136. **The large Eurobond-related inflows in 1998 included a sizable voluntary exchange of GKOs for Eurobonds undertaken by the government in July**. With

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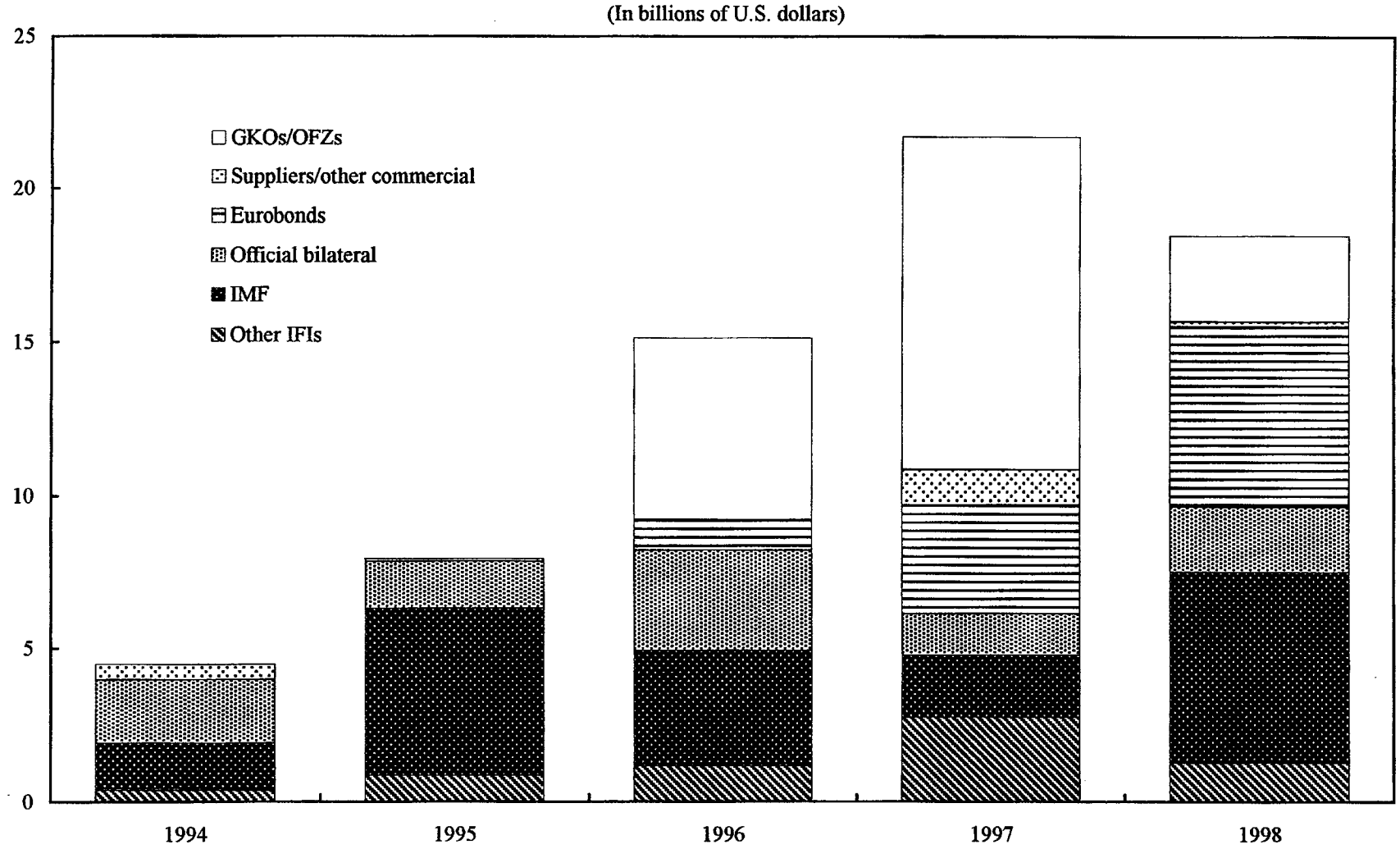
[46]These consisted of a $1.2 billion, 7-year, 9 percent bond; and two 10-year, 10-percent bonds for $400 million and $2 billion.

[47]Detailed information on Federal Government debt service obligations and payments are provided in Table 34.

Figure 20. Russian Federation: Disbursements from Non-residents to the Federal Government, 1994-98 1/



Source: Russian authorities.

1/ Excludes MinFin bonds issued in 1996.

increasing uncertainties in capital markets, starting in the latter part of 1997, there was a decline in demand for GKOs. This reflected in part net sales of such instruments by investors in a number of other emerging markets, including Brazil and Korea, who were rebalancing portfolios in the context of the overall emerging market downturn.[48] To lengthen the maturity structure of its ruble-denominated debt, the government sought not only to move budgetary financing away from short-term GKOs to longer-term OFZs, but also to exchange some of the outstanding GKOs for Eurobonds. To this end, in July 1998, the authorities undertook a debt exchange under which about $4.4 billion of GKOs, including some of Sberbank's holdings, were converted into 7- and 20-year Eurobonds. Both bonds were issued at very high spreads (940 basis points above U.S. Treasuries).[49]

Capital flows to other sectors

137. **The improved access to global capital markets in 1997 extended beyond the federal government.** The deficit in the nonsovereign capital account declined from $19.1 billion in 1996 to $13.5 billion in 1997, before widening again to $14.7 billion in 1998 (Table 32).[50] There was increased investor interest in equities and bonds issued by the Russian private sector, as well as in bonds issued by Russian regional governments. However, such access diminished with the intensification of the crisis in emerging markets and concerns about Russia's financial position.

138. **Foreign direct investment (FDI) inflows surged to $6.2 billion in 1997, from $2.5 billion in the year before, but fell to about $2.2 billion in 1998**. While the pickup in 1997 was substantial, compared with FDI in other transition countries and Russia's vast potential, the magnitude of inward FDI remained small. A host of factors continued to hinder inward investment, including uncertainty about the robustness of macroeconomic stability, shortcomings in the protection of property rights and the enforcement of contracts, and inadequacies in bankruptcy laws. In 1997, food and retail trade and catering services remained a major recipient of FDI, and there was a sharp pickup in investment in the financial sector. In 1998, the food industry regained its position as the leading recipient of investment. FDI outflows from Russia amounted to $2.6 billion in 1997, but fell to $1 billion in 1998.

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[48]Net purchases of GKOs/OFZs by nonresidents during January-August 1998 amounted to $2.8 billion, compared with $10.9 billion in 1997 as a whole.

[49]The amount of the GKO conversion, however, was well below the amounts eligible for conversion (about $40 billion, including holdings by the Central Bank of Russia which were in practice excluded from the instrument exchange).

[50]The nonsovereign capital account consists of three broad categories: foreign direct investment, portfolio investment, and other investments. There is, however, considerable uncertainty about the coverage, classification, and reliability of the data, especially with respect to the latter category, which includes items such as nonrepatriated export earnings that are very much akin to capital flight.

139. **At $2.4 billion, portfolio investment inflows—other than to the federal government—remained high in 1997, but, as with FDI, fell back significantly in 1998 to $1.1 billion**. In 1997, reflecting the overall concerns about emerging market equity markets, there was a shift in the composition of portfolio inflows away from equities and toward bonds, especially those of local governments, who succeeded in issuing Eurobonds for the first time.[51] Russian banks and corporations were also able to issue bonds abroad and attracted interest to their issues in the form of American Depository Receipts (ADRs). In 1998, local governments remained the largest recipients of portfolio investment ($0.5 billion). During 1997–98, portfolio outflows were small, averaging about $200 million a year.

140. **The balance on other investments—which consist of changes in holdings of foreign currency cash and deposits, trade credit, loans, arrears, and changes in the stock of nonrepatriated export earnings and import payments—improved significantly in 1997–98.** However, there are shortcomings in the quality of the official data on some of these transactions, particularly in the estimation of nonrepatriated export proceeds and nonrepatriated import advances (which amounted to $11.5 billion in 1997 and $8.6 billion in 1998), and other forms of capital flight. Loans to banks and to nonfinancial enterprises picked up sharply, before falling dramatically in 1998; loans to nonbank financial enterprises rose rapidly in the first three quarters of 1998, but stopped in the fourth quarter. The rise in external borrowings by nonfinancial enterprises was particularly large in 1997, rising to $7.7 billion, compared with less than $1 billion in the previous year, but came to a halt in 1998.[52]

141. **Capital flight, especially through misinvoicing of trade transactions, remained a significant factor in Russia's balance of payments, and containing it has been a major component of the authorities' recent policies**. There has been extensive debate on the nature and size of capital flight from Russia (Box 8). The Russian authorities have tentatively estimated that capital flight averaged about $11 billion during 1994–98. While there is little doubt that there have indeed been outflows, the estimates are subject to a great deal of uncertainty.

142. **The Russian authorities have been seeking to limit capital flight, especially since August 1998, through the intensification of exchange controls.**[53] In the past, they had tightened tax administration and financial sector supervision, and had introduced the so-called "passport system" (which was intended to monitor closely residents' trade-related

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[51]Three regional governments issued Eurobonds totaling $900 million.

[52]This is not consistent with information on changes in the stock of nonbank corporate debt reported in Table 33 ($6 billion), which might be due to incomplete coverage of corporate debt data for 1997.

[53]See Annex III for summary of changes in the exchange restrictions.

Box 8. Capital Flight From Russia

Capital flight from Russia has been the subject of a controversial debate in academic and policy circles. As in other countries, there is considerable debate on its definition and measurement, and policy implications. In Russia, capital flight has been done through misinvoicing of barter and cash external trade, and illegal financial transactions. As noted by Tikhomirov (1997), using different definitions and data sources, a number of studies have arrived at estimates of capital flight from Russia flight during 1990-95 in the range of $35 billion (Russian government) and $400 billion (Russian Security Ministry). More recently, a project on capital flight from Russia by Moscow Institute of Economics and the Center for the Study of Economic Relations at the University of Western Ontario, using balance of payments data, has estimated capital flight during 1994 through September 1997 at $17 billion per annum. Recently, the CBR has provided highly tentative estimates of capital flight (defined as the sum of nonreceipt of export earnings, unredeemed import advances, nonequivalent barter, and 50 percent of errors and omission) from Russia to have amounted to $54.2 billion during 1994–98, or an average of more than $10.8 billion per annum (including the entire errors and omissions would yield an average annual figure of $14.1 billion instead).

Channel	1994	1995	1996	1997	1998	Total
Nonreceipt of export earnings	3.9	4.9	4.2	3.7	3.2	19.9
Unredeemed import advances	0.0	0.0	4.3	6.9	4.3	15.5
Nonequivalent barter	0.0	0.0	1.3	0.8	0.4	2.5
50 percent of errors and omissions	0.2	3.9	4.3	3.9	4.0	16.3
Total capital flight	4.1	8.8	14.1	15.3	11.9	54.2

Source: CBR.

These estimates are subject to very great uncertainty due to the continuing shortcomings in balance of payments data. The existence of a persistent negative entry for "errors and omissions" does not necessarily imply persistent capital outflows, but could reflect a persistent underrecording of current accounts outflows, in particular imports.

transactions) and other current and capital account restrictions. More recently, the intensification of controls has included an increase in the surrender requirement on exports from 50 percent to 75 percent; a 100 percent deposit requirement on advance payments for imports; more rigorous monitoring of trade-related transactions undertaken through the banking system (e.g., CBR Directive 500-U, requiring more detailed reporting by banks to CBR on suspicious trade transactions); suspension of conversion operations through nonresidents' S-accounts (special nonresident bank accounts used for GKO-OFZ transactions) limiting investors' ability to effect moderate amounts of amortization from proceeds of bond transactions; and the imposition of a $10,000 limit on transfers of cash abroad without CBR approval.

The impact of the August crisis on Russia's relations with external creditors

143. **The measures announced on August 17, especially the unilateral restructuring of OFZs/GKOs and the moratorium on private external debt payments, had wide-ranging implications for Russia's financial relations with external creditors**. The GKO/OFZ conversion—which entailed prolonged and difficult negotiations with nonresident holders of these instruments—led to a freezing of the government securities market, cutting off the government from a major source of financing, and a deep and protracted banking crisis (Box 9). At the same time, the imposition of the moratorium on private debt payments—especially the legal and payment uncertainties surrounding the treatment of Russian banks' foreign exchange forward contracts and the asset stripping done by the Russian banks under cover of the moratorium—adversely affected its relations with external creditors (Box 10). Financial and market uncertainties and sentiment also deteriorated on account of the intensification of exchange restrictions. While a number of Russian banks and nonbank corporations managed to service some of their external debt under the moratorium, relations with foreign creditors have been harmed by actual and potential litigation.

C. External Debt and Claims

Sovereign debt

144. **Prior to the August crisis, the Russian government had made important progress in regularizing its relations with external creditors.** It had reached key rescheduling agreements with Paris and London Club creditors, which were finalized in April 1996 and October 1997, respectively, and allowed a substantial lengthening of the maturity structure of sovereign debt and reduced debt service pressures. In December 1996, the government had also reached an agreement in principle on a rescheduling of its debt to uninsured suppliers.

Box 9. The GKO/OFZ Novation

As a part of their policies to overcome pressures on public finances, on August 17 the Russian authorities announced their decision to restructure all GKOs/OFZs (except for holdings by the CBR and individuals) with maturity dates through end-December 1999 and suspended all trading in the GKO/OFZ market indefinitely. About Rub 190 billion in GKOs/OFZs, of which about ruble 83 billion was held by nonresidents, were affected by the restructuring. In addition, nonresident investors were faced with new restrictions, imposed under the private debt moratorium, on payments by Russian banks to nonresidents toward settlement of forward foreign exchange contracts that investors had written to hedge their GKO/OFZ holdings against a ruble devaluation.

It took several months for an agreement to be reached between the Russian government and external creditors on restructuring. An offer made by the authorities on August 25—which some market participants have argued was more attractive than the final terms of the agreement reached in March—included cash payments and new OFZs, with a partial Eurobond option, but was declined by nonresident holders who would have incurred significant losses on their holdings. In a further round of negotiations, the authorities sought to improve their offer by including in the restructuring negotiations nonresidents' claims on Russian commercial banks. This was also rejected by creditors. Russian domestic law provided little legal recourse for creditors, either resident and nonresident. Domestic banks were allowed to exchange collateral held in frozen GKOs against CBR credit for CBR debt securities. To accelerate discussions, the authorities announced the formation of a steering committee of nonresident creditors in October, and published substantially modified terms for the restructuring in December. Finally, after months of often difficult negotiations with nonresident creditors—who displayed deep disagreements among themselves—an agreement was reached that has since been accepted by the overwhelming majority of holders. Under the terms of the novation scheme, finalized in March, most resident and nonresident holders had the amount of their original GKOs/OFZs adjusted by discounting the stream of payments on such GKOs/OFZs from their scheduled payment date to August 19, 1998 at a rate of 50 percent per annum. Subsequently, they received a package including cash, GKOs and OFZs, as follows:

Type of payment/security	Percentage of adjusted holdings	Coupon (in percent)	Comments
Cash payment	3 1/3	None	Funds must be deposited in "restricted" ruble account
3-month GKO (Maturity March 1999)	3 1/3	None	Funds must be deposited in "restricted" ruble account
6-month GKO (Maturity June 1999)	3 1/3	None	Funds must be deposited in "restricted" ruble account
Cash-value OFZ	20	None	Can be used, at par, to pay tax obligations that were in arrears as of July 1, 1998; purchase newly issued shares of Russian banks. Any sales receipts must be deposited in "restricted "ruble accounts.
OFZs with maturities ranging from 4 to 5 years	70	30, 25, 20, 15 and 10 each year, respectively	Funds must be deposited in "restricted" ruble account

The rubles that are received by nonresidents under the novation (up-front cash payment, coupon, or principal, as well as proceeds from secondary market trading in GKOs/OFZs) must be deposited in their S-account. These "restricted rubles" could then be used for purchases of permitted Russian corporate bonds and equity securities. Nonresidents electing to convert and repatriate "restricted rubles" would need to deposit the funds in noninterest bearing transit accounts for one year, after which repatriation would be allowed. In addition, the CBR has agreed to hold at least four sales of foreign currency of at least $50 million each in 1999, through which nonresidents could purchase and repatriate foreign currency at an exchange rate that is at most 20 percent more depreciated than the market rate by offering either ruble balances in S-accounts or securities government securities held in S-accounts to the CBR. The first two sales were based on an exchange rate which was depreciated by 10 percent from the market exchange rate. In view of the complexity of the package, it has been difficult to obtain a reliable estimate of the loss suffered by investors. Some have indicated that, under the restructuring, returns to investors would amount to only 5 cents on the dollar. It should be noted, however, much of the losses suffered by the GKO/OFZ investors would be related to the depreciation of the ruble. Accordingly, the loss to investor due purely to the restructuring would be much smaller.

Russian institutional holders which were required by law to hold GKO/OFZs received slightly better terms (10 percent cash, 10 percent 3 - month GKOs, 10 percent 6-month GKOs, 20 percent cash-value OFZ, 50 percent OFZs with maturities ranging from 4 to 5 years). Some Russian institutional investors and individuals, as well as those holders who did not agree to the novation offer, would be paid according to the original terms of their holdings. Nonresidents, however, would not be allowed to repatriate their funds for a period of five years.

Box 10. The Moratorium on Private External Debt

As part of the set of measures to address Russia's financial crisis, the authorities announced a 90-day moratorium, effective from August 17 to November 14, 1998, on the repayment of private external debt. The moratorium was adopted primarily to protect official reserves in the face of an acute balance of payments crisis and to aid the domestic banking sector whose liquidity position was sharply diminished on account of the unilateral conversion of GKOs/OFZs and the suspension of trade in these instruments.

The moratorium suspended payments by residents to nonresidents of principal on loans with maturity exceeding 180 days, margin payments on loans collateralized with securities (including repo transactions), and foreign currency forward contracts. The moratorium did not cover payments on debt of the Russian government (directly or through Vnesheconombank), CBR, or local governments. Also excluded were payments on loans from the EBRD. In principle, the moratorium did not affect payments in foreign currency from and to Russia by nonresidents. In practice, however, nonresidents faced restrictions on transfers of funds from their S-accounts, containing the proceeds of nonresidents' transactions in GKOs/OFZs, as these transfers required a forward transaction of three days, which was covered by the moratorium. To work out relations with external creditors, the authorities encouraged residents whose payments were affected by the moratorium to seek, individually or in groups, from their foreign creditors a rescheduling of their obligations.

According to the authorities, payments that fell due to nonresidents during the moratorium (excluding payments against forward contracts) amounted to $3.1 billion, of which $2.7 billion were liabilities of commercial banks. Despite restrictions imposed under the moratorium, commercial banks actually settled $1.8 billion of their obligations (excluding forwards), leaving only $0.9 billion in unsettled arrears when the moratorium expired. Reportedly, Russian commercial banks (and nonbank corporations) circumvented the moratorium and settled some of their external obligations by utilizing their foreign assets held abroad or foreign currency earnings outside Russia or by making deposits with the Russian branches of foreign creditor banks, which was not prohibited under the moratorium.
Regarding forward contracts, CBR data indicate that prior to the declaration of the moratorium, the banking system's net forward position was close to neutral (-$0.2 billion) (Table A). With the sharp movement in the dollar/rubble exchange rate, however, this net position had moved to -$2.9 billion by November 1, 1998.

Table A. Claims and Obligations of Banks on Forward Contracts with Nonresidents
(Notional values, in billions of U.S. dollars)

		August 1	Sept. 1	Oct. 1	Nov. 1	Dec. 1
1	Claims in FX	10.3	7.5	3.2	1.8	1.2
2	Obligations in FX	15.1	12.1	8.3	7.8	6.6
3	Net obligations in FX (2-1)	4.7	4.6	5.1	6.0	5.4
4	Claims in rubles	13.5	10.1	3.9	3.8	3.3
5	Obligations in rubles	8.9	5.6	1.3	0.7	0.5
6	Net claims in rubles (4-5)	4.6	4.5	2.6	3.1	2.8
7	Net position (6-3)	-0.2	-0.1	-2.5	-2.9	-2.6

Source: CBR.

As noted in Box B3, the authorities originally intended to solve jointly the issues of nonresidents' holdings of GKOs/OFZs and the nonresidents' forward claims on Russian banks. However, in the course of negotiations, this approach was abandoned and the GKO/OFZ exchange and the settlement of forward claims were delinked. As a result, foreign creditors have been free to seek bilateral agreements with Russian debtors, or pursue their claims through litigation. As some of the forward contracts between Russian banks and foreign creditors were written under English law, some Russian banks are now vulnerable to litigation abroad. Several foreign creditors have been able to pursue Russian banks in courts abroad. For example, Lehman Brothers was able to obtain injunctions from U.K. courts to freeze the assets of Inkombank and Uneximbank. Thus far, however, there have been fewer instances of litigation abroad against Russian banks than had been anticipated. In recent months, some foreign and Russian banks have reached agreements with regard to the forward contracts. The ability of foreign creditors to pursue Russian banks in Russian courts has been undermined by ambiguities over the legal status of forward contracts under Russian laws.

In retrospect, while it provided some breathing space for Russian banks and nonbank corporations in meeting their external obligations, there is evidence that the moratorium was a costly undertaking. Reportedly, some Russian debtors circumvented the moratorium and serviced their external obligations. Second, there is anecdotal evidence that a number of other Russian bank and nonbank corporations used the debt moratorium as a cover for asset stripping and as an excuse for not settling their domestic obligations to other Russian creditors, with the attendant adverse implications especially for the banking and payments systems.

145. **At end-1998, Russia's sovereign foreign currency debt stood at $158 billion (48 percent of GDP),[54] up from $135 billion in the previous year** (Table 33). Two thirds of this debt was inherited from the Soviet era (prior to 1/1/1992).[55] [56] [57] Except for some arrears on Soviet-era debt, nearly all of Russia's sovereign foreign-currency debt is of medium- and long-term maturity. About 60 percent is owed to official creditors. Russia's debt to private creditors includes $16 billion in Eurobonds. Comprehensive debt data by *residency* are not available. However, Russia's sovereign debt to nonresidents is estimated at $152 billion (46 percent of GDP) at end-1998.[58]

146. **In the aftermath of the August financial crisis and the subsequent loss of access to global capital markets, the Russian government was not able to meet all of its external obligations and has been accumulating arrears on its Soviet-era debt**. By end-December 1998, Russia's overdue obligations to Paris and London club creditors stood at $851 million and $364 million, respectively, up from zero on the eve of the crisis (Table 33). In addition, Russia has been accumulating arrears on its Soviet-era debt vis-à-vis some of its other creditors. Following the 1996 agreement with the Paris Club, agreements in principle on rescheduling terms were reached with a number of non-Paris Club official bilateral creditors, the International Investment Bank (IIB), the International Bank for Economic Cooperation (IBEC), and uninsured suppliers. The Russian authorities, however, were not able to finalize these agreements and make the payments necessary to regularize those obligations. At end-1998, the Russian government's total overdue obligations, including new (1998) arrears to

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[54]It should be noted that in view of the massive depreciation of the ruble in 1998, dollar GDP in 1999 will be substantially below that in 1998. Accordingly, the debt to GDP ratios will be substantially larger.

[55]In 1992, under the so-called *zero-option plan,* Russia agreed to assume the external debt of the Former Soviet Union (FSU) if all other FSU states agreed to transfer their share of the external claims of the FSU to Russia.

[56]Technically, Russia's Paris Club cutoff date is 1/1/1991, but the Paris Club agreement of 1996 also included a rescheduling of debts that fell due in 1991. Accordingly, the *effective* cutoff date for Russian-era debt is 1/1/1992.

[57]Soviet-era sovereign debt includes $11 billion in foreign currency bonds, known as Minfin bonds, Taiga bonds, or OVVZs, issued domestically by the Ministry of Finance, $15 billion convertible-currency debt to the former COMECON countries and $31 billion in obligations to financial institutions, mostly to London Club creditors. It should be noted that while Russia's obligations to London Club creditors are, in effect, the debt of the Russian government, legally they are the obligations of the Vnesheconombank.

[58]This figure has been calculated by adjusting sovereign foreign currency debt for residents' holdings of Eurobonds issued in July 1998, and Minfin bonds, and for nonresidents' holdings of GKOs/OFZs.

Paris and London Club creditors and amounts outstanding on debts that were never formally rescheduled by non-Paris Club official bilateral creditors, IIB/IBEC, and uninsured suppliers, amounted to $10.9 billion (including penalty interest). Of that amount, about $2 billion were accumulated during 1998.[59]

Nonsovereign debt

147. **In late 1998 nonsovereign debt, consisting of external obligations of local governments, banks, and nonbank corporations, is estimated at $31.7 billion (10 percent of GDP).** Reflecting improved access to global capital markets, local governments were able to raise funds abroad during 1997–98. At end-1998, their external obligations amounted to $2.2 billion, of which about $1.4 billion were in the form of Eurobonds. The financial crisis in August also affected the ability of local governments to service their external debt; the Republic of Tatarstan was unable to pay its $100 million bond falling due in October 1998, but was able to reach agreement with its creditors on a rescheduling.

148. **The external debt of banks, which more than doubled to $19 billion in 1997, fell sharply after the August crisis to $9.9 billion at end-1998 (including about $1 billion in arrears), of which $7 billion was short term.**[60] In addition to the above, Russian banks had off-balance sheet obligations to nonresidents on account of forward foreign exchange contracts amounting to $7 billion (notional value) on December 1, 1998.[61] The authorities have attributed the decline in bank debt in the second half of 1998 to the repayments of loans, valuation effects, and accounting issues. With the near-collapse of the banking system after August 17, Russian banks have been increasingly facing difficulties servicing their external obligations; for example, in January 1999, Uneximbank indicated that it would not be able to service its external obligations, including on a Eurobond, the first such default for a Russian bank.

149. **Recently improved CBR data suggest that at end-1998 nonbank corporate debt, mainly of the energy sector, stood at $19.6 billion (of which $1.6 billion was in Eurobonds), up from $13.6 billion in 1997.**[62] Corporate overdue obligations amounted to $330 million. According to market sources, external creditors have been effectively rolling

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[59]Such arrears are estimated to have risen by about $5 billion between January and June 1999.

[60]This excludes the external obligations of one bank that is now in bankruptcy.

[61]This includes $0.5 billion in ruble-denominated forward liabilities to nonresidents. The net forward liabilities of Russian banks amounted to $2.6 billion on 12/1/1998.

[62]As noted above, this picture is at variance with that arising from the CBR balance of payments data that indicate that there were no inflows to the nonbank corporate sector in 1998.

over the distressed debt of Russian corporations. However, corporate creditors have also been facing increasing difficulties meeting their external obligations, including Eurobonds.

Russia's external claims

150. **Russia is a major creditor to a number of developing countries**. As of December 1, 1998, Russia's claims on former socialist and developing countries amounted to $114 billion in nominal terms. In September 1997, an agreement was finalized between Russia and Paris Club creditors on the terms of Russia's participation in reschedulings as a creditor. That agreement provided for up-front discounts on Russia's claims on rescheduling countries, with larger discounts for the poorest countries. The post-discount claims would then be subject to the same terms granted by the Paris Club. This agreement has facilitated the regularization of Russian claims on developing countries, and the implementation of the HIPC Initiative. While Russia participated as a creditor in the Paris Club rescheduling meetings for Bosnia, the Central African Republic, and Yemen, and is negotiating bilateral agreements with a number of countries that had Paris Club reschedulings in the past, progress in signing bilateral reschedulings has been slow. After debt relief to be provided pursuant to the terms of Russia's accession to the Paris Club, Russia's claims would amount to about $33 billion.

D. Trade Policy, Regional and CIS Trade Relations, and WTO Accession

Overall trade policy

151. **Before the August 1998 crisis, the authorities were pursuing a strategy of progressively liberalizing the trade system.**[63] The weighted average tariff rate rose slightly from 13.6 percent in 1996 to 13.9 percent in 1997, and is estimated to have remained broadly unchanged in 1998 (Table 35).[64] After the onset of full-blown financial and economic crisis in August, however, the authorities felt compelled to take a number of steps in the opposite direction. To bolster revenues, export taxes were reintroduced in January 1999, applying to crude oil, natural gas, and a variety of other products including nonferrous metals. Food exports were banned to ensure that food aid from the West was not re-exported. And, also effective as from January 1999, a ban on private imports of ethyl alcohol was imposed. At the same time, other measures continued the earlier trend toward a more open trade regime. To attenuate the impact of the crisis on consumers, in October the authorities lowered import duties on several essential items, and, in November 1998, removed the 3 percent import surcharge (originally adopted in July 1998) on foodstuffs, medicines, and several other priority

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[63]There have been numerous changes in the trade regime since 1997; the main ones are listed in Annex IV.

[64]In Russia's tariff code, the minimum tariff rate is formally 5 percent (with one exception for 1 percent) and the maximum rate is 30 percent. The tariff code has six bands (5, 10, 15, 20, 25, and 30 percent).

items. With the increased use of restrictive trade and exchange measures (including the increase in the export surrender requirement from 50 percent to 75 percent), on the Fund's index of trade restrictiveness, Russia's ranking has changed from 2 to 5. That index ranges from 1 to 5, with 1 indicating the most open trade regime.

External trade issues of Russian regional governments

152. **The August crisis also led to the imposition of some trade restrictions by regional governments**. In principle, regional governments do not have the power to set foreign trade regulations, and their powers in the area of foreign trade are limited to providing exemptions from local taxes, loans, and guarantees to encourage direct foreign investment. In the aftermath of the crisis, several regions exceeded their legal powers and adopted some restrictions on food exports. In 1998, about 50 cases of bans/restrictions were recorded at the Ministry of Justice. The authorities are of the view that these restrictions would not have a significant impact on foreign trade.

Relations with the CIS and other countries in the region[65]

153. **While some progress has been made in harmonizing policies among the members of the CIS customs union, important difficulties remain**. The CIS customs union, formed in 1995, comprises Russia, Belarus, Kazakhstan, and Kyrgyz Republic. Tadjikstan has also taken steps to join; in 1998, it began to harmonize its trade regulations with those of the CIS customs union. While progress has been made in removing trade restrictions among the members, success has been more limited in achieving a common external tariff. Belarus and Russia have harmonized 95 percent of their common external tariffs, Belarus-Kazakhstan-Russia 55 percent, and Belarus-Kazakhstan-Russia-Kyrgyz Republic 25 percent. A further problem relates to the large number of tariff exemptions granted by Belarus to non-union members, which effectively means that these exemptions apply to Russia as well. Russia does not agree to these exemptions and has enhanced border controls with Belarus since 1997 to lower the inflow of imports of goods which have tariff exemptions in Belarus (e.g., automobiles, alcohol, tobacco). The customs union has also adopted a general system of preferences for tariffs on developing countries (by commodity and country). The Kyrgyz Republic's accession to the WTO on December 20, 1998 has caused difficulties inside the CIS union, as the WTO obligations on tariffs that it has accepted are at variance with the CIS customs union tariffs. The union does not have any provisions for sanctioning members for such variations, and the issue would need to be addressed by the heads of state of the countries involved.

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[65]In response to ethnic tensions within Latvia, some Russian corporations and regions imposed punitive measures on trade with Latvia. In addition, the CBR adopted some restrictions on Latvia, including a prohibition on Russian banks opening branches in Latvia. According to the Russian authorities, most of these restrictions lasted for a short while and were effectively abandoned with the August crisis.

154. **Russia and Belarus are also taking accelerated measures toward the formation of a comprehensive political and economic union.** Progress has been achieved in the relative harmonization of the customs, tax, and civil codes, but no concrete progress could be reported in the adoption of a single currency. The CBR, for the time being, has agreed only to a bilateral clearing system using only the Russian ruble.

WTO Accession

155. **Accession negotiations with the World Trade Organization (WTO), which began in 1993, have continued; the working party on Russia last met in December 1998**. Russia has made an offer on tariffs, which the partners have not yet accepted. Discussions are expected to proceed further in 1999 on the tariff side, and Russia is expected to make an offer to its partners on trade in services.

Table 26. Russian Federation: Balance of Payments, 1994-98

(In billions of U.S. dollars, unless otherwise indicated)

	1994	1995	1996	1997	1998
Current account	8.4	4.8	3.9	-3.0	2.3
Trade balance	19.3	18.7	17.8	11.6	17.9
Exports	67.8	82.7	90.6	89.0	74.8
of which: Oil	14.6	18.3	23.4	22.0	14.2
Natural gas	10.6	12.1	14.7	16.4	13.3
Imports	48.5	64.0	72.8	77.4	56.8
Services and income, net	-10.6	-13.9	-14.0	-14.3	-15.3
Services, net	-6.5	-8.1	-6.4	-4.7	-3.2
Net income	-4.1	-5.8	-7.6	-9.6	-12.2
Interest, net	-4.3	-5.6	-7.1	-8.7	-11.3
Receipts	0.5	0.9	1.1	1.2	0.9
Payments	-4.8	-6.5	-8.2	-10.0	-12.2
of which: Official	-4.8	-6.5	-6.4	-9.5	-11.0
Dividends, net	0.0	-0.1	0.0	-0.2	-0.4
Other income, net	0.2	-0.1	-0.5	-0.7	-0.5
CurrentTransfers, net	-0.3	0.1	0.1	-0.3	-0.4
Capital account	-27.1	-4.2	-10.9	6.3	-9.7
Capital flows relating to the federal government	-11.2	-9.7	1.7	15.1	7.7
Disbursements	2.7	2.5	5.5	8.8	9.5
Amortization, net	-14.0	-12.6	-10.9	-4.6	-4.1
Payments	-14.0	-12.7	-11.2	-5.3	-4.8
Receipts	0.0	0.0	0.3	0.7	0.7
Purchases of government securities, net (includes GKOs/OFZs)	0.0	0.0	5.9	10.9	2.8
Other 1/	0.0	0.5	1.2	0.0	-0.4
Medium- and long-term capital to other sectors	0.4	1.6	3.8	5.8	2.2
Foreign direct investment, net	0.5	1.7	1.7	3.6	1.2
Reinvested earnings	0.0	0.0	0.0	0.0	-0.1
Other	-0.1	-0.1	2.1	2.2	1.2
Other, including short term 2/	-16.4	3.9	-16.4	-14.5	-19.6
Errors and omissions, net	-0.3	-7.9	-8.6	-7.8	-7.9
Overall balance	-19.1	-7.3	-15.6	-4.5	-15.3
Financing	19.1	7.3	15.6	4.5	15.3
Net international reserves	3.9	-5.4	4.6	-1.4	10.2
Gross reserves (- increase)	2.4	-10.8	1.7	-2.5	5.6
Net Fund liabilities	1.5	5.4	2.9	1.5	5.3
Other liabilities	0.0	0.0	0.0	-0.4	-0.7
Arrears/debt under negotiation 3/	2.8	0.7	2.6	2.8	2.3
Deferral/rescheduling 4/	12.4	12.1	8.4	3.1	2.8
Memorandum items:					
Trade balance (percent of GDP)	7.1	5.5	4.3	2.7	5.7
Current account (percent of GDP)	3.1	1.4	0.9	-0.7	0.7
Gross reserves	6.5	17.2	15.3	17.8	12.2
(months of imports of goods and nonfactor services)	1.2	2.4	2.0	2.2	2.0
External debt service payments 5/	19.0	19.4	20.1	15.5	17.5
(percent of exports of goods and nonfactor services)	24.7	20.4	19.6	15.0	20.0

Sources: Data provided by the Russian authorities, and staff estimates.

1/ Receipts and payments on debts denominated in non-convertible currencies net of reschedulings deferrals, including debts to COMECON countries (payable almost entirely in kind), and short-term banking sector flows.

2/ Includes cash-related transactions, enterprise credits, inter-FSU trade arrears, unrepatriated export proceeds, and short-term banking sector flows.

3/ In 1998, includes accumulation of arrears of $1.2 billion to London and Paris Club creditors.

4/ Includes arrears, debt rescheduling, and debt deferrals. Consists of interest capitalization by commercial banks, according to the London Club agreement, and debt reschedulings from uninsured suppliers and non-Paris Club creditors.

5/ Excludes payments on short-term debt.

Table 27. Russian Federation: Destination of Exports, 1994-98 1/

(In percent of total exports)

	1994	1995	1996	1997	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1998 Year
Exports to:									
CIS	**21.5**	**18.5**	**18.4**	**19.5**	**23.2**	**19.1**	**20.4**	**22.8**	**21.5**
Belarus	4.9	3.8	3.6	5.4	7.1	6.9	7.1	7.3	7.1
Kazakstan	2.6	3.4	3.0	2.9	2.9	3.3	3.5	3.3	3.3
Ukraine	10.6	8.9	9.0	8.5	10.6	6.8	6.5	9.1	8.3
Other	3.3	2.4	2.7	2.6	2.6	2.1	3.2	3.1	2.8
Non-CIS	**78.5**	**81.5**	**81.6**	**80.5**	**76.8**	**80.9**	**79.6**	**77.2**	**78.5**
Europe	55.5	54.2	54.5	55.7	55.0	53.6	50.4	51.5	52.4
Czech Republic	2.2	2.7	2.1	2.1	2.1	2.0	2.1	1.8	2.0
Finland	3.2	3.1	3.1	3.3	3.1	3.0	2.1	2.0	2.5
France	2.0	2.0	1.9	1.9	1.9	2.1	3.2	2.3	2.4
Germany	8.7	7.8	8.0	7.7	7.9	8.3	9.6	7.1	8.2
Hungary	1.9	2.1	2.1	2.2	2.4	2.2	2.3	1.6	2.1
Ireland	1.9	3.3	3.4	2.9	1.5	0.9	0.0	2.4	1.3
Italy	4.3	4.2	3.3	4.2	5.5	4.3	3.4	4.6	4.4
Netherlands	3.8	4.1	3.9	5.4	5.1	5.3	1.8	6.2	4.7
Poland	1.8	2.1	2.5	3.0	3.1	2.9	3.2	2.6	2.9
Slovak Republic	1.2	1.5	2.2	2.0	2.3	1.9	2.0	1.6	1.9
Switzerland	6.0	4.8	4.7	4.4	3.6	4.1	1.0	1.9	2.5
UK	5.8	4.0	3.8	3.3	2.9	4.1	3.1	2.5	3.1
Other	12.7	12.5	13.4	13.3	13.6	12.6	16.5	14.8	14.5
Asia	12.3	14.7	14.0	12.3	9.5	11.1	12.5	12.8	11.7
China	4.5	4.4	5.6	4.7	3.8	5.5	5.4	4.7	4.8
Japan	3.6	4.1	3.5	3.4	2.7	2.9	2.9	3.1	2.9
Other	4.2	6.3	5.0	4.2	3.0	2.7	4.2	5.0	3.9
Western Hemisphere	7.5	9.4	9.0	8.0	8.0	11.5	10.5	7.8	9.3
US	5.9	6.6	7.6	5.8	5.4	8.2	6.7	5.0	6.2
Other	1.6	2.8	1.4	2.2	2.6	3.3	3.8	2.8	3.1
Middle East and Africa	2.3	2.5	2.6	2.5	2.9	2.9	3.8	3.3	3.3
Other	0.9	0.7	1.4	2.0	1.4	1.8	2.4	1.7	1.8

Source: IMF Direction of Trade Statistics.

1/ Based on exports according to the Direction of Trade Statistics, which differ somewhat from those compiled by the Central Bank of Russia and shown in Table 26.

Table 28. Russian Federation: Composition of Merchandise Exports, 1994-98

	1994	1995	1996	1997 Q1	1997 Q2	1997 Q3	1997 Q4	1997 Year	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1998 Year
						(In millions of U.S. dollars)							
Total exports (f.o.b.) 1/	63,285	78,290	84,387	19,288	18,531	19,616	22,930	80,365	15,929	15,928	15,919	17,211	64,987
Food, beverage, tobacco and agricultural products	1,410	1,332	1,654	285	280	336	507	1,407	267	233	264	414	1,177
Stone and ore	641	943	750	156	170	201	257	784	175	226	232	165	798
Fuel products	27,288	30,440	38,365	10,604	8,984	8,451	10,023	38,062	8,011	6,403	6,005	6,789	27,208
Oil and oil products	15,530	17,291	22,056	5,382	5,079	5,192	5,083	20,736	3,570	3,458	3,214	3,041	13,283
Crude	11,335	12,403	14,860	3,523	3,318	3,523	3,456	13,821	2,619.4	2,558	2,323	2,047	9,546
Oil products	4,195	4,888	7,196	1,859	1,761	1,668	1,627	6,915	950.8	901	891	994	3,737
Gas	10,355	11,410	13,988	4,888	3,527	2,871	4,502	15,788	4,145	2,668	2,500	3,458	12,771
Coal	752	1,012	978	188	177	202	218	786	156	155	157	147	615
Other	651	727	1,343	145	201	186	220	752	140	122	134	143	539
Chemicals (incl. pharmaceuticals and rubber)	5,476	7,453	6,899	1,490	1,441	1,654	1,993	6,578	1,170	1,290	1,607	1,376	5,443
Leather	373	307	355	107	83	69	125	383	97	82	68	114	361
Wood and paper products	2,623	4,320	3,451	851	873	876	902	3,502	794	830	835	909	3,367
Textiles and clothing	1,310	1,071	951	189	208	213	217	826	170	193	177	163	702
Gems and precious metals	6,458	5,356	3,625	197	341	833	1,774	3,145	200	949	1,345	1,569	4,062
Metals	11,242	15,280	16,107	3,800	4,156	4,392	4,367	16,715	3,536	3,737	3,793	3,386	14,451
Non-ferrous	4,895	7,522	7,974	2,005	2,138	2,302	2,267	8,713	1,896	1,976	2,183	1,406.7	7,462
Ferrous	6,347	7,758	8,133	1,795	2,018	2,089	2,100	8,002	1,640	1,761	1,610	1,978.8	6,990
Machines, equipment (including cars) and instruments	6,213	8,333	8,620	1,460	1,801	2,348	2,567	8,176	1,409	1,877	1,451	2,147	6,884
Other, including ceramics and glass	251	3,456	3,610	151	193	243	199	786	101	110	145	179	534
						(In percent of total exports)							
Total exports (f.o.b.) 1/	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Food, beverage, tobacco and agricultural products	2.2	1.7	2.0	1.5	1.5	1.7	2.2	1.8	1.7	1.5	1.7	2.4	1.8
Stone and ore	1.0	1.2	0.9	0.8	0.9	1.0	1.1	1.0	1.1	1.4	1.5	1.0	1.2
Fuel products	43.1	38.9	45.5	55.0	48.5	43.1	43.7	47.4	50.3	40.2	37.7	39.4	41.9
Oil and oil products	24.5	22.1	26.1	27.9	27.4	26.5	22.2	25.8	22.4	21.7	20.2	17.7	20.4
Gas	16.4	14.6	16.6	25.3	19.0	14.6	19.6	19.6	26.0	16.7	15.7	20.1	19.7
Coal	1.2	1.3	1.2	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.9	0.9
Other	1.0	0.9	1.6	0.8	1.1	0.9	1.0	0.9	0.9	0.8	0.8	0.8	0.8
Chemicals (incl. pharmaceuticals and rubber)	8.7	9.5	8.2	7.7	7.8	8.4	8.7	8.2	7.3	8.1	10.1	8.0	8.4
Leather	0.6	0.4	0.4	0.6	0.4	0.4	0.5	0.5	0.6	0.5	0.4	0.7	0.6
Wood and paper products	4.1	5.5	4.1	4.4	4.7	4.5	3.9	4.4	5.0	5.2	5.2	5.3	5.2
Textiles and clothing	2.1	1.4	1.1	1.0	1.1	1.1	0.9	1.0	1.1	1.2	1.1	0.9	1.1
Gems and precious metals	10.2	6.8	4.3	1.0	1.8	4.2	7.7	3.9	1.3	6.0	8.4	9.1	6.3
Metals	17.8	19.5	19.1	19.7	22.4	22.4	19.0	20.8	22.2	23.5	23.8	19.7	22.2
Non-ferrous	7.7	9.6	9.4	10.4	11.5	11.7	9.9	10.8	11.9	12.4	13.7	8.2	11.5
Ferrous	10.0	9.9	9.6	9.3	10.9	10.7	9.2	10.0	10.3	11.1	10.1	11.5	10.8
Machines, equipment (including cars) and instruments	9.8	10.6	10.2	7.6	9.7	12.0	11.2	10.2	8.8	11.8	9.1	12.5	10.6
Other, including ceramics and glass	0.4	4.4	4.3	0.8	1.0	1.2	0.9	1.0	0.6	0.7	0.9	1.0	0.8

Source: State Customs Committee.

1/ Excludes shuttle trade and other adjustments to the customs data that appear in estimates in Table 26.

Table 29. Russian Federation: Origin of Imports, 1994-98 1/
(In percent of total imports)

	1994	1995	1996	1997	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1998 Year
Imports from:									
CIS	**26.7**	**29.0**	**31.8**	**26.9**	**24.9**	**26.4**	**27.4**	**32.2**	**28.0**
Belarus	5.4	4.2	6.1	8.8	9.0	10.1	11.1	13.6	11.1
Kazakstan	5.2	5.9	6.8	5.2	5.0	4.1	5.6	4.7	4.9
Ukraine	11.4	14.3	14.1	7.6	7.4	8.0	5.6	7.2	7.0
Other	4.7	4.6	4.9	5.2	3.6	4.1	5.1	6.8	5.0
Non-CIS	**73.3**	**71.0**	**68.2**	**73.1**	**75.1**	**73.6**	**72.6**	**67.8**	**72.0**
Europe	53.3	53.2	47.5	50.4	50.7	47.3	50.8	49.1	49.6
Czech Republic	1.1	0.9	1.2	1.1	1.2	1.3	0.9	1.5	1.2
Finland	4.2	4.4	3.7	3.6	3.1	3.4	4.2	3.1	3.5
France	2.6	2.3	2.8	3.0	3.6	3.6	2.5	1.9	2.8
Germany	14.7	14.1	11.6	12.7	13.1	11.7	13.7	9.4	11.9
Hungary	1.9	1.8	1.5	1.8	1.8	1.6	2.3	2.2	2.0
Ireland	0.6	0.7	0.7	0.8	0.7	0.8	0.4	0.5	0.6
Italy	4.1	4.0	5.2	5.1	4.8	4.0	4.7	4.9	4.6
Netherlands	4.2	3.5	2.3	2.3	2.1	2.2	2.2	2.5	2.3
Poland	2.5	2.8	2.1	2.0	2.8	2.5	3.0	3.9	3.1
Slovak Republic	0.5	0.6	0.6	0.5	0.5	0.5	0.6	0.8	0.6
Switzerland	1.5	1.5	1.1	1.0	0.9	0.9	0.5	0.4	0.7
UK	2.3	2.4	2.5	2.8	3.5	2.6	2.5	1.2	2.3
Other	13.0	14.0	12.2	13.7	12.8	12.3	13.4	16.9	14.0
Asia	10.1	7.6	9.5	9.3	9.6	9.4	10.2	10.8	10.1
China	2.5	1.9	2.2	2.4	2.7	2.6	2.8	3.7	3.0
Japan	2.9	1.6	2.2	1.9	2.2	1.7	1.6	0.9	1.5
Other	4.7	4.1	5.1	5.1	4.8	5.1	5.8	6.2	5.5
Western Hemisphere	7.9	8.5	9.6	11.2	12.8	14.6	9.4	5.9	10.3
US	5.4	5.7	6.5	7.8	8.2	8.5	5.3	4.2	6.3
Other	2.5	2.8	3.1	3.5	4.5	6.2	4.1	1.7	4.0
Middle East and Africa	1.3	1.2	1.0	1.5	1.2	1.6	1.7	1.5	1.5
Other	0.8	0.5	0.5	0.6	0.8	0.6	0.4	0.5	0.5

Source: IMF Direction of Trade Statistics.

1/ Based on imports according to the Direction of Trade Statistics, which differ somewhat from those compiled by the Central Bank of Russia and shown in Table 26.

Table 30. Russian Federation: Composition of Merchandise Imports, 1994-98

	1994	1995	1996	1997 Q1	1997 Q2	1997 Q3	1997 Q4	1997 Year	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1998 Year
						(In millions of U.S. dollars)							
Total imports (c.i.f) 1/	38,616	46,614	45,438	9,758	11,358	12,798	14,344	48,258	11,664	11,392	9,120	5,885	38,061
Food, beverage, tobacco and agricultural products	10,700	13,041	11,028	2,535	3,212	3,494	3,474	12,715	3,190	3,413	2,236	1,118	9,957
Stone and ore	1,130	1,028	733	155	139	231	238	764	197	197	120	84	598
Fuel products	1,389	1,584	1,703	393	437	496	544	1,870	480	402	268	246	1,397
Chemicals (incl. Pharmaceuticals and rubber)	3,802	4,857	6,140	1,416	1,642	1,864	2,097	7,019	1,713	1,851	1,354	909	5,827
Leather	197	144	144	24	27	46	58	155	27	22	25	20	93
Wood and paper products	566	1,066	1,427	365	410	445	518	1,738	453	457	350	239	1,499
Textiles and clothing	2,963	2,345	1,948	399	441	469	627	1,936	372	370	253	240	1,234
Gems and precious metals	87	426	555	35	41	20	9	105	8	11	8	4	31
Metals	2,524	3,396	3,718	800	777	839	894	3,310	796	767	612	434	2,609
Non-ferrous	562	779	813	189	224	259	280	952	219	243	170	110	742
Ferrous	1,962	2,617	2,905	611	553	580	614	2,358	577	524	442	324	1,866
Machines, equipment (including cars) and instruments	14,824	18,222	17,434	3,293	3,863	4,435	5,348	16,939	4,080	3,536	3,580	2,387	13,583
Other, including ceramics and glass	434	505	608	342	369	459	539	1,708	348	367	315	203	1,234
						(In percent of total imports)							
Total imports (c.i.f) 1/	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Food, beverage, tobacco and agricultural products	27.7	28.0	24.3	26.0	28.3	27.3	24.2	26.3	27.3	30.0	24.5	19.0	26.2
Stone and ore	2.9	2.2	1.6	1.6	1.2	1.8	1.7	1.6	1.7	1.7	1.3	1.4	1.6
Fuel products	3.6	3.4	3.7	4.0	3.8	3.9	3.8	3.9	4.1	3.5	2.9	4.2	3.7
Chemicals (incl. Pharmaceuticals and rubber)	9.8	10.4	13.5	14.5	14.5	14.6	14.6	14.5	14.7	16.2	14.8	15.4	15.3
Leather	0.5	0.3	0.3	0.2	0.2	0.4	0.4	0.3	0.2	0.2	0.3	0.3	0.2
Wood and paper products	1.5	2.3	3.1	3.7	3.6	3.5	3.6	3.6	3.9	4.0	3.8	4.1	3.9
Textiles and clothing	7.7	5.0	4.3	4.1	3.9	3.7	4.4	4.0	3.2	3.2	2.8	4.1	3.2
Gems and precious metals	0.2	0.9	1.2	0.4	0.4	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Metals	6.5	7.3	8.2	8.2	6.8	6.6	6.2	6.9	6.8	6.7	6.7	7.4	6.9
Machines, equipment (including cars) and instruments	38.4	39.1	38.4	33.8	34.0	34.7	37.3	35.1	35.0	31.0	39.2	40.6	35.7
Other, including ceramics and glass	1.1	1.1	1.3	3.5	3.2	3.6	3.8	3.5	3.0	3.2	3.5	3.5	3.2

Source: State Customs Committee.

1/ Excludes shuttle trade and other adjustments to the customs data that appear in estimates in Table 26.

Table 31. Russian Federation: Foreign Currency Disbursements to the Federal Government, 1994-98
(In millions of U.S. dollars)

Creditors	1994	1995	1996	1997	1998
Multilateral	1,931	6,319	4,940	4,776	7,519
IMF 1/	1,544	5,450	3,758	2,019	6,240
World Bank	280	826	1,107	2,699	1,219
EBRD	6	43	75	59	60
Other	101	0	0	0	0
Bilateral	2,057	1,554	3,280	1,375	2,110
Tied	2,057	1,554	1,090	1,375	2,110
Untied	0	0	2,190	0	0
Bonds 2/	0	0	1,000	3,549	9,615
Suppliers/other commercial	507	93	0	1,136	156
Total	4,496	7,966	9,220	10,836	19,399
(excluding IMF)	2,952	2,515	5,462	8,817	13,160
Memorandum item:					
Minfin bonds 3/	0	0	3,500	0	0
Nonresident purchases of GKOs/OFZs (net)	0	0	5,934	10,882	2,767
Total including Minfins and nonresident GKOs/OFZs	4,496	7,966	18,654	21,718	22,166
(excluding IMF)	2,952	2,515	14,896	19,699	15,927
Total disbursements from nonresidents, including GKOs/OFZs, excluding Minfins	4,496	7,966	15,154	21,718	18,466

Source: The Russian authorities.

1/ Full amount of Fund purchases. In 1998 part of this amount was disbursed directly to the CBR.
2/ Figure for 1998 includes $3,700 of Eurobonds purchased by residents. Data on resident purchases in other years were not available.
3/ Only Minfin bonds VI and VII, issued in 1996, are included here. Prior Minfin bond issues did not entail any new inflows to the government but were in exchange for foreign currency deposits of enterprises held at the Vnesheconombank. These bonds are recorded at face value; information on discounted amounts were not available.

Table 32. Russian Federation: Nonsovereign Sector Capital Account, 1994-98

(In millions of U.S. dollars)

	1994	1995	1996	1997	1998
Direct investment	539	1658	1708	3640	1155
Abroad	-101	-358	-771	-2603	-1027
In Russia	640	2016	2479	6243	2182
Portfolio investment	81	-1,611	2,140	2,223	842
Assets	114	-1,705	-172	-156	-256
Equity	-145	-144	-75	32	-10
Debt securities	259	-1,561	-97	-188	-246
Liabilities	-33	94	2,312	2,379	1,098
Equity	45	59	2,152	1,265	714
Banks	45	47	50	93	33
Nonfinancial enterprises	0	12	2,102	1,172	681
Debt securities	-78	35	160	1,114	384
Local governments	0	0	0	897	500
Banks	-78	7	76	110	-266
Nonfinancial enterprises	0	28	84	107	150
Other investments	-13,615	1,874	-22,934	-19,342	-16,700
Assets	-14,418	6,292	-28,686	-34,009	-14,559
Cash foreign currency and deposits	-4,411	4,167	-9,596	-13,122	2,021
Trade credit	-3,721	8,040	-9,500	-6,948	-6,810
Loans	-1,085	-360	360	-2,639	-334
Banks	-1,085	-356	443	-2,164	39
Nonfinancial enterprises	0	-4	-83	-475	-373
Arrears	-29	-4	-28	22	-291
Banks	-29	-4	-28	22	-151
Nonfinancial enterprises	0	0	0	0	-140
Changes in the stock of nonrepatriated Export proceeds and nonrepatriated Import advances	-3,860	-4,928	-9,773	-11,458	-8,625
Other	-1,312	-623	-149	136	-520
Liabilities	803	-4,418	5,752	14,667	-2,141
Cash foreign currency and deposits	474	1,779	1,427	4,240	-2,759
Trade credit	-978	-8,090	-759	-64	322
Loans	984	971	4,203	9,977	300
Banks	426	661	1,705	3,840	-3,395
Nonbank financial organizations	0	0	1,516	-1,516	3,695
Nonfinancial enterprises	558	310	982	7,653	0
Arrears	2	0	0	3	693
Banks	2	0	0	3	693
Nonfinancial enterprises	0	0	0	0	0
Other	321	922	881	511	-697
Total (net)	-12,995	1,921	-19,086	-13,479	-14,703

Source: Central Bank of Russia.

Table 33. Russian Federation: External Debt, 1994-98 1/
(In billions of U.S. dollars)

	1994	1995	1996	1997	1998
I. SOVEREIGN DEBT					
A. Russian-era foreign currency debt (post 1/1/1992)	11.3	17.4	27.7	35.6	55.4
Medium and long term	...	...	...	...	55.4
Multilateral Creditors	5.4	11.4	15.3	18.7	26.0
IMF	4.2	9.6	12.5	13.2	19.4
World Bank	0.6	1.5	2.6	5.3	6.4
Other	0.6	0.3	0.2	0.2	0.2
Official creditors 2/	5.9	6.0	7.9	7.6	9.7
Eurobonds	0.0	0.0	1.0	4.5	16.0
Minfin bonds (Minfins VI and VII)	0.0	0.0	3.5	3.5	3.5
Commercial creditors (includes financial institutions)	0.0	0.0	0.0	1.3	0.2
Short term	...	...	...	...	0.0
B. Soviet-era foreign currency debt (pre 1/1/1992)	116.2	110.6	108.4	99.0	102.8
Medium and long term	...	...	...	...	102.8
Multilateral Creditors	0.0	0.0	0.0	0.0	0.0
Official creditors 2/	69.9	62.6	61.9	56.9	59.5
Paris Club	39.6	41.6	42.3	37.6	40.0
of which: arrears	...	...	...	...	0.8
COMECON	25.7	16.6	15.4	14.9	14.7
of which: arrears	...	...	...	...	0.0
Other, including non-Paris Club bilateral	4.6	4.4	4.2	4.4	4.7
of which: arrears	...	...	...	...	4.0
Commercial creditors	36.0	38.3	37.8	33.9	35.2
Financial institutions	31.1	33.0	32.5	29.7	31.2
of which: arrears	...	...	...	...	2.1
Other 3/	4.9	5.3	5.3	4.2	4.1
of which: arrears	...	...	...	...	4.1
Eurobonds	1.7	1.1	0.1	0.1	0.0
Credits contracted by entities other than VEB	1.0	1.0	1.0	0.5	0.5
Minfin bonds (Minfins III, IV and V)	7.6	7.6	7.6	7.6	7.6
of which: arrears	0.0	0.0	0.0	0.0	0.0
Short term	...	...	...	...	0.0
C. Total sovereign foreign currency debt (= A + B)	**127.5**	**128.0**	**136.1**	**134.6**	**158.2**
(In percent of GDP)	**45.8**	**36.8**	**31.6**	**30.2**	**48.1**
D. Total sovereign debt to nonresidents (= C - E - F + G)	**...**	**...**	**...**	**...**	**152.4**
(In percent of GDP)	**...**	**...**	**...**	**...**	**46.3**
E. Residents' Minfin bonds 5/	...	...	...	...	7.3
F. Residents' eurobonds 6/	...	...	...	...	3.7
G. Nonresidents' GKOs/OFZs (ruble denominated) 7/	...	...	...	...	5.2
II. NONSOVEREIGN DEBT					
Local governments	...	...	...	1.1	2.2
Medium and long term	...	...	...	1.1	1.9
of which: Eurobonds	0.0	0.0	0.0	0.9	1.4
Short term	...	...	...	...	0.3
Banks 9/	2.6	5.2	9.2	19.2	9.9
Medium and long term	...	...	...	...	2.8
Short term	...	...	...	...	7.1
Nonbank corporations (including arrears)	...	...	...	13.6	19.6
H. Total	**...**	**...**	**...**	**...**	**31.7**
(In percent of GDP)	**...**	**...**	**...**	**...**	**9.6**
III. TOTAL EXTERNAL DEBT (to nonresidents) (= D + H)	**...**	**...**	**...**	**...**	**184.0**
(In percent of GDP)	**...**	**...**	**...**	**...**	**55.9**
Memorandum items:					
Sovereign arrears	...	...	...	...	10.9

Sources: Russian Federation authorities and Fund staff estimates.

1/ Foreign currency values of outstanding external debt have been converted into U.S. dollars at the relevant market exchange rate prevailing at the respective dates indicated.

2/ Includes government to government creditors and official export credits.

3/ Subject to reconciliation.

4/ Arrears on principal are included in the debt figures.

5/ Estimated by the authorities at 60 percent of outstanding issues.

6/ Applies only to Eurobonds issued in July 1998, in the context of the GKO-Eurobond exchange. Data on nonresident holdings of other Eurobond issues are not available to Fund staff.

7/ Equivalent to Rub. 76 billion, valued at the end-1998 exchange rate. The ruble amount is the discounted amount that resulted after the GKO/OFZ conversion. Also includes Rub 75 billion of OFZs not covered by the GKO/OFZ conversion.

8/ Includes interest on arrears.

9/ Figures for 1994-97 include equity. At end-1998 such equity amounted to about $0.5 billion.

Table 34. Russian Federation: Foreign Currency Debt Service, 1994-98 1/
(In billions of U.S. dollars)

	1994	1995	1996	1997	1998
Debt Service Due	18.78	19.15	17.94	11.76	13.01
Principal	13.99	12.65	11.68	5.84	5.76
Interest	4.79	6.50	6.26	5.92	7.25
Principal	13.99	12.65	11.68	5.84	5.76
Russian-era debt	2.09	2.28	1.60	1.54	3.27
Multilateral	0.21	0.43	0.74	0.52	1.03
Bonds	0.00	0.00	0.00	0.00	0.00
Official bilateral	1.88	1.85	0.86	0.92	1.10
Commercial	0.00	0.00	0.00	0.10	1.14
Soviet-era debt	11.90	10.37	10.08	4.30	2.49
Multilateral	0.00	0.00	0.00	0.00	0.00
Bonds	0.06	0.80	0.98	0.00	0.07
Official bilateral and other commercial	11.84	9.57	9.10	4.30	2.42
Interest	4.79	6.50	6.26	5.92	7.25
Russian-era debt	0.65	0.94	0.96	1.42	2.29
Multilateral	0.28	0.40	0.61	0.77	1.10
Bonds	0.00	0.00	0.00	0.21	0.66
Official bilateral	0.37	0.54	0.35	0.43	0.47
Commercial	0.00	0.00	0.00	0.01	0.06
Soviet-era debt	4.14	5.56	5.30	4.50	4.96
Multilateral	0.00	0.00	0.00	0.00	0.00
Bonds	0.12	0.14	0.08	0.00	0.00
Official bilateral and other commercial	2.20	3.07	2.79	2.62	4.44
Interest on arrrears	1.82	2.35	2.43	1.88	0.52
Debt Service Paid	3.66	6.40	6.92	5.89	7.77
Principal	2.27	3.32	2.86	1.68	3.49
Interest	1.39	3.08	4.06	4.21	4.28
Principal	2.27	3.32	2.86	1.68	3.49
Russian-era debt	2.09	2.28	1.59	1.54	3.27
Multilateral	0.21	0.43	0.74	0.52	1.03
Bonds	0.00	0.00	0.00	0.00	0.00
Official bilateral	1.88	1.85	0.85	0.92	1.10
Other commercial	0.00	0.00	0.00	0.10	1.14
Soviet-era debt	0.18	1.04	1.27	0.14	0.22
Multilateral	0.00	0.00	0.00	0.00	0.00
Bonds	0.06	0.80	0.98	0.00	0.07
Official bilateral	0.12	0.24	0.29	0.14	0.14
Other commercial	0.00	0.00	0.00	0.00	0.01
Interest	1.39	3.08	4.06	4.21	4.28
Russian-era debt	0.65	0.94	0.96	1.42	2.22
Multilateral	0.28	0.40	0.61	0.77	1.03
Bonds	0.00	0.00	0.00	0.21	0.66
Official bilateral	0.37	0.54	0.35	0.43	0.47
Other commercial	0.00	0.00	0.00	0.01	0.06
Soviet-era debt	0.74	2.14	3.10	2.79	2.06
Multilateral	0.00	0.00	0.00	0.00	0.00
Bonds	0.12	0.14	0.08	0.00	0.00
Official bilateral	0.50	1.40	1.71	1.94	1.29
Other commercial	0.12	0.60	1.31	0.85	0.77

Source: Russian authorities.

1/ Debt service in foreign currency.

Table 35. Russian Federation: Import Tariff Regime, 1995-97
(In percent)

Product	Average statutory rates 1/		
	1995	1996	1997
Food, beverages, and tobacco 2/	14.5	15.7	18.7
Clothing	20.3	29.5	26.2
Stone and ore	5.0	5.0	5.0
Fuel products	5.0	5.0	5.0
Chemicals	9.5	8.4	10.1
Leather	15.4	15.3	51.3
Wood and paper products	11.7	7.9	9.3
Textiles	10.1	12.2	12.2
Stone and glass	19.7	18.4	18.2
Gems and prec. metals	50.0	50.0	30.0
Non-ferrous metals	18.2	10.8	13.2
Ferrous metals	5.0	16.1	12.7
Machines and equipment	10.9	11.8	12
Instruments and other	12.0	12.8	14.3
Trade weighted average	12.7	13.6	13.9
Memorandum items:			
Average effective duty 3/	5.9	11.7	11.9
Trade weighted standard deviation 4/	9.6	8.2	8.1

Source: World Bank

1/ Trade weighted average rates. Rates include for some products specific duties which have have been converted into ad valorem equivalents.
2/ Excludes alcoholic beverages.
3/ Defined as the ratio of actual duty collections to imports (fob) from non-CIS countries as as registered by customs.
4/ Measured over the list of individual goods (over 1,300) to which statutory rates apply.

VI. Structural Reform

A. Introduction

156. **Uneven progress in structural reform can be seen as one of the main underlying reasons for Russia's weak economic performance and persistent fiscal problems throughout the transition period.** The early years of transition were marked by rapid privatization and liberalization of prices and trade, but little institution-building. Mass privatization between 1992 and 1994 put over 15,000 medium- and large-sized enterprises, employing over 80 percent of the industrial workforce, into the private sector. Most prices were liberalized in early 1992, the exchange rate was unified in July of the same year and foreign trade was substantially liberalized over the following two years.

157. **However, by the time macroeconomic stabilization took hold in 1995, Russia did not possess an adequate legal and institutional framework to support a market economy**, suffering among other things from poorly defined property rights, weak corporate governance structures, a lack of bankruptcy discipline, weak rules-based competition policy, and accounting and auditing standards that diverged widely from international standards. The Government's economic programs through 1996–98 therefore contained wide-ranging and ambitious structural elements. But notwithstanding some success in accelerating reforms during 1997 and in the first part of 1998, implementation of structural programs has generally fallen short of plans. Since the August 1998 crisis, the structural reform process has stagnated and there have been reversals in some areas, including the suspension of state-initiated bankruptcy, quantitative restrictions on alcohol imports, state directives mandating fuel deliveries to nonpaying customers, and administered price decisions made outside the established regulatory framework.

158. **While the private sector was reported to account for 70 percent of GDP by 1996, the hoped-for benefits of large-scale private ownership have yet to be realized, owing to a continued lack of financial discipline.** Soft budget constraints throughout the economy, associated with the nonpayments crisis (see Annex II), have limited gains in efficiency and productivity by allowing loss-making enterprises to avoid restructuring or closure. This has involved them drawing resources from other sectors of the economy, and in particular from the budgetary sector. This protection of incumbent firms adds to the significant policy and institutional barriers to entry by new companies. Establishing hard budget constraints requires policy actions across a broad front, including reforms of fiscal management, competition policy, infrastructure monopolies, privatization methodology, corporate governance structures, bankruptcy procedures, legal processes, and accounting practices. Such actions have been attempted but have not been fully carried through. The following sections discuss the main aspects of policy developments in the major areas of structural reform.

B. Private Sector Development

159. **Following the experience of the early mass privatization program and the loans-for-shares scheme of 1995—which were widely criticized for lack of transparency and for promoting insider ownership and poor corporate governance—the privatization program for large firms has increasingly been based on a case-by-case approach.** As well as tailoring transactions to individual circumstances, this practice seeks to ensure that transactions are transparent and competitive, open to both domestic and foreign bidders without favoring insiders, and involve independent financial advisors at key stages. The case-by-case methodology was supported by the passage of a new Privatization Law in mid-1997. Eight large-scale privatizations were carried out in 1997 and 1998, although these mostly did not involve the sale of controlling stakes in the firms concerned. Privatization proceeds were a little under 1 percent of GDP in 1997 and 1998.

160. **Privatization of small- and medium-sized enterprises has continued, albeit at a slower pace than in earlier years.** About 3,500 such firms were privatized in 1997 and an additional 2,500 in 1998. Importantly, the list of "strategic" enterprises which could not be privatized was reduced in July 1998 from 3,000 to 700. However, the enterprises thus freed for privatization have not yet been brought to market, in part because of soft market conditions following the August crisis. As of end-1998 over 130,000 enterprises had been privatized since the start of the transition. Some 90,000 enterprises remained entirely state-owned, but these are generally small, and mostly in regional or municipal hands.

161. **Weak corporate governance structures have played a significant role in hampering restructuring and efficiency improvements in the enterprise sector.** A central challenge is to strengthen the role of enterprise owners in relation to enterprise managers. Without effective oversight, managers have tended to focus on maintaining control and maximizing personal gain rather than restructuring enterprises and maximizing shareholder value, and have reportedly engaged widely in illegitimate activities such as diversion of cash-flow and asset-stripping. The incentive to seek short-term personal gain instead of longer-term shareholder value has arisen even when the managers and owners are one and the same, as is commonly the case in Russia—managers have majority ownership in around 60 percent of large- and medium-sized enterprises—because of widespread uncertainty about formal ownership rights and a lack of trust in the legal system to uphold these rights. Further, where enterprise "insiders" do not themselves enjoy formal majority ownership rights they may be able to exert effective control through various means of denying influence to minority shareholders.

162. **The Federal Commission for Securities Markets, established in 1996, has generally lacked the enforcement power needed to tackle these problems of violation of shareholder rights.** In July 1998 the government announced a Program on Protection of Investors' Rights, but the associated legislative steps have not yet been made effective. The government has also adopted a nationwide program for accountancy reform based on the phased adoption of International Accountancy Standards, and auditing reforms have been

launched. Still, weaknesses in accounting and auditing methods remain a major source of poor corporate governance.

163. **Russian competition law is broadly in line with international standards, but implementation has been problematic.** The State Anti-Monopoly Committee (now part of a new Ministry for Anti-Monopoly Policy and Support of Entrepreneurship) has been responsible for promoting competition, but has suffered from underfunding, requiring the closure of 12 regional offices since 1994. In the early years of the transition process, the Committee classified thousands of firms as dominant and regulated their prices, profits and output; more recently the Committee has concentrated more on addressing anti-competitive pricing and oversight of merger activity, but has still been criticized for operating according to a poorly clarified economic rationale and for unwieldy procedures. Survey evidence collected by the World Bank suggests that the Committee has been reluctant to impose sanctions in cases of collusion to fix prices, and regional branches of the Committee have been accused of bowing to local political pressure to protect established firms.

164. **Conditions in Russia for new firm entry have continued to be very difficult, and the creation of a vibrant *de novo* business sector has lagged behind other transition countries**. Numbers of small enterprises (where one would expect *de novo* business growth to be concentrated) have shown very little growth in recent years, from 841,000 in 1996 to 868,000 in 1998. A number of factors have been cited by the World Bank and others as contributing to a lack of new entry. Apart from an overall poor climate for investment, these include onerous and discretionary licensing and regulatory requirements, a complex and burdensome tax system, absence of bank credit, weak enforcement of property rights, factors hindering the release of resources tied up in existing firms, discriminatory access to business premises and urban land and to warehousing and distribution facilities, political influence of incumbent firms, and corruption and organized crime. In particular, the average new business applicant must deal with 20–30 registration and licensing agencies and a tax system consisting of over 25 different varieties of taxes and fees that can apply to businesses. There has been some progress in eliminating policy barriers to entry in recent years, including a new Federal law to reduce the licensing burden passed in September 1998, but barriers to business development are still pronounced at the local level.

165. **Russia's relatively liberal foreign trade regime has facilitated competition in the form of imports, although some backtracking has taken place since the August crisis.** Internal price controls and barriers to trade were reported to have re-emerged in some regions in the aftermath of the August 1998 crisis. However, it is not clear how extensive these restrictions were, and reports suggest that they have been widely circumvented.

C. Industrial Restructuring

166. **One of the greatest challenges of Russia's transition has been to restructure the ailing industrial base inherited from the Soviet era.** Reflecting their central planning origins, industrial enterprises have tended to be characterized by inefficiency, poor management, labor hoarding, and wasteful use of energy and other inputs. Further, the orientation of production under central planning meant enterprises tended to concentrate on defense-related products, and to be inefficiently large and geographically remote. The demand for military output has substantially declined since the reductions in military procurement in the earlier part of the transition period, and efforts to convert to civilian production have had very limited success. The authorities' policy towards industrial restructuring has been based, in principle, on the attempt to impose hard budget constraints on enterprises through market-based mechanisms and institutions, emphasizing competition and the use of insolvency processes for reorganization or liquidation. While there has been some restructuring of industry in recent years, at least in terms of employment reduction and reallocation (see Chapter II), these policies appear to have had mixed success at best: competition has been slow to emerge; the nascent bankruptcy process generally has not provided an effective hard budget constraint; and political pressures, particularly at the subnational level, have tended to ensure that nonviable enterprises survive.

167. **A new Bankruptcy Law, which took effect in March 1998, represents a significant improvement over the previous law, although success in implementation has been mixed**. The new legislation provides for: an increased role for creditor committees in the resolution of insolvencies; quicker appointment of trustees with authority to replace incumbent management; differentiation of classes of creditors; and stricter observance of time limits for workout and liquidation proceedings. The law still incorporates biases against private creditors and towards enterprise restructuring over liquidation, but nevertheless now represents a generally adequate legal framework. However, implementation capacity remains lacking in the courts and bailiff services. In addition, frequent political interventions have continued to undermine the effectiveness of the threat of bankruptcy, and the process is also vulnerable to manipulation by private interest groups. In January 1999 the Government decided to cease initiating any bankruptcy proceedings against tax debtors; given that the state has been the key player in initiating bankruptcies, this decision threatened to provide a significant impediment to industrial restructuring, as well as potentially affecting tax compliance. However, the decision has recently been rescinded. The number of bankruptcy cases has grown sharply in recent years, to around 4,000 in 1998. This still represents a very low rate by international standards; all the more so given the incidence of insolvency in Russia, with over 50 percent of firms reported to be making losses in mid-1998.

168. **Inflexible labor markets have contributed to the slow pace of restructuring.** The Russian Labor Code, which was inherited from the Soviet era, has been subject to piecemeal amendments. It contains a number of serious impediments to labor mobility, including constraints on the right of management to lay off workers, such as requirements of trade union consent and obligations to offer alternative employment. The government has recently

introduced a new Labor Code to the Duma, but the draft does not address some of the shortcomings of the current code, including the involvement of trade unions in firm management and overly tight stipulation of the form of labor contracts.

169. **Industrial restructuring is also hampered by the lack of an effective social safety net to help cushion the social and political impact of large-scale layoffs.** This problem is exacerbated by the fact that housing and other social benefits are commonly provided by the employer. Reform in these areas has been slow, and unemployment benefits available to laid-off workers represent a low percentage of former salaries. Social factors are particularly important in one-company towns, which lack alternative employment opportunities. A related problem is overpopulation of inhospitable areas in the North and Far East of Russia. Special wage benefits and social privileges, intended in the Soviet period to encourage workers and their families to move to such areas, still exist on paper, but are often not delivered in practice, and in many settlements it has become increasingly difficult to cover basic social needs. The government has been working on pilot projects to encourage voluntary out-migration from these areas.

170. **Constraints on the housing and land markets have continued to limit labor mobility significantly, as well as adversely affecting new business activity.** Municipal administrations exercise effective monopoly control over urban land. The enactment of a Land Code intended to confirm the constitutional rights of citizens to own land and engage in market transactions of land has been held up for some time in the Duma. A few regions have bypassed the delay by adopting their own legislation allowing the free trade of land. Laws developing land registration and a mortgage market were passed in 1998, but have not yet been made fully effective.

D. Reforms of the Infrastructure Monopolies

171. **The major infrastructure firms, including gas giant Gazprom, the oil transport company, the national electricity company and its subsidiaries and partners, and the state rail company, play a central role in the economy.** Tariffs often fail to reflect economic cost and demand factors, numerous exemptions and rebates are granted to customers on social and political grounds, and the companies suffer very low cash collection rates, largely because they fail to terminate access of nonpayers, or are not permitted to do so due to political pressure. Apart from misallocating resources in the economy, this has led to quasi-fiscal losses for the government: financial losses pass to the government via reduced, or in-kind, tax payments and reduced returns on the government's ownership stakes.

172. **Reform of the infrastructure sectors has concentrated on introducing effective regulation, establishing financial discipline, restructuring and divestiture of ancillary businesses and social assets, and encouraging competition and new entry, including foreign participation.** Independent regulatory agencies were established in 1996 for the energy, telecommunications and rail sectors, and have since developed their roles in

tariff-setting and improving transparency and payment discipline. There has been some rationalization of prices and tariffs, to reduce cross-subsidies benefiting households at the expense of industry and better reflect economic costs. In 1997, a new cost-based gas pricing methodology was introduced, under which household gas prices have been increased, reaching 88 percent of industrial wholesale prices in June 1998. In addition, by July 1998, aggregate electricity prices were set at a level to fully finance operating and investment costs; and cross-subsidies to households, while still substantial, had declined. However, the regulators have been slow in responding to new distortions introduced by the collapse of the ruble and subsequent inflation. Energy price increases were delayed until the spring of 1999 and, since the devaluation, a very large discrepancy has emerged between rail tariffs applying to goods being shipped for export and those applying to domestic deliveries, as the former are priced in foreign currency. In the fall of 1998 a decision was taken to integrate the Federal transport and telecommunications regulatory agencies into the new Anti-Monopoly Ministry. The organizational structure of the new Ministry has not yet been fully elaborated, and it is unclear whether the change represents a threat to the independence of these regulatory agencies.

173. **Nonpayments within the utilities sectors have not been effectively tackled.** Lengthy lists of strategic customers that are protected from disconnection have been significantly shortened, but the impact of this positive development has been diminished by the fact that even enterprises not on the strategic lists have largely been able to escape disconnection for nonpayment. Budgetary organizations have persistently failed to meet their energy obligations in cash. Overall these conditions have led to very low cost recovery, with the December 1998 data showing cash collection rates for domestic energy supply at around 15 percent and for rail freight traffic at below 50 percent. Collection rates are generally higher for households than for enterprises, with telephone services enjoying the highest cost-recovery, reflecting a credible threat of disconnection in the sector. Significant increases in cost-recovery levels have been achieved for housing and communal services, but only to a level of 50 percent at the end of 1998, which still represents a considerable drain on fiscal resources.

174. **Some initial steps have been taken in separating production from transmission operations in the energy sector, but the objective of establishing competitive wholesale energy markets remains distant.** In 1998, a competitive wholesale market for electricity was piloted in one region, and the government issued instructions for Gazprom to embark on restructuring to separate financially the pipeline system from production activities. A draft law on nondiscriminatory oil pipeline access is in the early stages of preparation. New private sector entry in the energy sectors has been very limited, partly because of problems in access to transmission networks, but also because of Russia's generally difficult investment climate.

RUSSIAN FEDERATION: REGIONAL DEVELOPMENTS

A. Introduction

1. **A number of factors point to the importance of understanding developments in Russia at the regional level.** First, subfederal governments play an extremely important economic role in Russia, accounting for about 60 percent of government revenue and expenditure, and exercising a significant degree of autonomy in economic policy. Second, the authorities have undertaken a reform of the system of fiscal federalism, with a view to providing clear assignments of revenue and expenditure responsibilities, improving the efficiency of the federal-regional transfer system while increasing benefits to the poorest regions, and incorporating increased conditionality for transfers. Evaluating these policies requires an understanding of regional issues. Third, there has been a large dispersion in the experience of Russian regions during transition, and documenting these difference would be a first step toward understanding the reasons behind them.

2. **It is clear that Russia's economy is very diversified on a regional basis, and that economic stratification has increased during the country's transition from socialist to market economy.** It should be noted, however, that owing to the uncertain quality and often unclear definitions of regional data available from officially published sources, only a suggestive analysis can be provided at this point.

3. **The Russian Federation includes 89 top-tier territorial administrative units, commonly referred to as regions**. Among them are: 21 ethnic-minority republics, 6 krais (territories), 49 oblasts (regions), 2 metropolitan cities (Moscow and St. Petersburg), 1 autonomous oblast (Jewish autonomous oblast), and 9 autonomous okrugs. These units differ widely in terms of their area, population, climate and geographic conditions, culture, and religion, in addition to their economic base and performance. There are also differences in political status between the "ethnic" republics, whose presidents are elected, and other regions, whose governors have mostly been appointed by and can be dismissed by the president of Russia. In 1991, about 18 percent of Russia's population was officially counted as non-Russian by "nationality".

B. Economic Activity

4. **Economic activity is concentrated in a small number of regions.** Under central planning, investments aimed toward an equalization of incomes across regions, combined with forced migration from the cities of European Russia into the remote regions of Siberia and Asia. Despite these policies, economic activity has become increasingly concentrated as the move toward a market economy has meant the elimination of many subsidies to remote regions. In 1994, the top ten regions of Russia (in terms of contribution to GDP) accounted for about 41 percent of the country's GDP, while in 1996 the same group produced

46 percent of the total GDP (see Table 36). These same regions' population accounted for just 31.2 percent of the total Russian population.

5. **The top regions, in terms of GDP, are either large industrial centers developed before or during the central planning era or are major producers of oil and minerals.** In addition to the historic core cities of Moscow (which contributed 11.8 percent of 1996 GDP) and St. Petersburg (3.3 percent of 1996 GDP), economic centers have arisen around the oil and gas deposits in Western Siberia and the Urals (Tyumen, and the autonomous Khanty-Mansi and Yamalo-Nenetsk districts located within Tyumen, Samara, and Tatarstan) and near large mineral and metal deposits in East Siberia (Krasnoyarsk Krai, Irkutsk, Kemerovo) and the Urals (Sverdlovsk, Chelyabinsk, Bashkortostan).

6. **The diversification of the Russian regions in terms of per capita GDP is striking.** In 1996 average per capita GDP in the ten most developed regions was five times higher than in the ten least developed ones, and per capita GDP in the richest region, Tyumen Oblast, was 21 times higher that in the lowest, the Ingush Republic. The differences are apparently lessened by cross-regional transfers—per capita incomes in the ten most developed regions were only four times higher than in the ten least developed regions, and the richest region was 14 times higher than the poorest. The correlation coefficient for regional per capita GDP and average monthly income in 1996 equaled 0.78.

7. **While industrial production has declined across Russia, the experiences of regions have again varied greatly.** Compared to the 1991 pre-reform level, Russia's industrial production fell by about 51 percent during 1992–98. In nineteen regions the cumulative decline was higher than 70 percent, including those located in North-Kaukaz region, affected by the Chechen war. Lower than average declines have been experienced by the republics of West Siberia dominated by the oil and mineral industry, and the Northern Region.

8. **Services and small businesses have tended to be the most dynamic sectors in Russia during transition.** The largest growth in per capita services was registered in Moscow, and Moscow Oblast, while the smallest growth was registered in the republics of East Siberia and Far East. There have been widely different experiences in terms of the role of small enterprises. In 1996–98, the number of small enterprises increased by 3.1 percent in Russia, but regional experiences varied from an increase of 145 percent (Ingush Republic) to a decline of 76 percent (Chukotsk); in terms of employment, the regional differences are even larger. Those regions with the most active small business sector tended to be the most successful—the highest share in total output of small enterprises was registered in Moscow and St. Petersburg, and seven out of ten regions with the highest share of small enterprises in total output were also among the top ten contributors to the 1996 Russian GDP.

C. Investment

9. **The regional concentration of investment has mirrored that of economic activity.** While the nationwide reduction in investment over the period 1992–98 was about 13 percent, in seventeen regions the decline was higher than 50 percent. Positive investment growth over this period was observed only in nine regions, with the three regions with the highest growth in investment (Moscow, St. Petersburg and Moscow Oblast) accounting for 17½ percent of total 1992–97 investments in fixed assets in the country. Ten regions accounted for more than 51 percent of the total fixed asset investment in the country.

10. **The concentration of foreign investment has been even higher—Moscow city alone absorbed nearly 60 percent of total foreign capital invested in Russia in 1995–98.** Per capita foreign investment totaled $683 in Moscow in 1998 compared to $80 for the other regions of Russia. About 82 percent of total foreign investment in this period was made in ten regions, again most of them major contributors to the country's GDP.

11. **Investment activities are closely related to the allocation of credit—in 1997 Moscow City absorbed 44 percent of total credit for enterprises, banks, and household in the country, compared to 35.3 percent in 1995.** Next in line was St. Petersburg with only a 2.9 percent share in the country total. The Moscow economy is also apparently far more monetized than the rest of the country, with a credit-to-GDP ratio in 1996 of 55 percent (down from 65 percent in 1995) compared with a national average (weighted) of 14 percent with some regions receiving credit of as little as 0.1 percent of their regional GDP.

12. **Foreign investment and credit availability are undoubtedly related to investors' evaluation of risks associated with activity in individual regions.** According to studies performed by the Bank of Austria on the basis of 1996 data, Moscow city was the least risky region in Russia in terms of financial, economic, and social risk. Among the ten regions with the lowest general risk of investment, seven were major contributors to the country's GDP.[66]

D. Labor Market Developments

13. **Unemployment varies widely across regions, and is strongly related to the level of economic activity, suggesting that labor mobility is geographically limited.** According to October 1997 data, while the unemployment rate in the country equaled 11.4 percent, unemployment was only 3.7 percent in Moscow, but 52 percent in Ingush Republic. Most of

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[66]Interestingly, Kemerovo Oblast (twelfth in terms of contribution to GDP) was rated eighth in terms of general risk, and fifth in terms of labor market risk. In 1998 Kemerovo contributed to the social and financial crisis in Russia by initiating strikes and blockades of the Trans Siberian railway.

the high unemployment regions are located in North Kaukaz (troubled with ethnic conflicts and the war in Chechnia), and in East Siberia regions; unemployment in Ingush Republic and Krasnodarsk can partly be explained by the inflow of immigrants (mostly from Chechnia), who in 1998 represented 28 and 9 percent of the Republics' population respectively.[67]

14. **Labor market conditions in Russia are also characterized by large variation in wages across regions.** In December 1998, the average wage in the country equaled 1,515 rubles with a regional minimum of less than 700 rubles (Dagestan Republic). The highest wages were observed in Far Eastern regions (especially in Chukotsk, Kamchatka and Magadan Oblast) and West Siberia Regions (Tyumen Oblast), partly reflecting the relatively high cost of living. Moscow ranked only 12th on the list of regions in terms of average wage. Regional differences in average wages have increased in recent years—the highest average regional wage in U.S. dollar terms in 1997 was 68.7 percent higher than in 1994, while the lowest average regional wage increased in the same period by only 28.2 percent.

15. **Wage arrears are an important problem throughout Russia and have reached endemic proportions in a number of regions.** At end-1998 wage arrears accounted for 88 percent of the monthly wage bill[68] nationwide, but in some regions arrears are as high as 630 percent of the monthly wage bill (Kurgan Oblast in the Urals). In 1998, the nonpayment of wages was mostly concentrated in the regions of West Siberia, with Kemerovo Oblast accounting for 9 percent of total arrears in the country. Due to strikes of unpaid workers (mostly coal miners) and blockades of railways, the governor of Kemerovo in May of 1998 introduced a state of emergency in the Kuznetsk coal basin (Kuzbass). In contrast, Moscow experienced relatively low levels of wage arrears, amounted to only 8 percent of monthly wages.

16. **Although labor markets remain quite segmented by region, some interregional migration is taking place**. Data indicate that there was a significant flow of labor from regions with difficult living conditions to those with lower costs of living and better employment opportunities. In particular, significant inflows of population were registered in most industrialized Central and Povolgzski regions over the period 1992–98 (with Moscow and Moscow Oblast accounting for 400,000 immigrants). Over this period, the highest out-migration was observed from the Far East, Northern and East Siberia regions (net emigration

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[67]Very high unemployment rates were also observed in Jewish Autonomous Oblast (25.1 percent, North Ossetia (22.8 percent), Kalmykiya (22.5 percent, Dagestan (21.6 percent), Murmansk (19.5 percent), Buryat Republic (19.1 percent), and Chitinsk Oblast (19.0 percent).

[68] Calculated as an average regional monthly wage multiplied by October 1997 regional employment (disaggregated data on 1998 employment are not available).

from these regions accounted for over 1 million people). For at least one region (Chukotsk Oblast), 84 percent of the population emigrated in 1992–98 to other regions.

E. Development of the Private Sector

17. **The wide divergence in the performance of regional economies is mirrored by differences in the direction of economic policy, in particular with respect to privatization.** The experience of particular regions with respect to privatization is of interest both because it has a direct bearing on economic performance and because it can be viewed as an indicator of attitudes toward reform more broadly. From 1991, when the privatization process began, until end-1997, the share of state ownership in fixed assets (according to their book value) declined from 91 percent to 45 percent. In 1998 only 6.1 percent of firms were considered as state owned.[69] According to the cumulative index developed by the Bank Austria on the basis of regional data for 1996,[70] the most successful regions in terms of privatization were the city of Moscow, St. Petersburg and other most developed regions of Central Russia.

18. **The pace of large scale privatization in the regions is determined, in part, by the structure of the regional industry and the degree of autonomy exercised by the authorities.** In particular, the share of large private enterprises is smaller in the regions dominated by strategically important industries, such as machine building (in particular defense industry), metallurgy and extracting industries. Privatization in these industries is either prohibited or requires agreeing on terms of privatization with corresponding governing bodies. The economic sovereignty exercised by regional authorities in some national republics apparently contributes to the difference in the levels of privatization as well, with a low percentage of privatized companies in a number of such republics. A slow pace of privatization is also typical for the Northern and some Eastern regions.

19. **Small-scale privatization has proceeded at a much faster pace than the privatization of industrial enterprises in the majority of the regions, but even here the differences are significant.** For instance, while privatization of retail trade is, from a nationwide standpoint, almost complete—at the end-1998 only 7 percent of retail trade turnover was accounted for by state-owned enterprises—in some regions this share remains significantly higher. In particular, a relatively large share of state enterprises in total trade

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[69]However, the government continues to hold stakes—often majority—in enterprises that are no longer considered state owned in official statistics.

[70]Including data on authorized capital of stock companies, shares of different groups of enterprises and organizations privatized, revenues from privatization, employment in private sector, and output of private sector.

turnover was observed in East Siberia and Far East (including a high of 68 percent in Chukotsk). This likely reflects the continued web of implicit and explicit subsidies to these remote regions, allowing retail establishments to continue in operation.

F. Payment Discipline

20. **Tax compliance appears to vary significantly among regions.** Regional tax contributions vary widely as a share of regional GDP, which may be used as a rough proxy for the tax base.[71] As a share of 1996 GDP,[72] regional 1998 tax payments to the enlarged government varied from 67.1 percent (Kalmykia) to 12.4 percent (Amur Oblast), with the weighted average for the country equal to 26.4 percent of GDP. The highest relative tax burdens are found in major cities mostly located in Central Russia, and the lowest tax burdens in the relatively isolated regions of East Siberia and Far East. This suggests that tax payments may depend in part on the ability of central authorities to exercise some element of control over taxpayers and local tax authorities.

21. **The spread of the problem of nonpayment more generally can be seen clearly in trends with respect to inter-enterprise arrears.** In real terms, overdue payables increased over the period 1994-98 by 176 percent. However, in ten regions, the growth of arrears was higher than 400 percent, with the Moscow Oblast experiencing an increase of over 750 percent. Arrears are concentrated in the most industrialized regions of Russia: Tyumen, Kemerovo, Sverdlovsk, Chelyabinsk.

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[71]However, differences in revenue/GDP ratios would be expected to result from different industrial bases, as the tax burden varies by industry.

[72]More recent regional GDP data are not available.

Table 36. Russian Federation: Main Characteristics of Ten Top and Ten Bottom Contributors to Regional GDP

	Share in total GDP, 1996, in percent	GDP per capita, 1996, in Rubles	Share in total population, end 1998, in percent	Average wage, Dec.98, in Rubles	Unemployment as percent of labor force, end 1997	Wage arrears as percent of regional wage bill, Dec.98	Share in total foreign investment in 1995-98, in percent	Cumulative decline in industrial production, 1991-98	Tax payments to enlarged government as percent of GDP, 1996	Credit to non-government sector as percent of GDP, 1996
Moscow	11.8	26,719	5.8	2,660	3.7	8.0	59.6	67.3	52.0	54.6
Tyumen Oblast	9.6	59,217	2.2	3,684	10.8	45.0	2.3	35.4	25.5	2.4
Sverdlovsk Oblast	3.7	15,371	3.2	1,462	10.6	59.2	0.6	62.2	23.8	3.8
Saint Petersburg	3.3	13,456	3.2	1,801	9.0	19.6	2.9	66.7	35.3	9.7
Tatarstan Republic	3.1	16,296	2.6	1,342	7.7	131.2	4.8	30.9	19.8	3.5
Samara Oblast	3.1	18,455	2.3	1,624	9.3	30.9	1.2	41.7	24.3	3.5
Moscow Oblast	3.0	9,066	4.4	1,548	11.0	33.7	4.1	70.8	45.0	5.9
Krasnoyarsk Krai	3.0	18,751	2.1	2,131	12.8	61.2	1.1	39.9	22.6	1.8
Bashkortostan Republic	2.9	13,729	2.8	1,212	10.8	304.9	0.3	47.1	20.1	4.1
Chelyabinsk Oblast	2.5	13,478	2.5	1,304	9.7	72.9	0.4	62.6	21.8	1.5
Kabardino-Balkar Republic	0.23	5,584	0.54	945	17.1	155.6	0.01	73.3	19.3	1.2
North Ossetian-Alaniya Republic	0.16	4,786	0.45	867	22.7	117.5	0.00	76.8	20.6	4.8
Karachaev-Circassian Republic	0.13	5,639	0.30	947	18.7	487.8	0.01	79.2	16.9	3.6
Adygeya Republic	0.12	5,380	0.31	916	11.8	172.0	0.00	73.4	18.2	2.8
Chukotsk A. Oblast	0.12	27,248	0.06	4,925	10.8	94.8	0.00	52.6	16.9	0.1
Jewish Autonomous Oblast	0.07	6,972	0.14	1,576	25.1	316.4	0.00	89.2	15.6	1.1
Tyva Republic	0.07	4,620	0.21	1,294	18.9	264.4	0.01	64.5	13.2	1.7
Kalmykiya Republic	0.07	4,019	0.22	975	22.5	86.2	0.01	76.2	67.1	3.8
Altai Republic	0.06	5,964	0.14	1,270	17.7	218.6	0.00	72.7	35.3	12.9
Ingush Republic	0.04	2,785	0.22	849	52.0	296.8	0.00	...	23.8	2.4
Country average	...	14,893	...	1,516	11.4	88.0	...	50.6	26.4	14.1
Regional average	1.27	11,702	1.15	1,709	13.2	128.9	1.16	56.4	22.3	3.6
Standard deviation	1.79	7,516	1.03	1,365	5.9	125.4	6.36	15.3	7.8	6.3
Maximum	11.79	59,217	5.83	10,425	52.0	673.0	59.64	89.2	67.1	54.6
Minimum	0.04	2,785	0.01	699	3.48	8.0	0.00	1.9	12.4	0.1

NONMONETARY TRANSACTIONS AND ARREARS ACCUMULATION

A. Introduction

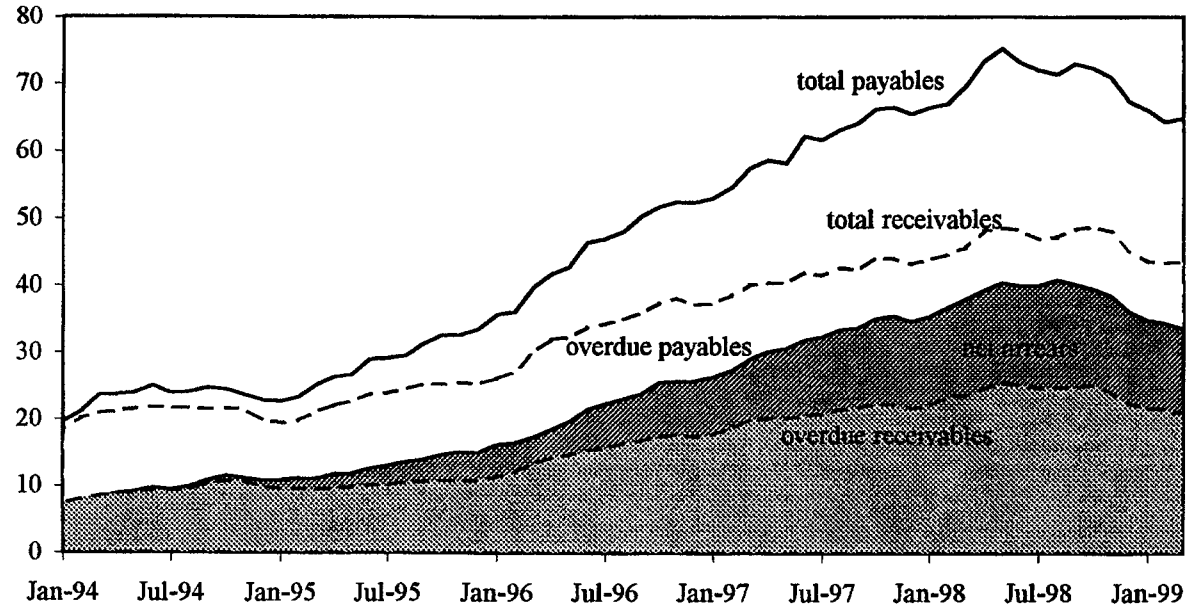
1. Nonmonetary settlements, such as promissory notes (*veksels*), tax-expenditure offsets, and barter, and arrears accumulation make up a significant proportion of transactions in Russia. Total overdue debts of enterprises reached 40 percent of GDP in 1998, half of industrial output is exchanged in barter, the stock of *veksels* has been estimated to exceed the size of ruble broad money, and a large share of government transactions are conducted in mutual offsets of tax liabilities for expenditure arrears. The associated costs to the economy are very significant. This note presents information available on nonpayments and nonmonetary transactions, reviews some of the theories advanced to explain the problem, analyzes the economic effects of the nonmonetary economy, and briefly considers potential policy responses.

B. Arrears

2. **Enterprise arrears are large and growing**. While use of interenterprise trade credits is normal in a well-functioning economy, the scale and rapid growth of such credits, and the high proportion that is overdue, make the situation in Russia very unusual. Total payables to large and medium-sized enterprises rose from around 20 percent of GDP in 1994 to over 70 percent of GDP in 1998 (Figure 21), while total receivables rose from 20 percent of GDP to about 45 percent of GDP over the same period.[73] The growing gap between payables and receivables implies that the enterprise sector has become increasingly indebted to other sectors. At the same time, the gap between overdue payables and receivables—**net arrears of**

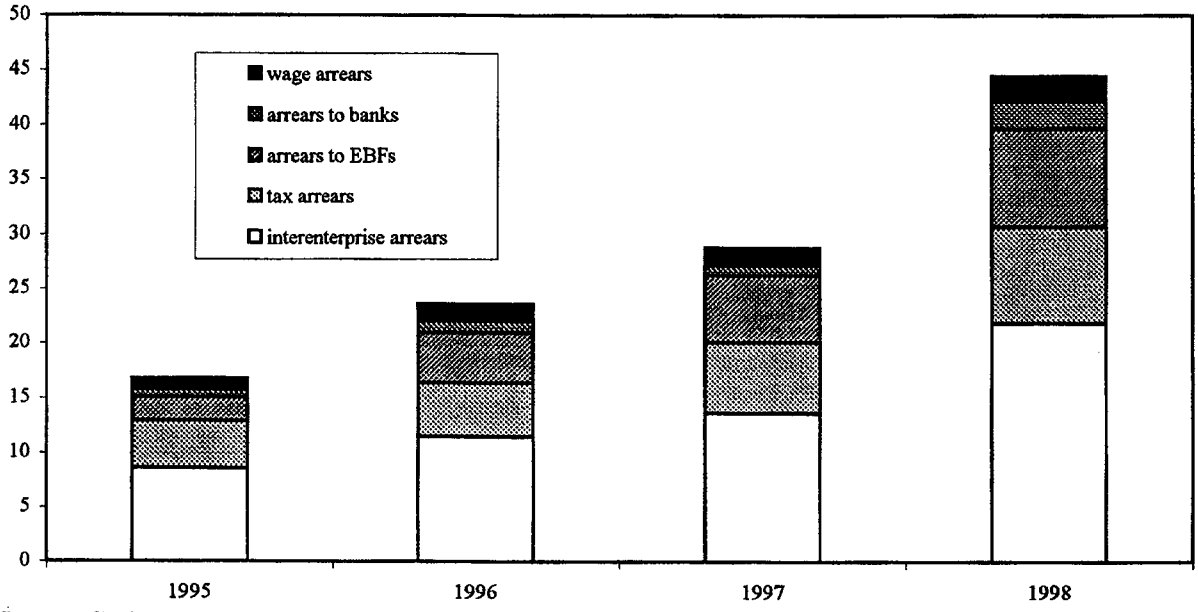
[73]The arrears data discussed in this paper all refer to "primary" debts, and do not include interest or penalties that accrue for nonpayment. Data prior to 1998 cover only four sectors (industry, construction, agriculture, and transport), but have been scaled up for consistency with 1998 data, which cover the whole enterprise sector. Scaling factors used were ratios of averages of the overlapping data available since January 1998. The four core sectors dominate total arrears. Monthly GDP data used in Figure 21 are smoothed.

Figure 21. Russian Federation: Enterprise Debt, 1994-99
(In percent of GDP)



Source: Goskomstat, and Fund staff calculations.

Figure 22. Russian Federation: Structure of Enterprise Arrears, 1995-98
(In percent of GDP)



Source: Goskomstat.

the enterprise sector—rose from zero in 1994 to some 15 percent of GDP in 1998.[74] The growth in net arrears reflects increased arrears to banks, workers, and in particular, the public sector. (Figure 22). **The growth in tax arrears over the period 1995–1998, implies a fiscal subsidy to the enterprise sector of 5 percent of GDP a year.**[75] The low level of arrears to banks partly reflects the relatively small amount of bank credit to enterprises. Wage arrears also make up a relatively small proportion of total arrears; in 1998, such arrears were reported to be 3.3 percent of GDP, up from 2 percent of GDP in 1996 and 1997. The government is responsible for about 20 percent of total wage arrears.

3. While interenterprise arrears and tax arrears have risen strongly, overdue debt of final consumers, including government and households, have remained very steady at about 2 percent of GDP throughout the 1994–98 period. This partly reflects the role of periodic offset operations in preventing the continuous accumulation of government spending arrears. While data on government spending arrears are generally of poor quality, in particular at the local level, the rapid growth of tax arrears, which are net of offset operations, points to the relatively slower growth of spending arrears.

4. **The incidence of subsidies implied by arrears varies significantly by sector**. Data on arrears related to deliveries suggest some cross-subsidization of the manufacturing and agriculture sectors by the energy and transportation sectors (Figure 23). However, all sectors, except the trade sector, have substantial tax arrears, so that even the energy and transport sectors are net debtors overall. Within the energy sector, the electricity companies have overdue claims on customers equal to some 21 months of output, or 6 percent of GDP. Most of these claims have been passed on to suppliers; the remainder have found their way to the government sector via tax arrears.

5. **The level of tax arrears in the energy and manufacturing sectors suggests that these sectors have received annual implicit fiscal subsidies equal to about 15 and**

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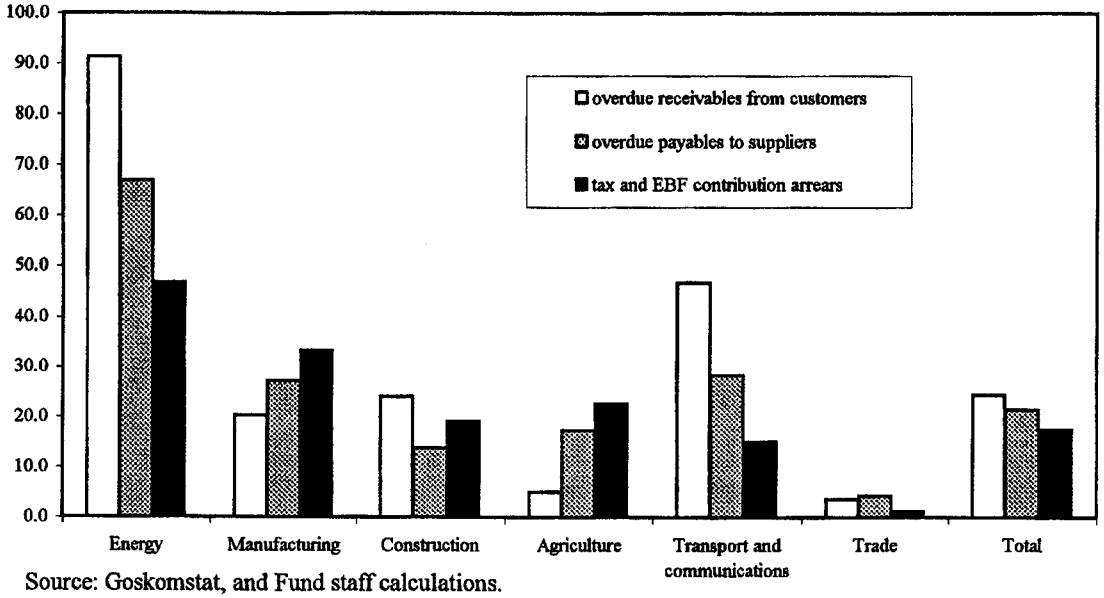
[74]Figure 1 appears to suggest that the arrears problem emerged seriously only in 1995 and has diminished since last August. However, both in 1994 and in the second half of 1998, rapid increases in inflation deflated stocks of debt without necessarily abating the flows of new arrears. In fact gross arrears accumulation remained relatively steady during the period 1994–1998, at around 12–15 percent of GDP a year, although net arrears growth does appear to have risen from 1995 on. And, since August 1998, nominal arrears have followed a very similar path to that of a year earlier, suggesting they are likely to revert to an upward trend relative to GDP as the price level continues to stabilize.

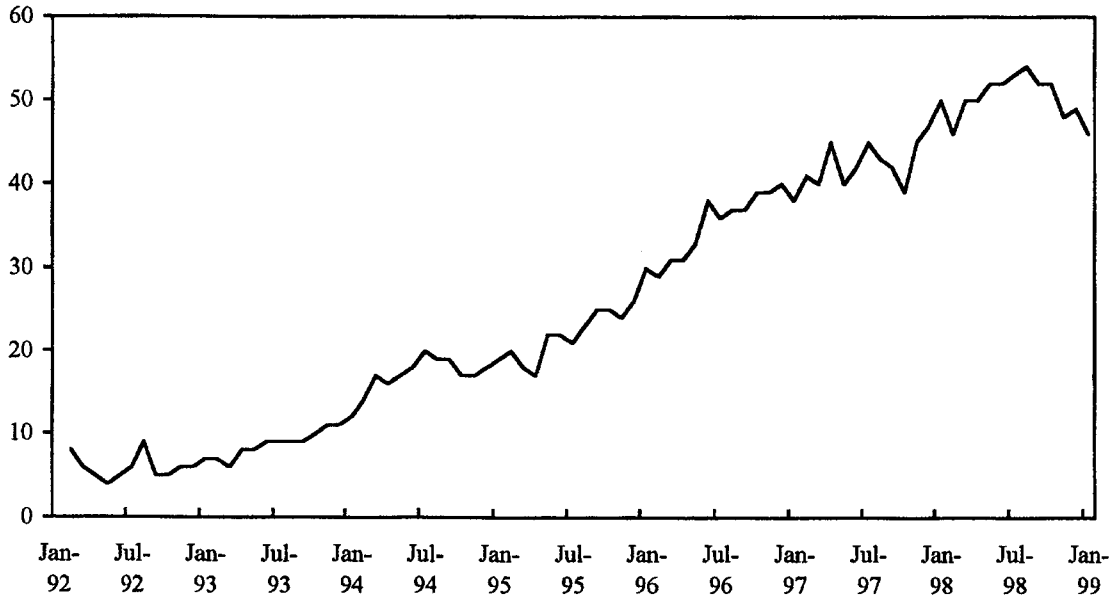
[75]The change in tax arrears during the year as a share of GDP was 3.9 percent in 1995, 6.5 percent in 1996, 4.9 percent in 1997, and 4.9 percent in 1998. "Tax arrears" here include arrears on contributions to extra-budgetary funds (EBFs).

Figure 23. Russian Federation: Enterprise Arrears by Sector, July 1998
(In percent of sectoral output)



Source: Goskomstat, and Fund staff calculations.

Figure 24. Russian Federation: Barter as Percent of Industrial Sales, 1992-99



Source: Russian Economic Barometer.

10 percent of output respectively, in recent years.[76] The equivalent figures for construction, agriculture and transport would be around 5 percent of output a year. However, the arrears data tell only part of the story of the total quasi-fiscal subsidies that occur due to the nonmonetary economy, as discussed below.

C. Nonmonetary Transactions

6. Data for arrears reflect only instances when no payment has been received at all. Perhaps a more serious problem, however, is the proliferation of nonmonetary transactions in Russia. Evidence suggests that nonmonetary instruments now predominate as the means of transactions in industry. Money surrogates abound, and barter has developed to encompass a range of forms. The main forms of nonmonetary transactions are described below.

Barter

7. **The use of barter has increased dramatically since the beginning of the transition period, peaking at over 50 percent of sales in mid-1998** (Figure 24).[77] Barter takes a number of forms. The simplest type of barter, the simultaneous exchange of goods between two parties each of whom desires the other's product, does not appear to be particularly prevalent in industrial barter. This is not surprising, given the problem of finding a "double coincidence of wants". Where such swaps do take place it may be out of a lack of trust between the parties precluding more sophisticated schemes. A more common form of swap is delayed exchange, where one firm provides a good in advance, to be repaid with goods after a period which can be as prolonged as six months or a year. Another simple form of barter is a linear chain, where a raw material passes through a chain of processors to become a final product, with counterflows of goods or promissory notes in the reverse direction.

8. **More sophisticated barter schemes are common, and a substantial infrastructure has grown up to administer them**. The 1998 EBRD survey reports that almost half of barter is arranged through intermediaries, and government often has an important role in the process. In an example given by Ledeneva and Seabright (1998), a gas equipment company owes taxes to the local budget. Instead of paying, it supplies equipment to the Urengoi gas deposit, which provides gas to the Chelyabinsk metal complex. The latter, in turn, supplies metal to the

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[76]Assuming sectoral tax arrears have grown in line with total tax arrears, the energy sector ran up tax arrears of 10 percent of output in 1995, 18 percent in 1996, and 14 percent in each of 1997 and 1998. Manufacturing benefited to the extent of 7 percent of output in 1995, 13 percent in 1996, and 10 percent in each of 1997 and 1998.

[77]A World Bank-Russian Academy of Sciences survey indicates similarly high levels of barter, equal to 11 percent of manufacturing output in 1992 and 43 percent in 1997. This survey also reported considerable variation in the use of nonmonetary transactions by region, with the lowest incidence in Moscow. (Hendley et al, 1998).

Nizhni Novgorod automobile plant, which supplies chassis for buses to the Kurgan bus plant. Buses are then supplied to the Kurgan city government.

9. **Price-setting behavior is a critical aspect of barter**. First, some reference to ruble prices seems universally to be used. Second, the "liquidity" (i.e. the ease with which a cash buyer can be found) of the goods in question is of crucial importance in determining relative prices. Third, relative prices reflect the relative power of the two parties; some transactions may be essentially forced, e.g. if a company has no alternative outlet for its product, is under political pressure to continue supplying a nonpaying customer, or is trying to collect a pre-existing debt.[78] The government is frequently put in this position by companies unable to meet their tax obligations in cash. Similarly, the energy sector often receives payment in kind on a take-it-or-leave it basis, being unable to disconnect delinquent customers for technical or political reasons.[79] Finally, **barter prices are usually higher than money prices** (not lower, as is commonly supposed to be the case for reasons of tax evasion).[80]

Veksels

10. *Veksels* are a primitive form of promissory notes—basically formalized, tradable IOUs—issued by banks, enterprises and the different levels of government. Most government *veksels* form part of the tax offset arrangements discussed in the next section. Estimates of the volume of *veksels* circulating in Russia vary widely: in 1997, they ranged from Rub 80 billion to Rub 500 billion, equivalent to 20–120 percent of broad money.[81] Bank *veksels*, which are estimated to make up 15–40 percent of the market, had generally been seen, before last years banking crisis, as close substitutes for money.

11. The majority of *veksels* are issued by enterprises—mostly large companies with solid reputations and, in particular, by the big infrastructure companies such as the energy producers and the railways. At least prior to last August, they have generally not been

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[78]Aukutsionek (1998) reports an average share of forced barter of 40 percent of the total volume of barter deals, with the highest proportion occurring in the firms most heavily exposed to barter.

[79]Technical reasons for inability to disconnect nonpayers may often be cited as cover for political decisions. Formal lists of "strategic" companies exempt from disconnection for nonpayment have been substantially cut back, but powerful political pressure is still often brought to bear on behalf of companies not on these lists.

[80]Only 9 percent of respondents in a 1998 EBRD survey reported lower prices for barter than for cash, with 28 percent reporting prices "a bit higher" and 25 percent reporting prices "much higher". (Commander and Mumssen, 1998.)

[81]Russian *veksels*, Renaissance Capital Group (1997) and OECD *Economic Survey* (1997)

considered as reliable as bank *veksels*, and consequently carry higher yields. Although *veksels* are legally supposed to be denominated in cash and to be freely tradable, enterprises usually write in restrictions ensuring that the *veksels* they issue are redeemable only in their product ("commodity *veksels*") and/or traded only within a specified set, or chain, of companies. Possible benefits from keeping *veksels* circulating within a small trusted group of companies include price discrimination and avoiding the attention of the tax authorities. Commodity *veksels* are important tools used in barter arrangements.

12. Beyond *veksels*, more direct money substitutes have emerged in different regions at different times. Some regions have issued their own quasi-money, for example watermarked bills in lieu of pension payments, usable at any of the many enterprises that owe taxes to the local government. The federal government has generally succeeded in curbing such practices.

Offsets

13. "Offsets" refer to a variety of transactions and instruments, originally involving the mutual settlement of pre-existing debts. Like the other nonmonetary instruments, however, offsets have evolved into different types, commonly involving lengthy chains, with mutual debts being netted out at each stage. They now frequently involve settlement of current transactions rather than pre-existing debt.

14. Offsets are commonly used between enterprises, but have their most pervasive macroeconomic implications in the case of government-sanctioned offsets of tax debt against government spending arrears or payments in kind. Such **tax offsets** are practiced between enterprises and all levels of government.[82] The mechanics of the more basic tax offset arrangements run as follows. An enterprise supplies a government entity with goods or services, e.g. heating. If the entity is unable, or unwilling, to pay, the enterprise may take the invoice, endorsed by the nonpaying entity, to the government finance office, where it is written off against taxes (or exchanged for a certificate to be used against taxes). However, the process has evolved so as often to run in the opposite direction, with enterprises negotiating with the government to accept their product—for which the government may have little demand—in lieu of taxes.[83] These processes, which are particularly prevalent at the subnational level, are inconsistent with proper budgetary management, distort expenditures, and are highly discretionary and fraught with opportunities for abuse. Enterprises are reported

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[82]See Box 2 for a detailed description of federal government offset operations.

[83]The circular barter chain described in the previous section gives an example of tax payments in kind. In that case the local government had no need of the product of the tax debtor, and only after a convoluted chain of barter was it able to receive goods it did want (buses). The effective price paid for the buses in terms of foregone taxes is not reported, but can be assumed to be high. The government may also be constrained by the arrangement in its choice of bus supplier.

to often present forged invoices to set against taxes, or to misstate the quantity of goods supplied, with the complicity of the entity endorsing the invoice. Moreover, the entity receiving the goods has little incentive to challenge the price invoiced by the supplier since the government bears the cost. In many cases, the government may be deliberately generous in order to help a favored industry.

15. Federal government tax offsets have fallen from about 25 percent of federal non-interest expenditure in 1996 to about 15 percent in 1998. Federal offsets make up only a relatively small share of total tax offsets, however. In 1996 money surrogates were estimated to average 50 percent of subnational government tax revenues.[84] Legislation adopted in 1997 restricted the issuance of *veksels* by regional governments, but the regions are reported to have sidestepped this by having local banks issue *veksels* on their behalf.

16. It is not possible to estimate the fiscal cost associated with tax offsets with any degree of accuracy, but there is some evidence suggesting that offsets purchase only about 50–75 percent of their face value in terms of supplies actually required by the government.[85] On this assumption, **the fiscal cost associated with offsets would be around 2½–5 percent of GDP a year**, about 8–15 percent of total government expenditure.

Nonmonetary wage payments

17. **Wages are commonly paid in kind or in quasi-money**. An enterprise often uses its own product to pay workers, who are then forced to sell or barter it. As with all in-kind payments, the value of the goods received in lieu of cash is likely to be much overstated compared to their market value. Often, enterprises pay wages not with their own product, but with goods that they have received through barter. Anecdotes abound of workers being paid in items such as shampoo and wallpaper in quantities far greater than they could ever use personally. A common variant is for enterprises to set up company stores containing goods either produced by the enterprise or received by it in barter deals, and to issue wages in the form of certificates that can be spent only in these stores.

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[84]OECD (1997). Commander and Mumssen (1998) find that offsets and barter account for 60–70 percent of local tax and EBF payments in a sample of firms with exposure to barter.

[85]Some support for this estimate is provided by the facts that tax offsets are reported to trade in the secondary market at discounts of around 50 percent, and that in the 1998 EBRD survey 24 percent of respondents reported that offset prices were "much higher" than cash prices, and 26 percent "a bit higher".

D. Explaining Arrears and Nonmonetary Transactions

18. A rapidly growing literature proposes a wide range of hypotheses as to what lies behind the growth of the nonmonetary economy. Underlying most of these explanations is the notion that the problem reflects a failure to enforce hard budget constraints at the enterprise level. Institutional and behavioral legacies inherited from the Soviet era may be partly responsible for this failure. It should be emphasized that different hypotheses are not necessarily competing; on the contrary, a combination of mutually-reinforcing factors has likely contributed to the problem.

The Soviet legacy

19. Most of the key characteristics of the nonmonetary economy can be traced to roots in the Soviet economic system. Most fundamental of these is the fact that the Soviet system was essentially **nonmonetary in nature**. Money was used only by the household sector, and even there its uses were limited, largely to a role in current transactions. Among enterprises money was used only as a unit of account. Volumes of inputs and outputs, their prices and their destinations were dictated by the plan. This helped lay the basis for the current problems in a number of ways:

- **Trading relations were essentially fixed**. These fixed relations have been replicated in the barter chains that have become established.[86]

- Under a fixed system of prices and volumes, some enterprises would naturally fall into deficit and some would be in credit. These imbalances were dealt with by **netting-out operations** at the end of each accounting period.

- A culture in which physical flows were considered more essential than financial flows led to a sense of duty on the part of enterprises to **continue supplying nonpaying customers.**

20. In addition, a skeptical **attitude to the state and the rule of law** and a **weak concept of ownership** hindered the development of contractual relations, taxpayer discipline and corporate governance. The use of nonmonetary transactions appears to be one of the main means of ensuring that revenues remain in the hands of managers.

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[86]1997 survey data showed that about 40 percent of industrial enterprise trade was with pre-1992 trading partners, and that greater preservation of pre-1992 trading links was associated with heavier exposure to barter (Aukutsionek 1998). Also, former civil servants from the planning departments are reported to have set up private trading operations, directing barter trade in the same way that they used to direct planned trade (Humprey, 1998).

21. Finally, the Soviet economy suffered from a number of **distortions in prices and demand**. Industries that would have been loss-making, or even value-subtracting, at world prices were sustained by subsidies, including low energy prices. Following the onset of the transitions process, inefficient enterprises have survived by not paying energy bills or taxes, or paying in kind. A further distortion is the geographic location of industries inherited from the Soviet era, which was determined by political considerations as much as economics, and resulted in particular in the overpopulation of the North and the "one-company towns." Poor labor mobility and lack of alternative local employment opportunities make closure or restructuring of industries in these situations politically problematic; protected but not provided for, they are sustained by nonpayment and barter.

The virtual economy

22. Several hypotheses concentrate on the mass of uncompetitive enterprises inherited from the Soviet industrial structure. Gaddy and Ickes (1998) describe a **"virtual economy"** in which recorded prices and outputs are largely illusory. In the model, a value-adding sector of the economy (natural resources) supports a value-subtracting sector (industry) by means of artificially-priced barter trade. Government and households are willing participants in the virtual economy. The government receives "virtual" tax payments, which it prefers to the political pain of letting the loss-making firms close. Similarly, workers receive only partial wage payment, but prefer this to losing their jobs altogether, and the social benefits that go with them. The natural resource sector chooses to sell output at below market prices because of an implicit contract whereby, in return for subsidizing industry, the government grants it access to lucrative export markets and opportunities for managers to enrich themselves. Variants on the virtual economy model place greater emphasis on the role of fiscal subsidies, rather than subsidies provided by the energy sector.[87] As explained above, the manufacturing sector receives indeed a sizable subsidy from both the government and the energy sectors.

Opportunistic motives

23. Nonmonetary payment may be motivated by the desire to **conceal information** from those with claims on transactions. Barter and other nonmonetary transactions are harder to monitor than cash transactions, either in terms of the prices and volumes involved or the very

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[87]For example, Woodruff (1999) questions the assumptions that manufacturing firms are value-subtracting and that the energy sector's access to export markets is controlled by the government. He notes that the constraint on exports comes principally from limited physical transportation capacity, and argues that it is this constraint that is responsible for driving domestic energy prices below world prices: Gazprom is pricing to market, at above marginal cost, for commercial reasons, and not providing subsidies. To him the important part of the virtual economy concept, and the point at which subsidies arise, is that the government is willing to accept industrial goods at face value in payment of tax, because of its desire to protect jobs and to overstate revenues.

existence of the transaction. They can therefore be used by enterprise managers to **defraud enterprise owners and workers, and to avoid the attention of the tax authorities.** Hendley et al (1998) find that firms with greater outside ownership are more prone to engage in barter, possibly supporting the theory that managers are using barter to hide information on transactions from enterprise owners.

24. There are also other ways in which barter might assist in **tax evasion**. Bilateral deals can be arranged to reduce tax liabilities: a profitable firm engages in barter trade with a loss-making firm at artificial prices which reduce both the recorded losses of the loss-maker and the recorded profits of the profit-maker. Total tax liability falls because of the asymmetry in the tax system, and the two companies share the spoils. Further, as tax settlements tend to be negotiated in Russia, firms may deliberately starve themselves of cash in order to have a stronger bargaining position in such negotiations.

25. However, survey results cast doubt on these tax evasion arguments. In 1994 and 1998 *Russian Economic Barometer* surveys and in the 1998 EBRD survey, tax considerations did not figure among the most important reasons reported for use of nonmonetary transactions (the most important reasons were lack of liquidity and efforts to increase sales). Indeed, firms frequently report that barter actually increases their tax bills, because payments in kind tend to be overvalued. These results suggest that although the nonmonetary economy is associated with substantial fiscal costs, the main channels by which these are directed are tax arrears and offsets, neither of which are regarded as tax evasion by firms.

Macroeconomic conditions

26. Arrears, both in Russia and elsewhere, have often been seen as a macroeconomic phenomenon associated with tightening **monetary conditions**. However, data on flows of new arrears show little relationship with monetary conditions, suggesting that a tightening of monetary policy exposes the problems underlying nonpayments rather than actually causing them. As for barter, the only continuous time series available (Figure 24) shows strong growth throughout the period from 1993 to mid-1998, but no discernable relationship with monetary conditions within that period. Barter does appear to have fallen somewhat since August 1998, however.

Institutional factors

27. There are a number of institutional factors relating to the fiscal sector that are very commonly blamed for contributing to the nonpayment crisis. First, weak **government expenditure management** has meant that the government is often unable to meet spending obligations in cash, while suppliers, particularly of energy, come under political pressure to continue deliveries despite nonpayment on the part of the government. Judging only from the relatively small magnitude of government spending arrears in total arrears, it would seem unlikely that budgetary arrears could carry as much blame for the nonpayments crisis as is

commonly attributed to them; on the other hand, the government's delinquency is likely to have powerful negative demonstration effects in legitimizing the practice of nonpayment, particularly in respect of taxes.

28. Second, Russia's **federal structure**, in particular the tax-sharing arrangements between the center and the regions, provide a strong incentive for subnational government to collect taxes in noncash form, since they will then have less cash receipts to share with the federal government. This is reflected in the fact that, while tax revenues are supposed to be shared equally between federal and subnational governments, the federal government suffers the majority of tax arrears.

29. Third, **the integration of tax administration with the banking system provides incentives for noncash transactions**. A company with tax arrears is required to close down all but one bank account, and any money entering this account is directed to the tax authorities. The conduct of transactions in nonmonetary form provides a means to keep revenues out of the banking sector, and therefore away from the tax authorities.

30. Fourth, the fact that some **taxes, including the VAT, are levied on a cash basis**, also encourages barter.

31. Finally, **wage arrears and nonmonetary wage payments** are widely interpreted as a means of real wage adjustment in the presence of rigid nominal wage structures and other institutional labor market rigidities. Desai and Idson (1998) find that wage arrears are allocated among workers so as to minimize the real wage declines experienced by higher productivity workers. Other commentators see wage arrears as a symptom of a lack of liquidity, as a cynical bargaining tactic in seeking financial assistance from the government, or simply as theft on the part of enterprise managers.[88]

E. Economic Effects of Arrears and Nonmonetary Payments

32. The proliferation of nonmonetary transactions and of the increase in arrears are associated with highly harmful processes in the economy. Nonpayments and nonmonetary payments essentially work as a means of redistributing resources, resulting in different allocations than would be achieved by the market or by official government policy. This raises obvious **equity concerns**. But these redistributions are also associated with very considerable **efficiency costs**.

33. Possibly the most significant of these costs is the effect of softening budget constraints in reducing incentives for **enterprise restructuring**. Enabling nonviable firms to continue in operation prevents the efficient reallocation of resources and adds to barriers to entry by new

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[88]See, for example, Earle and Sabirianova (1998).

firms. Further, to the extent that the system of nonpayments *veksels* and barter is used deliberately by large enterprises as a means of price discrimination, this also inhibits restructuring and adjustment on the part of the enterprises' customers. In particular, nonpayments may be used by the energy companies to undermine efforts of the regulatory agencies to ensure uniform cost-based pricing of energy throughout the economy.

34. In addition, the use of nonmonetary settlements **obscures information**, thereby facilitating fraud, corruption, and tax evasion. Financial signals are confused, making it difficult to evaluate the true financial situation of a company. For example, a fundamentally competitive firm may appear to be unprofitable because it receives partial payment for its products, while an inefficient firm may appear profitable because it does not pay for its energy use or its taxes. This frustrates corporate governance and hinders the development of the banking sector by making it harder to evaluate enterprise creditworthiness.

35. Further, notwithstanding the sophistication of the barter markets that have developed, barter remains an **inefficient means of transactions**. The typical cost of a barter deal has been estimated at around 20–25 percent of the value of the goods concerned.[89] Payments in kind also introduce significant distortions in consumption, notably when workers and taxes are paid in goods.

36. Finally, **offsets** carry serious short- and longer-term fiscal costs. Most significantly, offsets are a means of extracting resources from the budget. In addition, offsets distort government expenditure allocation by directing spending to companies with tax arrears rather than to genuine public policy needs. Looking forward, offsets beget expectations of further offsets, giving firms an incentive not to pay taxes so as to build up arrears for exploitation in future mutual settlements.

F. Policy Towards Arrears and Nonmonetary Transactions

37. Consistent with the view that nonpayments are fundamentally linked with a failure to enforce hard budget constraints, efforts to address the nonpayments problem should be aimed at encouraging financial discipline throughout the economy.

38. First, necessary measures to **establishing discipline in the government's own interactions with the economy** would include: ceasing use of offsets; simplifying the tax system and strengthening its administration; setting realistic budgets and improving expenditure management; and reforming intergovernmental relations.

39. Second, steps are needed to **establish hard budget constraints in the enterprise sector**. Among these are: enforcing strict disconnection policies in the energy sector; shifting

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[89]Hendley et al (1998)

to accruals-based taxation; improving corporate governance; implementing competitive and transparent privatization; strengthening the legal system, particularly bankruptcy processes; improving accounting standards; effective bank restructuring; and establishing an adequate social safety net to assist the process of industrial restructuring.

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RUSSIAN FEDERATION: CHANGES IN THE EXCHANGE SYSTEM, 1997–99

1997

April 2	The share of forward contracts guaranteed by the CBR was reduced to 50 percent from 65 percent.
May 1	The limit on the term of forward contracts was eliminated.
July 31	A 0.5 percent tax on the purchase of foreign exchange was introduced.
November 10	The CBR announced an exchange rate band of Rub 5,270–Rub 7,130 per $1 for the period 1998–2000.

1998

May 29	The CBR no longer considers requests of credit institutions to open branches in Latvia, or of Latvian banks and affiliates to start operations in Russia, or of residents of Latvia seeking participation in existing credit institutions.
June 1	Capital outflow to Latvia is no longer allowed without guarantees of the government of Latvia on return of investments and its earnings, and guarantees against the discrimination of entities with Russian capital.
June 1	Russian credit institutions are no longer allowed to participate in the statutory capital of subsidiaries in Latvia.
July 1	All advance payments of Latvian food and consumer goods exports to Russia to be for a maximum of 180 days.
July 1	All payment for Russian exports to Latvia of energy metals, and raw materials are to be settled within 180 days.
August 17	The exchange rate band was widened to 6.0–9.5 from 5.3–7.1 rubles per $1.
August 17	The authorities suspended repayments and converted all treasury bills maturing before end-1999 into longer term paper, and introduced a 90-day moratorium on the payment of many private sector foreign currency obligations.
August 25	The ruble was allowed to depreciate to 7.86 from 7.14 rubles per $1.

August 26 The fixing of the exchange rate in the MICEX auctions was terminated.

September 2 The exchange rate band was eliminated.

September 28 A two-session regime was introduced in foreign exchange trading.

December 1 The reserve requirement was unified at 5 percent of all reserveable liabilities.

December 28 The period for deferred payments was shortened to 90 days from 180 days.

1999

January 1 The export surrender requirement raised to 75 percent and the period within which the surrender must be effected was shortened to 7 days from 14.

January 1 A temporary 6 months export tax was introduced on a number of commodities.

January 1 A ban on private imports of ethyl alcohol was imposed. Licenses are required for the import of a number of items.

February 11 In the absence of an inspection report for exports, export transactions are prohibited and the customs authorities deny customs clearance and release of goods.

March 22 The purchase by residents of foreign exchange for imports is solely effected in the special trading sessions of interbank currency exchanges. A 100 percent deposit requirement is introduced by the CBR for all purchases of foreign exchange connected to the prepayment of imported goods.

March 23 The CBR conducts sessions for the sale of foreign exchange to banks, which are authorized to open and operate S accounts for nonresident investors. The exchange rate on these sessions is the official rate multiplied by a coefficient determined by the CBR. Nonresident investors may freely repatriate the foreign exchange thus obtained by the authorized banks.

April 5 Nonresident banks having correspondent accounts in rubles with a resident bank are prohibited from converting the balances on these accounts.

April 14 The 100 percent deposit requirement for imports is reduced by the amount of an irrevocable letter of credit by an authorized bank, a guarantee of a nonresident bank, a contract to insure the risk of non-repatriation in case of the default of the nonresident payer, a promissory note issued by a nonresident secured by a nonresident bank, a special permit from the CBR.

June 9 Resident natural persons may take out of the Russian Federation foreign exchange not exceeding $10,000. Amounts exceeding $10,000 may be taken out only with the authorization of the CBR.

June 29 The trading sessions of the interbank foreign currency exchanges were unified into a single trading session (UTS). Export proceeds in foreign currency, which are subject to mandatory sale at the interbank foreign currency exchanges, have to be sold in the UTS.

June 29 Clarification by the CBR that remuneration for the deposit to be placed at the time of the prepayment of imported goods is market-based.

June 30 Nonresident banks having correspondent accounts in rubles with a resident bank are allowed to convert the balances on these accounts.

July 2 The obligatory export inspection was changed to a voluntary system.

RUSSIAN FEDERATION: CHANGES IN THE EXTERNAL TRADE REGIME, 1997–99[90]

May 1997: Government Decree 601 provided for the introduction in January 1998 of a mandatory holographic mark of compliance with quality standards for a wide range of goods (10 commodity groups). As of September 1997, Decree 601 was amended to apply to just two commodity groups (alcohol products and audiovisual equipment), and to postpone until January 1, 1999 the introduction of the marks of compliance with quality standards. In October 1998, additional changes were made, further postponing its entry into force until April 1, 1999, and the opportunities for the use of quality compliance marks applied in the course of manufacturing products themselves were expanded substantially.

May 1997: A temporary ban was imposed on the re-export of cotton fibre until the end of 1997.

June 1997: Government Decree 773 excluded precious metals and articles made of precious metals from the list of goods whose prices are set by the state.

July 1997: Amendments were made to the 1995 Federal Law No. 157-FZ "On Government Regulation of Foreign Trade Activity," modifying the terms and definitions used in government regulation of foreign trade activity to bring them into conformity with the norms of international trade law.

July 1997: Article 17 of Federal Law 100-FZ "On Government Regulation of Agro-Industrial Production," introduced into Russia's national legislation certain norms and provisions of the WTO Agreement on Agriculture.

July 1997: Presidential Edict 747, expanded upon in Government Decree 772, gave a range of commercial banks and credit organizations the right to effect foreign trade transactions and export gold, silver, and other precious metals without quantitative restrictions.

July 1997: Exports of partially cut natural diamonds were forbidden.

November 1997: Government Decree 1423 amended the list of ozone-depleting substances, the importation of which is subject to licensing, to bring the Russian list into conformity with that established by the Montreal Protocol.

August 1997: Government Decree 037 regarding the mandatory labeling of nonfood products imported into Russia with information in the Russian language.

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[90]Based primarily on information provided by the Russian authorities.

December 1997: Government Decree 1606 simplified the importation of certain categories of medical supplies into Russian territory.

December 1997: A system of reference prices for customs valuation was adopted.

December 1997: Quotas were put in place on imports of carpets from the European Community (EC), but removed in *March 1998*. Imports of carpets from the EC were made subject to licensing as from *May 1998*, however.

January 1998: A requirement was introduced that imported alcoholic beverages, audio and VCR equipment be sold only if they have special "conformity stamps."

February 1998: Government Decree 207 granted commercial credit organizations the right to export refined gold and silver under one-time licenses, and in May 1998 Government Decree 432 expanded this right to exports under general licenses granted for up to three years.

February 1998: Government Decree 114 introduced import licensing for fruit brandies with a strength of more than 28 proof.

February 1998: Federal Law 29-FZ amended the 1997 Federal Law "On Excise Taxes," revising specific excise values and simplifying the procedure for the calculation of excise taxes and excise payments.

March 1998: Article 1 of Law 41-FZ "On Precious Metals and Precious Stones," provided for the first time a clear definition of the concept of "precious metals and stones." Articles 10 and 25 outlined the principles and procedures for government regulation and control of the import and export of precious metals, precious stones, and articles made of precious metals and stones, onto and from Russian territory.

April 1998: Federal Law 63-FZ "On Measures to Protect the Economic Interests of the Russian Federation in Foreign Commodities Trading" outlined the procedure for the application and introduction of safeguard measures, antidumping measures, and countervailing measures, as well as other mechanisms for government regulation of exports and imports of goods permitted under the provisions of GATT-94.

June 1998: Russian Government Directive 726 provided for the reduction in the number of tariff peaks (i.e., items with duty rates of 30 percent) from 857 to 557 and for the reduction in those duty rates from 30 percent to 20 percent.

July 1998: Federal Law 118-FZ amended the 1997 Federal Law "On Excise Taxes," reducing excise taxes on low-alcohol carbonated beverages, and affording more favorable tax treatment to natural alcoholic beverages than to artificial ones.

July 1998: A 3 percent surcharge on imports was imposed. However, this surcharge was abolished for some goods in *October 1998*, for natural diamonds in *December 1998*, and for remaining items in *March 1999*.

August 1998: Import licenses for raw and white sugar were introduced. Also, temporary special duties for sugar were introduced (74 percent for raw sugar and 20 percent for white sugar). The duty on raw sugar was canceled as of *January 1999*, and the duty on white sugar was removed in *February 1999*. However, in *May 1999* new temporary duties of 45 percent were introduced, covering the period August-November 1999 for raw sugar and August 1999-January 2000 for white sugar.

August 1998: Government Decree 968 introduced non-automatic permit-based licensing of exports and imports of sturgeon species, with licenses issued by the Ministry of Trade based on a positive finding from the Ministry of Agriculture and Food or the State Environmental Protection Committee.

August 1998: Government Decrees 868 and 908 legalized and simplified the import and use in Russia of a number of high-frequency radio-electronic devices.

September 1998: Federal Law 86-FZ "On Medical Supplies" subjected all foreign economic activity involving the export and import of medical supplies to licensing, with the Ministry of Trade responsible for issuing licenses.

October 1998: Government Decree 1347 set a minimum period of six months between changes in customs tariff rates, and limited changes in a duty rate made at any one time to at most 10 percentage points for an ad valorem rate or the equivalent amount for a specific and combined rate.

October 1998: Import duties on 92 essential goods were lowered or canceled.

October 1998: Government Directive 1235 allowed importing corporations to delay the payment of customs duties and related taxes for up to two years for products withdrawn from customs warehouses by December 31, 1998.

December 1998: Decree 1596 lowered duties on cellulose acetate from 10 percent to 5 percent, but raised them on acetate fiber for the production of cigarette filters from 5 percent to 15 percent.

January 1999: Government Decree 68 reduced the list of goods affected by the Russian Federation's national preferences scheme by approximately 35 percent.

January 1999: Government Decree No. 18 introduced automatic licensing (without any quantitative restrictions) of the importation of valuable species of hardwood.

January 1999: The export surrender requirement was raised from 50 percent to 75 percent, and the period within which surrender must be effected was shortened from 14 days to 7 days.

January 1999: A ban on private imports of ethyl alcohol was adopted. In addition, the obtaining of import licenses for alcoholic products was made more difficult. Further tightening of alcohol import licensing was effected in *March 1999*.

January 1999: Temporary export taxes on a number of commodities were introduced. A 10 percent duty was levied on some of varieties seeds, skins and leather, timber and nonferrous metals scrap. A 5 percent duty was imposed on coal, oil, natural gas, petroleum products, asphalt, and nonferrous metals and products.

February 1999: With Government Resolution 155, the Federal Service of Currency and Exports Control of Russia (VEK) was authorized to monitor the quantity and quality of exported goods.