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Russia



# The Economy and Investment Climate in Russia

2005

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# Contents

<b>Introduction</b>	<b>2</b>
<b>A Summary of the Year's Results</b>	<b>2</b>
<b>Economic Policy and Reform</b>	<b>5</b>
<b>Reform of the Budget and Federal Systems</b>	<b>10</b>
<b>GDP and Investment</b>	<b>13</b>
<b>Legislation</b>	<b>16</b>
<b>Taxes and Customs</b>	<b>18</b>
<b>Banking System and Financial Market</b>	<b>19</b>
<b>Electric Industry Reform</b>	<b>22</b>
<b>WTO</b>	<b>23</b>
<b>Conclusion</b>	<b>24</b>

# Introduction

This report was prepared jointly by NBF Expert Institute, the American Chamber of Commerce in Russia, and Ernst & Young for the Sixth Annual AmCham Investment Conference, held on March 29, 2005 in Moscow.

The purpose of this report is to provide a brief overview of the main economic events that took place in Russia in 2004, to evaluate the investment climate and growth trends in the Russian economy, and to focus the attention of the business community in Russia and the Russian government on the most urgent issues that require resolution today.

The growth of the Russian economy depends on the success of reforms aimed at surmounting the social and economic difficulties blocking Russia's stability and international integration, and which are negatively impacting the level and quality of social life.

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## A Summary of the Year's Results

2000 – 2004 were the most successful years for Russia in the post-Soviet period, which began in 1991. Both society and the economy enjoyed stability.

2004 was a benchmark year. On the face of it, the economic situation in

Russia is quite favorable. Russia demonstrated progress as measured against global indicators, with 7% GDP growth as of the year-end, which is above the world average of 4%, yet is considered to be quite moderate for emerging markets. Russia has been a

dynamic segment of the global economy for the past six years (its economic growth was approximately 45% for the period in question) and will retain its position on the list of successful economies in the forthcoming years.

**Table 1. GDP Growth Rates, %**

	2000	2001	2002	2003	2004*	2005**
<i>Russia</i>	10	5.1	4.7	7.3	7.1	6.2
<i>Emerging markets</i>	5.4	2.8	3.4	5.2	6.1	5.4
<i>Europe &amp; Central Asia</i>	6.4	2.3	4.6	5.9	7.0	5.6
<i>Latin America &amp; Caribbean</i>	3.8	0.3	-0.6	1.6	4.7	3.7
<i>Middle East &amp; North Africa</i>	4.2	3.2	3.2	5.7	4.7	3.7
<i>South Asia</i>	4	4.3	4.6	7.5	6.0	6.3
<i>Pacific &amp; East Asia</i>	7.4	5.5	6.7	7.9	7.8	7.1
<i>High-Income countries</i>	3.5	0.8	1.3	2.1	3.5	2.7
<i>OECD countries</i>	3.4	0.9	1.3	2	3.5	2.6
<i>USA</i>	4.1	0.3	1.9	3	4.3	3.2
<i>EU</i>	3.5	1.5	0.9	0.5	1.8	2.1
<i>World</i>	3.9	1.2	1.7	2.7	4	3.2

*International Bank for Reconstruction and Development, Rosstat, Ministry of Economic Development and Trade (MEDT), Center for Macroeconomic Analysis and Short-Term Forecasting (CMAKP)*

\*\*Projection

\*Estimate

During the past six years the growth of the Russian economy was secured by a number of factors. Dramatic (by 450%) devaluation of the domestic currency in 1998 to some extent enhanced the competitive status of the Russian economy. Subsequently the global market saw growth of prices for basic Russian export products (primarily energy supplies and metals). The availability of spare production capacity and underemployment, and the flow of revenues into the economy triggered a recovery, accompanied by an increase in overall aggregate demand.

Besides favorable exogenous factors, the improvement of the economic situation in Russia was supported by the balanced and consistent economic policy pursued during these years, which targeted the rehabilitation and improvement of the financial system, the support of macroeconomic stability, the reduction of risks, the improvement of the investment climate, and the development of market infrastructure. Considerable effort was made to eliminate the shortcomings and gaps in the legal framework, and reduce red tape at the regional and federal levels. Changes for the better include a reduction of the tax burden on entrepreneurs, an improvement in small business regulations, and the development of the corporate governance system.

This allowed the quick improvement of financial issues and the resolution of barter problems, non-payments, and the crisis of public finance. Growth was supported by increased business activity in the private sector, with expanding cash supplies and increased investment and household consumption. In recent years services have come to account for a greater share of Russian GDP as com-

pared to production (including of industrial goods), whose share in the GDP has decreased. Non-energy industries and the services and retail sectors grew at accelerated rates, which gave rise to the proper conditions for economic diversification.

Confidence in the ruble increased and the share of savings in GDP rose, while inflation rates gradually decreased. In 2002 there was a lull in the rate of economic growth, but by 2004 the Russian economy had, on the whole, been able to overcome the consequences of the 1998 crisis and had entered a new stage of development. It is highly possible that, in the mid-term, the Russian economy will be able to retain its stability and balance, even taking into consideration any drastic changes in external economic factors (although oil prices are expected to remain high, at over USD 30 per barrel, in the coming years).

Public finance improved considerably. The high global oil prices of recent years<sup>1</sup> ensured a massive inflow of revenues to the Russian economy from the export of energy resources, considerable growth of gold and forex reserves,<sup>2</sup> and the establishment of the Stabilization Fund.<sup>3</sup> At present, government reserves exceed the amount of current external sovereign debt, which means Russia has transformed itself into a net creditor in global terms. The availability of such reserves provides various possibilities for managing of the national debt (which has been considerably reduced in recent years<sup>4</sup>), the budget of the government as a whole, and the tax burden on the economy. This enhances the security of the Russian economy, reduces credit risks and exchange rates,

and improves the budget system and economy in general. Now the possibility exists to support or reduce the tax burden, and to optimize its structure.

Current financial policy aims to reduce inflation and support exchange rate stability. Timely settlement of governmental liabilities promotes macroeconomic stability and points to the recovery of the Russian financial system and its safety margin: The Russian economy will not see financial destabilization in the near future, and the Russian government will be able to continue servicing its obligations in a timely fashion.

In the past four years, the leading international rating agencies have upgraded Russia's sovereign rating due to the improvement in the country's economic environment. In early 2005, Russia has long-term investment-grade credit ratings (BBB- from Standard & Poor's, Baa3 from Moody's, and BBB- from Fitch) and is characterized by stable forecasts. These are important indicators for international investors, since they enhance Russia's investment appeal (especially for institutional investors) and will contribute to the reduction of loan costs, both on the external and internal capital markets.

However, despite the positive processes of recent years, there are threats to the future successful development of Russia's economy. Since recovery growth is always of a declining nature due to the limitation of available resources, growth rates will certainly slow if no new economic stimuli are employed and no modernization of the economy is carried out.

Furthermore, there are a number of fundamental weaknesses and structural

<sup>1</sup> According to data from the Ministry of Economic Development and Trade (MEDT), the monthly average price of Urals oil in 2004 was USD 34.4 per barrel, which is an increase of 26.6% as compared to 2003.

<sup>2</sup> Reserves of the Central Bank of Russia (CBR) increased by USD 48 billion in the past year; as of February 1, 2005; total reserves amount approximately to USD 125 billion.

<sup>3</sup> RUR 740 billion as of February 1, 2005, which is equivalent to over USD 26 billion.

<sup>4</sup> At the beginning of 2005 the external sovereign debt accounted for approximately 25% of GDP.

imbalances, which represent difficulties for long-term and sustainable development of the Russian economy. Such weak points are: low export diversification; competitive weakness of the majority of Russian goods; considerable share of the gray market<sup>5</sup> in the economy; improper structure of relative prices; and dilapidated capital assets in most industries. In the meantime, Russian economic growth rates are likely to slacken in the near future due to the strengthening of the real ruble rate, the slowdown of energy-producing industries, and a lack of production facilities.

The existing raw materials-based export model<sup>6</sup> of the Russian economy is not a stable one, since the current contradictions in it are not resolved in a natural way; they accumulate, clash and are eliminated through crises. With globalization, the degree of strategic uncertainty in the development of the Russian economy is compounded by a considerable increase in the number of external factors impacting on the dynamics of internal social and economic processes.

In this situation both the economy and society should be highly adaptable to quickly changing opportunities and limitations and have a well-developed information infrastructure. An institutional environment is required, which would help enhance the quality of human capital and would generate incentives for creative business and social activity; it should be an environment where it is possible to reallocate economic resources (including international resources) to the most efficient development zones within a short time period. Economic stability and less dependence on the global environment can be ensured only in case of balanced growth, diversification, emergence of

new industries, modernization of existing industries, and an increase in the share GDP of processing and other industries generating value-added products.

The long-term efficiency of the growth mechanism can be ensured by the competitiveness of the Russian economy, which must be developed in an atmosphere of competition and self-improvement. For that reason, a competitive market environment must be established in order to provide for continuous innovation; enhance economic efficiency; reduce red tape, risks, and non-economic costs; develop culture, education, and healthcare; and improve living standards.

Since the above-mentioned problems are well known and acknowledged, as far back as 2000, regulators began to develop a program for the country's long-term social and economic development, providing for a body of reforms designed to upgrade various industries and the economy as a whole, and improve government and social institutions (as adjusted for the long-term development requirements of the country). It also established conditions for structural changes away from resource-intensive industries and toward productive ones. In 2001 these reforms were launched.

However, last year the transformation process slowed. To some extent, the slowdown of reforms in late 2003 and early 2004 can be politically accounted for by parliamentary and presidential elections. It is often the case in any country with public elections that the authorities refrain from any resolute steps, which would have uncertain or negative consequences in the short term, in order not to

jeopardize popularity ratings and change the electorate's preferences.

Furthermore, there were a number of subjective contributing factors. In March 2004, the federal government was reorganized in the course of overall administrative reform. This apparently slowed down the pace of state reforms, due to the fact that considerable effort was made to redistribute powers and resources, establish intergovernmental relationships, and make other adjustments. However, the first stage of this reform was accompanied by negative consequences. This was reflected in growing discrepancies in economic policy and diminishing transparency for the business community.

The government increased its role in business to some extent, despite all the deregulation initiatives of recent years. At the same time the quality of some decisions taken by the government deteriorated. One of the most dramatic examples of this was the insufficient preparation of the reform of social benefits, which began in January 2005 and was marked by considerable social unrest in most of the regions and failures in the social security system.

The recent trend towards centralization and reinforcement of the top-down government command structure ("power vertical") had a positive impact during past years, reducing the number of political risks; however, it has resulted in increased bureaucratization of governmental authority on the whole.

Along with that, investors and businessmen were concerned by events surrounding YUKOS and the claims made on a number of companies for 2000 – 2001 in the course of follow-up tax audits.<sup>7</sup> It was the unpre-

<sup>5</sup> E.G. Yasin. "Non-Market Sector. Structural Reforms and Economic Growth," 2003

<sup>6</sup> A.R. Belousov. "Development of the Russian Economy in the Mid-Term Perspective: Analysis of Threats," [http://www.forecast.ru/\\_ARCHIVE/Articles/PP-01-2004.pdf](http://www.forecast.ru/_ARCHIVE/Articles/PP-01-2004.pdf).

Production of oil and gas, metals, mineral fertilizers, forest products with a low degree of conversion, and arms are the most competitive goods, accounting for the major part of export revenue, while food products play the most significant part on the internal market.

<sup>7</sup> In particular, in only the first nine months of 2004, back tax claims against Russian companies for previous years amounted to RUR 470 billion, while in 2003 back tax claims did not exceed RUR 150 billion (Vedomosti newspaper, [www.vedomosti.ru](http://www.vedomosti.ru))

dictable behavior and unconvincing arguments of the authorities that resulted in a cautious attitude on the part of the business community. Stability and predictability of government policy, relevance and rationality of laws, and abiding by the rules of the game are important components of an efficient business environment.

The Russian Trading System (RTS) index grew by only 8% after considerable fluctuations, falling from its peak, which exceeded the January 2005 value by almost 30%. This is an important indicator of Russia's unfavorable investment climate, since in recent years the Russian stock market has been among the top five performing markets worldwide. There are no fundamental reasons for such dynamics; as noted above, the macroeconomic situation is stable, while actions of the authorities played a negative role.

A country can survive in the global competitive environment only if the authorities are controlled by society, if people are aware of their responsibility for everything happening in the country, if they participate in governance of the state, if laws and regulations are complied with, and if entrepreneurial activities are encouraged. Democratization is becoming an essential condition for Russia's further development.

The Russian economy has been successfully developing during recent years and it still has growth potential for the near future. At the same time, last year the government demonstrated strong tendencies towards interfering with further economic growth and implementation of reforms. As a result, the confidence of the business community in the government was jeopardized, and there was an

increase in capital outflow and a slowdown in business activity. As long as the state hinders development of civil society and the economy in the country, Russia's progress will not be stable, since the alignment of forces between civil society, business, and the government favors the latter. In order to overcome the threats faced by Russia in the mid-term, structural reforms in the economy must be implemented, the quality of the institutional system must be substantially improved, market environment mechanisms must be developed, and growth in business activity and development of a civil society and independent mass media must be ensured. Progress in all these directions, not only reinforcement of the government's role, is a necessary prerequisite for long-term social and economic growth in the global environment.

## Economic Policy and Reform

Until 2004, the strategic goal for Russia's development was to establish an economy with long-term growth potential, which would encourage business activity, reduce systemic risks, enhance the investment appeal of the Russian economy, and support the growth of living standards. The key tasks set by economic policy included the establishment of efficient policies to regulate the economy and implement the larger, more sophisticated social and economic reforms. In order to ensure more favorable integration of the Russian economy into the global community, it was planned to start the modernization of the economy and enhance its competitive edge and promote the country's security and co-operation with international organizations.

According to European Bank for Reconstruction and Development (EBRD)

estimates,<sup>8</sup> Russia made substantial progress during the transitional years between 1989 and 2004 as compared to other emerging economies. Reforms were implemented in all key areas,<sup>9</sup> including structural and institutional transformations. In mid-2004, the private sector accounted for 70% of GDP. The maximum value for emerging economies is 80%, and the minimum is 25%. High ratings were conferred on the market and foreign trade transformations; however, banking reforms, deregulation of interest rates, anti-monopoly reforms and structural reforms of enterprises scored lowest.

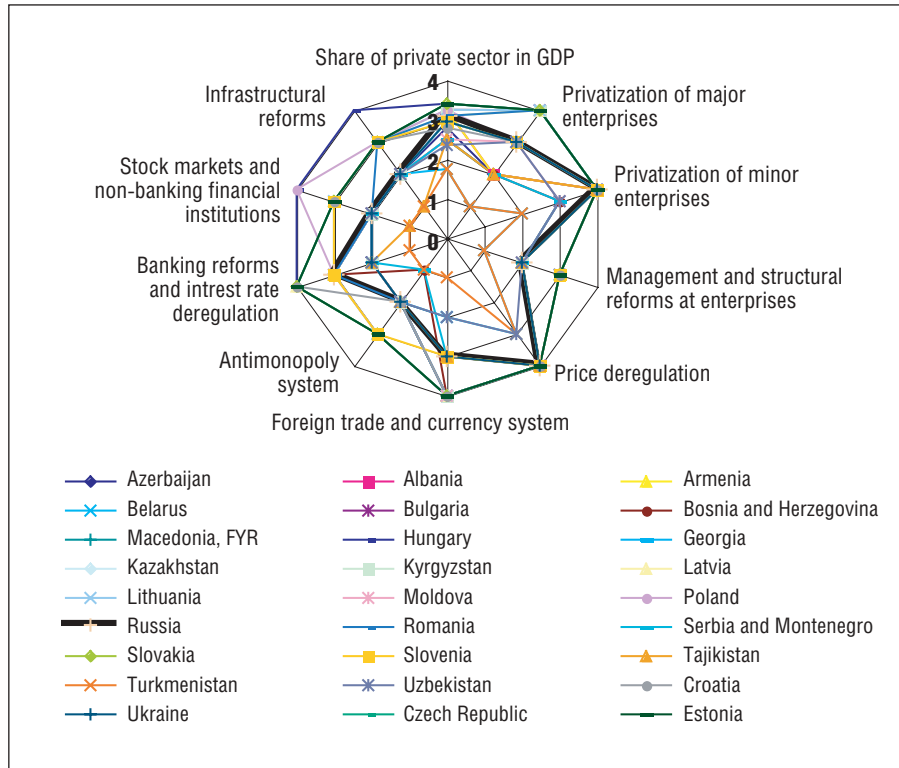
Essential changes were made to commercial technical regulations, which are now comparable to modern foreign regulations, and have created an incentive for Russian manufacturers to upgrade their production facilities and processes. The

legal framework for protecting property rights was also considerably improved. Budget, banking, pension, judicial, educational, electric power industry (the "Electronic Russia" program), and administrative reforms were launched.

After the 1998 crisis the economy has achieved macroeconomic stability: Non-payment problems and the debt crisis were resolved; financial rehabilitation was ensured; the investment climate improved; and the legal and regulatory framework was developed and enhanced. Steps aimed at liberalization of the economy and cutting red tape were taken, primarily in the registration of legal entities and control over their operations. The number of activities subject to licensing has also been reduced. All this should be recorded on the plus side of the economic policy carried out by Russian authorities.

<sup>8</sup> «Доклад о процессе перехода в 2004 г.» (Report on the transition progress in 2004). <http://www.ebrd.org/pubs/tr/04/russian/TR04R.pdf>

<sup>9</sup> It should be mentioned that EBRD does not monitor all reforms; in particular, reforms in the areas of administration, health care, education, the army, etc.

**Table 2. Indicators of the Status of Reforms in Emerging Economies**

European Bank for Reconstruction and Development (EBRD). Indicators range from 1 (very little or no progress in transition from the planned economy) to 4 (standards valid in developed market economies were reached).

As a result, Russia's credit rating has gradually increased, reaching the minimum investment level rating of the three key international rating agencies, while the EU and the US have recognized Russia as a market economy. The rapid growth of inbound investment over the past five years is compelling evidence of the justifiability and effectiveness of economic policy.

The Russian economic policy of 2004 was characterized both by commitment to the course pursued during the previous four years, as well as a new trend that emerged in 2003. The multiple economic tasks to be tackled within the next few years and the differences in opinion on the country's mid-term development strategy that emerged last year between the government and Russia's top leaders

are reflected in the inconsistent nature of the objectives of the economic policy. Current economic regulations contain significant contradictions, which may sharpen in the mid-term and negatively impact economic development. GDP growth rates are likely to fall to between 6% and 4% in 2005 and remain at this level for the next few years.

The liberal reform program and relevant mid-term development plans announced in 2000 were designed to establish the environment for an efficient market economy in Russia, stimulate entrepreneurial energy, and attract and enhance the efficient use of economic resources. In 2003, the concept of accelerating economic growth and doubling the GDP by 2010 was added. Though quite ambitious, it should not really be considered a key

goal, taking into account the necessity to implement a number of social and economic reforms.<sup>10</sup>

Doubling GDP means an increase in economic growth, without substantial amounts spent on structural and institutional changes. As noted above, the raw materials-based export model of the Russian economy involves internal conflicts that threaten the country's development, unless purposefully eliminated through special initiatives. That is why implementation of reforms is a key task to be resolved in the near future. An increase in Russia's competitiveness and efficiency is possible only if an authentic market environment is established; this would force economic agents to upgrade their production facilities and increase their operating efficiency to remain competitive. However, the GDP growth rates for the past several years can be regarded as a demonstration of the efficiency of the economic policy pursued by the government, since the government sector accounts for nearly one third of the GDP, while the main part is generated in the private sector.

At the same time the government declared its continued course of liberal reforms, including those pertaining to the social sphere. It should be noted here that two years before the 2003 parliamentary elections and 2004 presidential elections, the pace of the reforms slowed and unpopular initiatives were suspended. It was assumed that after the March 2004 elections there would be a window of opportunity to implement unpopular but vitally important reforms. Such unpopular measures include the monetization of social benefits; pension reform; housing and utilities reform, including encouraging affordable residential property; and reforms in healthcare, education, the natural monopolies, and the administra-

<sup>10</sup> Prerequisites and possibilities for rapid growth at this juncture would be as follows: High Levels of business activity with considerable export revenues stimulate economic growth and increase cash supplies; risks are moderate and annual inflation is at 7% - 10% for another three or four years, until monetization rises 2 - 2.5 times. In this case annual GDP growth rates could reach 8% - 12%. After that it would be necessary to change over to other, more stable growth factors, the most important of which would be an increase in confidence owing to the improvement of institutions.

tion. Monetization of social benefits and administrative reforms were launched immediately after the elections. The pension reform, including a gradual increase of the pension age and introduction of pension contributions by employees, was also announced.

Certainly an improvement in the quality of life and the development of human capital are the most important and urgent of the reforms. During the transition period of the Russian economy, the population (especially the least protected social groups) suffered significant hardships. Repeated falls in living standards related to economic destabilization considerably increased the poverty level as compared to the early 1990s. Transition from a paternalistic social policy to the current, random social-support initiatives of the 1990s curtailed social mobility; however, due to the widespread inertia of people's worldview, this did not provide enough incentive to increase business and creative activities among the majority of the population.

Until recently, social policy was not among the key priorities of the Russian government. Scarce social expenditures testify to the real state of affairs; in recent years, growth in spending on social programs has been much lower than that of the military and state administration. It is important that the government recognize the need to implement unpopular steps and carry out reforms rather than waiting for additional problems caused by economic crises. Further development of the country is impossible without resolving the existing problems in the social sphere,

which has been declining during the last 15 years. Healthcare, education, culture, social security, and the housing and utility systems need to be fundamentally improved and adjusted to market mechanisms. But it should be noted that social problems need to be resolved, as initially planned in the liberal reforms, in conjunction with market development and modernization of the economy.

Macroeconomic policy for 2004 was balanced and cautious. Public finance was stable during the whole year. On the one hand this was supported by substantial financial resources and on the other by methodical efforts designed to develop and modernize the budget system. The federal budget is in surplus, and the system of financial support for constituents of the Russian Federation has been settled. According to Ministry of Economic Development and Trade (MEDT) data, consolidated budget revenues<sup>11</sup> grew to 29.9% of GDP (in 2003 they made up 28.5% of GDP).

In 2004, the Russian government established the Stabilization Fund, where federal budget revenues<sup>12</sup> earned from high oil prices (over USD 20 per barrel in 2004) are allocated. This a tactical step aimed at neutralizing excessive liquidity in the economy, supporting macroeconomic stability, and counteracting drastic appreciation of the ruble and the growth of inflation amid the tremendous inflow of currency. The Stabilization Fund is a tool to mitigate the negative impact of a sharp fall in world oil prices and reduce the political risks to servicing the state debt.<sup>13</sup>

At the same time the Russian government intends to impose stringent restrictions on non-interest budget expenditures<sup>14</sup> (which is the reverse side of establishing the Stabilization Fund). This decision potentially conflicts with the projected institutional and structural reforms (especially pension, healthcare, education and the military), since it is impossible to implement structural reorganization, upgrade the material base, and create conditions for more qualified and efficient labor without considerable extra costs.

It should also be noted that a strict budget expense policy has been combined with a tax policy intended to redistribute the tax burden from the agents of production to the final output through improvement of tax administration, optimization of the structure of the fiscal burden on the economy,<sup>15</sup> and the reduction of subsidies.<sup>16</sup> However, a new set of problems arises relating to the redistribution of income from the consolidated budget to the federal budget<sup>17</sup> and the reduction of revenues to regional budgets accompanied by an increase in their budgetary obligations. At the same time, in the mid-term, the government intends to further reduce the amount of fiscal withdrawals and restrict non-interest income growth in order to avoid a budget deficit, enhance the efficiency of budget planning, and optimize budget expenses. It appears that this financial policy will undergo significant difficulties in the coming years. In 2005, due to the reduction by 10.5% of the Unified Social Tax (UST), the Pension Fund already has a deficit amounting to RUR 75 billion, which is currently covered by the Stabilization Fund.

<sup>11</sup> Without deductions for social insurance.

<sup>12</sup> It is expected that within the next two or three years the base amount of funds will be expressed in nominal terms (at RUR 500 billion), and starting from 2008 at between 3.1% and 4.5% of GDP.

<sup>13</sup> In recent years sovereign debt obligations have been discharged on a timely basis and in full; furthermore, in early 2005 Russia repaid its debt of USD 3.3 billion to the International Monetary Fund ahead of schedule.

<sup>14</sup> In 2004, non-interest budget expenses accounted for 23.2% of GDP (25.1% of GDP in 2003).

<sup>15</sup> Nevertheless, 2004 saw a slight increase in the share of net taxes on production and import in the GDP structure, up to 13.8% (13.5% in 2003).

<sup>16</sup> In accordance with MEDT data, in 2004 production subsidies accounted for 1.3% of GDP (1.6% of GDP in 2003).

<sup>17</sup> To a certain degree, this was possible due to changes in the structure and level of the tax burden and also to fluctuations in the tax base. Furthermore, 1.5% of the Profits Tax rate and natural resources related payments are contributed to the federal budget.

In monetary and credit policies, the complexity stems from the need to tackle two problems at once: reducing inflation rates and preventing significant ruble appreciation. Owing to the budget surplus, a large amount of cash is supplied to the economy. The gold and forex reserves of the Central Bank of Russia (CBR) and the Stabilization Fund are used as neutralization tools. This liquidity management mechanism is quite simple – and therefore sensitive – both to financial and cash flow fluctuations and to other dynamics, which restricts the ability of authorities to regulate the monetary and credit sphere and creates additional risks in this field. An increase in the cash supply is related to currency inflow to the economy. Volumes requiring neutralization considerably increase due to the slowdown in cash demand, which reflects a decrease of business activity.

Nevertheless, it can be stated that all the major macroeconomic challenges have been undertaken; macroeconomic processes have been stabilized in the mid-term perspective and their fluctuations are now predictable. On the whole, macroeconomic policy is not interfering with the progress of entrepreneurial activities. This is confirmed by high investment growth rates, gradual increases in labor efficiency, and increased employment. In the meantime, it is impossible to resolve the structural problems of the Russian economy only by macroeconomic methods.

In 2004, reform in Russia remained low in intensity. In part this can be accounted for by objective difficulties relating to the government's reorganization; however, the degree of bureaucracy at all executive levels increased and differences at the ministerial level were aggravated, which gave rise to inconsistencies in economic policy. Corruption and pressure on business has

grown. This puts further economic development at stake and does not allow for stable forecasts for more than a few years.

In accordance with data provided by the Center for Strategic Development, the progress of Russian reforms is inseparably related to the level of concentration of rent. That is why it would be most difficult to introduce any sort of reorganizations at Gazprom and in customs. That is also a reason for the emergence of a window of opportunity to carry out healthcare and education reforms due to the weakness of lobbyists in both sectors. Furthermore, there will be difficulties relating to the reform of the power (military and police) ministries (which still remain closed to the public eye, while their lobbyists have gained strength over recent years) and restructuring of the pension and education systems.

It is obvious that the government has become the key factor in the country's development. In this connection, administrative reforms are vital, since their results will directly impact the pace of other reforms, because the executive authorities play the key role in preparing the reforms and in implementing them.

The key aim of administrative reform is to make the government more efficient and improve the quality of its decisions and transparency. Additionally, corruption should be reduced, management processes improved, the economy liberalized, and red tape and excessive interference<sup>18</sup> of the government in the economy reduced.

The reform was launched in March 2004, when the government's structure was changed and a three-tier system of federal executive authorities was introduced.<sup>19</sup> This reorganization was designed to eliminate overlapping func-

tions of each authority. However, the first few months have shown that the expected division in the spheres of responsibility did not fully take place: The ministries still influence decisions taken by the authorities subordinate to them; at the same time a number of second- and third-tier authorities report directly to the prime minister, which is in breach of the asserted principles of the administrative reform.

In spite of the reduction of the number of ministries, the total number of federal authorities increased from 54 to over 70. The adjustment period following the reorganization dragged on, which jeopardized the quality of the government's operations and the timeliness and efficiency of decisionmaking. Drastic cuts in the number of deputy ministers and large scale resignations of department heads complicated the current activities of the ministries. The new and reduced personnel cannot cope with the full scope of tasks assigned to them. The competence level of some government officials also remains a problem.

The implementation of the administrative reform showed that one cannot underestimate the bureaucracy's ambitions to stabilize its position and focus its efforts on receiving personal inducement and appropriating the administrative rent, rather than discharging its duties as outlined in its job description. It was assumed that the reform of the executive authorities would take at least two to three years, following which it would take approximately the same amount of time to adapt to external conditions. However, the reform has so far not progressed fast enough. Experts believe that only 10% to 15% of the announced plan has been implemented. At present one cannot state that administrative reform

<sup>18</sup> According to MEDT data, 4095 out of 5318 functions of the government were analyzed in a survey carried out before 2004, and 1708 of these functions were ascertained to be superfluous, overlapping, and requiring reduction and specification, which accounts for 42% of the total number of analyzed functions.

<sup>19</sup> The reform is designed to improve the sharing of powers and responsibilities of authorities: ministries shall be responsible for the strategic and political interests of the state; federal services shall perform supervisory functions; and federal agencies shall provide services, manage property and keep registers on behalf of the state.

has resulted in a positive shift in government operations.

On top of that, the use of administrative leverage increased significantly last year in the unequal relationship between business and government. Back tax claims for prior years were made against a number of companies and their management; these claims do not necessarily appear justified in the eyes of the business community. Very often one gets the impression that the authorities are acting in the interests of certain groups, are biased, or that their actions are simply incomprehensible to the business community. For example, the mechanism employed for the sale Yuganskneftegaz looks strange, to say the least.

The confidence of the business community in the government's actions is at a low due to significant discrepancies between statements made by government officials and the actions of the tax authorities and the prosecutor's office, inefficient systems for the protection of ownership rights, bankruptcy procedures, and law enforcement. There are draft amendments to the Tax Code and the Criminal Code proposing to empower the tax authorities with the right to collect tax fines without court involvement, which glaringly contravenes the presumption of innocence, a cornerstone of the legal system. Dialogue between the business community and national leadership, which is effectively the only force influencing the events in the country, is less intense as in prior years.

The drastic increase in the involvement of the executive authorities and the redistribution of powers in favor of the federal government go against the concept of the separation of the three tiers of power and creates the conditions for the restoration of the centralized power hierarchy. Such a system of managing society and the economy squelches the impulse for change,

unless it either originates with the center or does not contradict the system's ideology; it discourages economic activity and prevents business initiatives and fair competition, forcing the economic participants to fight for administrative rent.

Under these circumstances, the Russian civic and economic systems will be driven closer to the traditional societal model of the "Rule of Force," whereby power belongs to the ruling group, which prevails over all other forces and has dominant control over economic resources. At the current developmental stage of the global community, such a system is less efficient, sustainable, and competitive than a society under the "Rule of Law," which is governed in accordance with established public laws based on fundamental individual rights and freedoms over collective and government interests.

One of the key tasks for Russia is the reform of the judicial system, the second stage of which began in 2001. The main goals of this reform are to increase the efficiency and confidence in the system, improve the quality and impartiality of court rulings, and generate civilized business practices and ethics. In 2000 – 2004 the legal base for implementing judicial reform was virtually accomplished, and laws were adopted to regulate judicial (including laws concerning court marshals, enforcement, and the judicial system) and investigative procedures (*Criminal Procedure Code*, *Civil Procedure Code*, *Arbitration Procedure Code*, and *Administrative Infraction Code*). The role of judges was enhanced and modern international best practices were taken into account, as were mechanisms and settlements for dispute resolution. Regulations were adopted in furtherance of judicial reform.

However, the previous year demonstrated that earlier-detected flaws in the judicial system remain in place. The judicial system can hardly meet the increased

demand for court rulings; courts are overloaded and procedural timeframes are not observed. The judicial system remains dependent on the executive authorities. The level of confidence in high-profile court cases is low, since the community sees that the principle of "equality before the law" may be violated because one side may either gain privileges and/or unfair competitive advantages or may suffer exclusive prosecution.

*Last year saw clear systemic problems in the Russian economy related to the state's internal problems. The economic policy being pursued is contradictory and inconsistent. Following the reform of the government, its performance decreased and not all reforms have been developed with sufficient quality. The implementation of scheduled reforms stalled. The Center for Strategic Reform estimates that the reforms not overly dependent on the protection of ownership rights and the quality of other institutions will be completed in the immediate future, whereas other reforms will progress with more difficulty. The uncertainty in the relationship between the government and business reduced the level of confidence, adversely affecting business activities and investment decisions. An efficient economic policy is vitally important for the Russian economy, since the conditions for development in the forthcoming years will be less favorable than before, due to exhaustion of capabilities for restorative growth in the export-oriented model. New growth areas are required, for which an environment favoring innovation and entrepreneurial activity is needed.*

# Reform of the Budget and Federal Systems

Along with administrative reform, modernization of the budget and federal systems plays an important role in the future of Russian society, as reorganization in the above spheres will have an impact on the quality of the overall functioning of state institutions. It is these institutions that ultimately will create the means for other economic and social improvements.

In recent years, the presidential administration and financial authorities have undertaken consistent steps towards reforming the federal system and local governance. Federal reform is focused on reinforcement of the country's territorial and economic integrity, enhancement of the living standards in economically backward regions, establishment of a unified legal framework over the whole territory of the Russian Federation, and creation of conditions ensuring stable and long-term development and overall security. The main objectives underlying the planned development of the regions include extension and upgrading of the transport network, electric power and defense sectors; the creation of an equally competitive environment for all business entities and regions within the territory of the Russian Federation; and the removal of barriers impeding the free movement of people, goods, services and resources.

Work on normalizing the federal structure and the development of local governance was started in 2001 by the Commission Under the Auspices of the President of the Russian Federation ("Kozak's Commission"). Over the past four years, a number of laws were adopted to clarify the scope of responsi-

bilities of the governing bodies at each level, determining the authority and conjuncture of funds and revenues (including title to various properties), and identifying unfunded state obligations.

The laws governing relations in and within the legislative and executive branches in the constituent entities of the Russian Federation and outlining overall organization of local governance in the Russian Federation will come into force in 2005 and 2006, respectively. In legal terms, this will provide for the strict division of authority and responsibility of the governing bodies and outline the main principles for allocation of funds.

The current system of inter-budgetary relations contains a number of deficiencies. One of them is the imbalance between obligatory spending and revenues at various budget levels, which leads to the failure to fulfill a considerable portion of legally established guarantees (especially in the social sphere) and insufficient funding of public sector projects (notably housing and utilities). Successful implementation of this reform will help ensure greater stability of the financial system and reduce the risk of non-payment or arrears in payment.

Over the coming years, the public sector will be subject to a number of changes involving the reform of the structure of the federal system, local governance, and inter-budgetary organization, as well as transition to new budgeting principles. At the present stage, bringing the legislation of the constituent entities of the Russian Federation into compliance with federal legislation<sup>20</sup> and increasing the economic

independence and responsibilities of the constituent entities of the Russian Federation are among the main objectives.

Reform of the budgeting process, the federal structure, and local governance should generally result in the enhanced stability of the state's finances, increased effectiveness of budget spending and reduction of related risks. This will have an overall positive impact on macroeconomic stability and the economic growth rate. However, mid-term prospects for the development of state finances are not completely clear given the variety of frequently contradictory objectives set to improve the budgeting process.

In the mid-term, one of the goals of the budget policy is the transition from cost-based to performance-based management.<sup>21</sup> Starting in 2005, the reorganization and optimization of the existing networks of recipients of budget funds should commence. This process is intended to fund result-oriented projects and provides for a greater independence of administrators of budget funds, coupled with increased responsibilities and self-control. A mechanism for long-term forecasting of the amount of fund allocations to finance specific functions and programs is also intended. In future, the practice of allocating pre-determined amounts to budget-funded entities will be abandoned, as it does not create adequate incentives to ensure increased efficiency and reduce costs, and has no impact on the overall results.

In terms of spending, declared priorities for the coming years are for social reforms (healthcare<sup>22</sup> and educa-

<sup>20</sup> Regional legislation needs to be brought into compliance with federal legislation by amending the provisions pertaining to the federal structure, local governance, funding of responsibilities of the governing bodies, and establishment of ownership title to state property.

<sup>21</sup> According to estimates by the Ministry of Finance, reforming the budget process in 2004 – 2007 may result in between 10% and 20% better efficiency per ruble.

<sup>22</sup> The goal of the healthcare reform is to create conditions improving public health by enhancing accessibility to medical care for the wider public and sustaining a good quality of medical service. To ensure this, the quality of public services needs to be improved and the existing informal practice of buying "free" medical services provided by the state health institutions needs to be legalized. This requires the rapid development of medical insurance and modernization of the existing system of obligatory medical insurance.

tion<sup>23</sup>); modernization of housing, utilities,<sup>24</sup> and the military; and development of infrastructure and science. The reforms might be hindered by disruptions in funding, which could impact budget processes, the federal structure, and local governance.

It is noteworthy that the recent changes to the taxation system and the reform of the budgeting process complicate the operation of most regional budgets, as their spending obligations will automatically increase (specifically those pertaining to benefit payments and financial support of technical secondary education), while growth in revenues is only possible in the case of sudden, rapid economic growth of the given constituent entity of the Russian Federation.<sup>25</sup> The imposition of limitations on the financial independence of local governance bodies is also planned, which will potentially give the upper hand to state authorities at the regional level. Note also the low level of long-term fixed local sources of income within the majority of regional and local budgets. This reduces independence and flexibility of municipal budgets and has an adverse effect on the development of local governance and other democratic institutions in Russian society. On top of that, covering the deficits of the regional budgets with federal funds (in the absence of a mechanism for financial rehabilitation) and limiting the responsibilities of the heads of constituent entities in cases of insolvency of territories subordinate to them is viewed by regional elites as a counter incentive.

The reform of the inter-budgetary and federal systems is accompanied by considerable changes in spending authority on all levels of authority and introduces additional uncertainty into the 2005 regional budgeting process. It should be borne in mind that the reform of inter-budgetary systems had already been devised before September 2004, when the president declared new principles for constructing the power vertical, notably the appointment of governors. This gives rise to risks associated with sustainable functioning of the regional social and economic systems, as the financial risks inherent to reforming the federal and inter-budgetary systems are being supplemented by political ones related to the increased dependence of governors on the federal center, coupled with the reduced influence of the population.

The above procedure leads to changes in the command structure: Being completely responsible for their actions (including funding of state obligations at the regional level, on time and in full), the governors have been turned into representatives of the executive authorities appointed by the president as opposed to officials elected by the majority of the region's population as they used to be. This potentially reduces the stability of the federal system and serves as a counterincentive for regional elites, headed by the governors, to look for efficient ways to develop the regions and try to resolve acute social and economic problems.

Among the new initiatives provided for by the local governance legislation is the change in the territorial structure of municipalities. This requires the revision of the

entire system of municipalities in the regions and may lead to redistribution of property (primarily land), which, in turn, will create new risks for entrepreneurial and investment activity, boost the price of land allotments to sell and to let, and reduce the growth of economic activity. Thus, instead of the stated goal of developing federalism and local governance, the current reform of the federal system may lead to centralization of power, further growth of red tape, and redistribution of financial resources from the regions to the center. This may impede modernization of the economy and reform of the state.

Another factor that may impede the course of reform of the federal system and local governance is the lack of resources (financial, material, information, human) in the majority of the regions. In view of the increased and amended responsibilities and authorities, the reform requires the rapid creation of a new organizational structure for local governance. This requires a significant increase in the number of employees working in these structures and the expansion of office space, which entails costs to carry out such activities. The bulk of the costs will be incurred during the initial stage due to purchasing office equipment, decorating the premises, and creating work areas for the employees.

Modernization of the system of social benefits<sup>26</sup> is currently being launched. It will have a significant impact on the budget and inter-budgetary systems, population, regional economies, strengthening of federalism, and overall development of the country. The changes will have various foci: transition to targeted forms of assistance; monetization of in-kind

<sup>23</sup> The goal of the education reform is to create an education system competitive in the world market (from preschools to universities and other training centers) which meets the need for qualified specialists, is capable of maintaining the scientific potential of the country and sustaining and increasing the average level of public education. It is planned to restructure and computerize the national school network, modernize university premises, and apply per capita financing norms with respect to state-funded educational institutions.

<sup>24</sup> Housing and utilities reform has the following goals: replacement of state subsidies with consumer payments (provided that social protection for targeted low-income population is retained) and increased efficiency of the housing and utilities sector by developing competition and effective regulation of the housing and utilities infrastructure. This should result in increased reliability of functioning coupled with reduced power consumption due to energy-saving measures, and the enhancement of both the quality of services and the overall investment appeal of this sector of the economy.

<sup>25</sup> Note that the planned transfers from the Russian Federal Fund of Financial Support for the Constituent Entities of the Russian Federation, Federal Compensations Fund, and Fund of Co-Financing of Social Expenditures are not sufficient to cover the emerging deficits in a number of regions (primarily those which already receive funds from the consolidated state financial system).

<sup>26</sup> The social support system which existed up until recently guaranteed an excessive (as compared to economic realities) number of benefits to the population. This gave rise to only partial funding of the relevant state obligations. This system was inefficient, not transparent, had a low level of funding, but had excessively high inputs for the potential recipients.

benefits;<sup>27</sup> and reduction of unbudgeted benefits.<sup>28</sup> These measures are meant to increase the efficiency and transparency of the structure of spending and revenues in the economy and reduce the gray market sector, abusive practices, corruption, and discretionary use of budget funds. These actions are crucial in light of planned reforms in education, healthcare, housing and utilities,<sup>29</sup> and the electric power industry to increase the investment appeal of these sectors.

Judging by the situation with benefits, in January 2005 it became clear that there were serious deficiencies in the preparation of the reforms related to various budget and federal matters. Many regions were not ready financially, organizationally, or in informational terms<sup>30</sup> to participate in the process of monetizing benefits. The delay on the regional level in the preparation for monetization of benefits is above all attributable to objective difficulties and evident political risks.<sup>31</sup> As there was not adequate information support for this reform in the mass media, the population appeared to be unprepared for it and gave it a rather hostile reception.

Additionally, most benefit recipients (especially those living in mega cities) considered the cash benefits insufficient as they did not compensate for the previous in-kind benefits (primarily those related to the use of public transport). This resulted in numerous protest actions initiated by benefit recipients and an increased level of social tension in a number of regions,

compelling the federal and regional authorities to urgently revise the amounts of compensation payments. Some regions<sup>32</sup> decided to retain in-kind benefits; others introduced integrated travel cards for public transport (as the cancellation of this type of benefit was the biggest cause of public frustration). Starting in March, an early increase in pensions and monetary allowances for military personnel will be put into effect.

It is noteworthy that the unsuccessful start of the reform of social benefits demonstrably displayed the weakness of regional policy. This happened firstly because existing regional elites are not ready to take on the full responsibility for resolving all social and economic problems, and secondly because the federal center is reluctant to develop strong regional power, preferring to foster centralization and concentration of financing at the federal level.

In the meantime, for reforms to occur, in healthcare, education, and the housing and utilities sector, and for increasing the business activity and investment appeal of the constituent entities of the Russian Federation, it is crucial that the regions pursue their own independent and responsible policies. No social strain related to the monetization of benefits was seen in those regions where governors had previously demonstrated an independent and knowledgeable stance. This is the best argument to support the idea that regional politicians in a federation should

be independent and responsible partners for the federal government, not just passive subordinates.

It cannot be ruled out that the introduction of the reform of local governance will bring with it chaos in the process of distribution of monetary benefits, as it will be accompanied by organizational problems related to the change of structures and borders of municipalities.

*Reforming the federal system, local governance and the budget sphere is of vital importance for further development of the Russian economy. Implemented successfully, these reforms will lay the groundwork for creation of a unified, integrated economic environment, implementation of a unified economic policy both by the federal center and the regions, reduction of transaction costs and risks, and an increase in macroeconomic stability. This would help reduce the gap in economic development among regions and give impetus for development of depressed regions and overall economic growth. Payment discipline of the budget-funded entities will be fostered and transparency of budget settlements will be increased. This will give rise to new incentives to increase the efficiency of activities of regional administrations and municipalities. It should be noted that there is potential conflict between a number of reform objectives and the federal government's intention to advance the authority of executive government bodies. However, this reform is necessary in view of the long-term development of the country.*

<sup>27</sup> In 2005, three in-kind benefits for those receiving benefits from the federal budget will be retained. These benefits will comprise a "social package" to the value of RUR 450 per month (medications, sanatorium-resort therapy, and suburban railway transport). From 2006, retaining the above three benefits in the present form will be left at the recipient's discretion. For those who will be receiving benefits from the regional budgets (approximately 20 million of the total 32 million beneficiaries), the provision of a "social package," amount of benefits, their retention, or abandonment is left at the discretion of the regions.

<sup>28</sup> The following types of benefits account for the bulk of expense items within the budget system: payment for transport, housing and utilities services, medical care and medications, and sanatorium-resort therapy. There are also labor-related, pension, tax, educational, and other benefits.

<sup>29</sup> Monetization of housing and utilities benefits has been postponed until at least 2006, although this expense item is not the most "expensive" one. This process has been put on hold mostly for populist reasons, not because the budget cannot cope with it. Retaining non-monetary forms of settlements is a significant obstacle to reform of the housing and utilities sector, and thwarts the increase of investment appeal and efficiency of this sector of the economy.

<sup>30</sup> Regional authorities do not possess adequate databases to define the list of potential recipients of benefits. In most regions, such lists have not been reconciled.

<sup>31</sup> The regions are authorized to make a choice between monetized and in-kind benefits, and to define the value of cash compensation. In view of the conflicting interests between the governor and local parliament in a number of regions, consensus with respect to this social issue is hard to achieve.

<sup>32</sup> According to Russian Ministry of Transport data, reform of public transport benefits was started in 33 regions, of which 29 introduced regional social monthly travel cards whose price is less than half that of the usual one; four introduced municipal monthly travel cards. In-kind benefits were retained as is in 15 regions. Thirty regions plan to switch over to monetization of benefits in the first half of 2005, nine regions have not yet decided on this issue at all. Based on information provided by RosBusinessConsulting, www.rbc.ru

# GDP and Investment

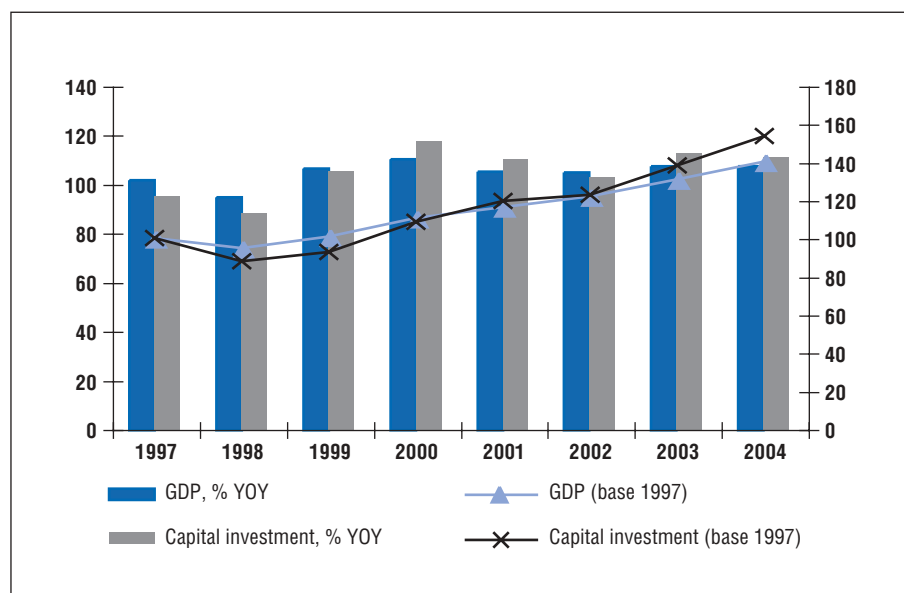
The Russian economy has enjoyed an average annual growth rate of 6% over the past six years. GDP increased by 7.1% in 2004, investment by 10.9%, and industrial production by 6.1%. The surplus balance of trade exceeded USD 88 billion in 2004, which was nearly 48% higher than in 2003; the gold and foreign exchange reserves of the CBR increased by nearly 62% to USD 125 billion as of January 1, 2005. Total employment was 66.7 million and unemployment decreased to 6 million, or 8.2% of the work force. However, the year's results could have been even more impressive.

It is noteworthy that the above-mentioned results were achieved under the most favorable international prices for oil and metals in the past several years, which caused record-breaking export revenues.<sup>33</sup> Nevertheless, growth slowed in comparison with the previous year (industrial growth stopped in the third quarter, and there was a moderate recession in August and September). The reduction in the economic growth rate is confirmed by the reduction in the growth rate of rail freight turnover to 8% in 2004 (10.5% in 2003).

In contrast to previous years, such results were achieved under conditions of significant private capital outflow, and lower confidence in the ruble and the actions of the authorities. These end-of-year results show increased risks for sustainable development of the Russian economy, as well as the impact of political factors on economic processes.

Slowdowns in the rate of economic growth have been seen in the past; however, 2004 seemed to witness a consistent trend in growth rate reduction, and not merely a fluctuation. The Russian econ-

**Table 3. GDP and Investment Growth in the Russian Economy, 1997-2004**



Goskomstat

omy remains reliant on the export of mineral resources and the foundations underlying economic growth have been unstable, which has had a negative impact on the total investment to the economy and has driven up interest rates and estimates of associated risks.

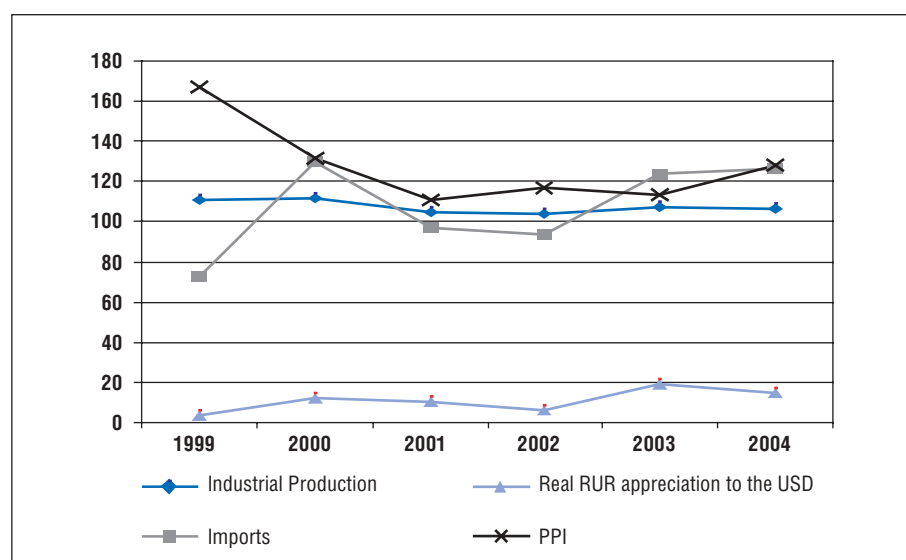
There were certain changes in economic growth factors in comparison with the previous year. Parallel to the growth of export-oriented industries – the growth rate accelerated in the chemical and petrochemical industry to 108.2% (102.2% in 2003), slowed in the fuel industry to 107.1% (109.3 in 2003), the ferrous metallurgy industry to 105% (108.9% in 2003), and the non-ferrous metallurgy industry to 103.6% (106.2% in 2003) – the share of processing industries (mainly due to stronger performances by the mechanical engineering and the food industries, which registered growth rates of 111.7% and 104.0%, respectively) increased in manufacturing. At the same

time, the industrial growth rate in general went down to 106.1% (107.5% in 2003). One should also note other causes of lower growth rates, such as a reduction in state procurement (which can be explained largely by a slow down in decision-making due to government restructuring and the beginning of administrative reform) and slower growth of credit to the economy due to the banking system instability in the first six months.

As compared to the previous years, growth in the construction industry fell to 110.2% (114.3% in 2003) and in agriculture to 102.9% (105.7% in 2003), while the growth rate of the telecommunications sector increased to 124.7% (120.7% in 2003) and of marketable services to 108.7% (107.4% in 2003) – which accounted for the growth of the services share in total production to 59.9% (50.5% in 2003). Imports<sup>34</sup> increased due to a high growth rate in the demand for non-food items, which signals a lack of competitiveness of Russian pro-

<sup>33</sup> According to CBR information, export receipts exceeded USD 183 billion, which was 34.8% higher than in the previous year.

<sup>34</sup> According to CBR information, total imports were nearly USD 95 billion, which was nearly 24.7% higher than in the previous year.

**Table 4. Growth of Production Indicators, Import and Producer Prices (% , YOY)**

Goskomstat, authors' own calculations

ducers in the context of current income levels and consumer preferences under the conditions of tighter price competition: The ruble appreciated by 14% in real terms, industrial costs and the consumer price index (CPI) grew rapidly (128.3%) in the past year.

Domestic consumer demand grew dynamically in 2004. Namely, retail trade turnover increased by more than 12%. However, growth in real household income declined somewhat (growth of 107.8% versus 114.9% in 2003). According to MEDT information, the high base of 2003 (partially due to indexing public salaries), high interest payments on retail loans, as well as lower growth dynamics of income from property and entrepreneurial activities, contributed to a slowdown in the growth of real household income. Similar to the previous years, wage growth outpaced labor productivity growth (according to Center for Macroeconomic Analysis and Short-Term Forecasting (CMAKP) information, the said indicators increased by

10.9% and 4.6% respectively in 2004, and by 10.9% and 7.3% in 2003). Such a trend casts long odds on the possibility of retaining the current consumer demand and household income growth in the long term if no measures to raise production efficiency are adopted.

Meanwhile, the share of savings in total household income was reduced to 10.2% (12.7% in 2003) while expenditures to buy foreign currency increased to 8.4% of total expenditures (7.3% in 2003). And the total volume of consumer loans rose by a significant margin. Thus, changes in consumer preferences and the development of financial incentives to bolster demand contributed to higher consumer demand, which brought about growth in the share of consumer expenditures in total household income to 70.2% and reversed the trend of continuing decline since 1999.

It may be, however, that this trend might also evince lower household confidence in ruble savings and higher inflationary

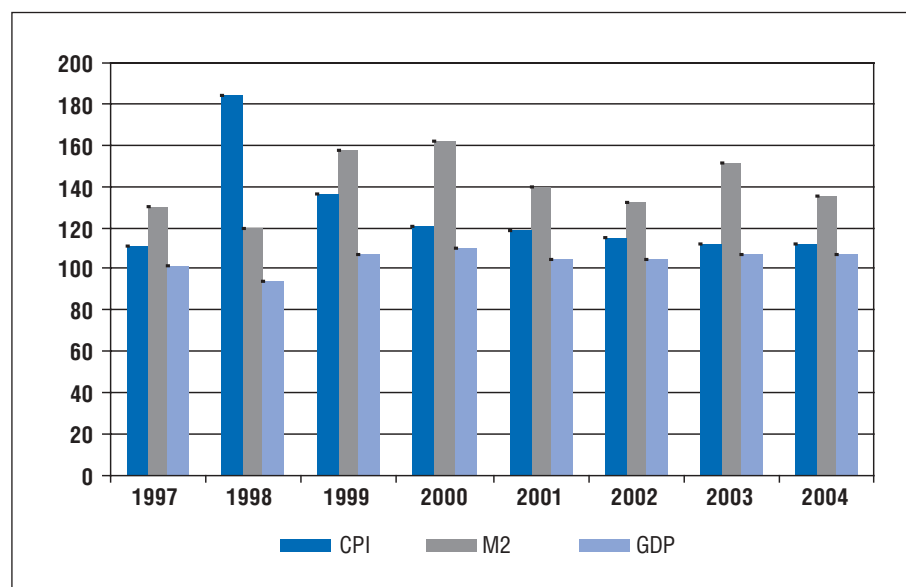
expectations. Russia's money supply increased by 35.8% in 2004, and the CPI reached 11.7%, although the government had hoped to contain inflation at 10%. In previous years higher growth rates in the money supply were accompanied by relatively low inflation and high economic growth. That being said, the monetization ratio (money supply (M2) to GDP) increased from 14% in 1998 to 22% in 2004; however, it decreased by a small margin in comparison with the previous year.<sup>35</sup>

In 2004 there was a slowdown in business activities, caused by a glitch in the banking system and government interference in the economy (which is confirmed by increased capital outflow), and the growth strategy that had evolved after the crisis ceased to function. This resulted in lower demand for money and influenced monetary indicators. Under such conditions, money supply increased largely by growth in loans to the economy. According to Troika Dialog, the money multiplier (ratio of M2 to the money supply) increased from 2.28 in January 2003 to 2.60 in January 2005. This raises the risk to the stability of the financial system. The unstable economic growth rate, typical of the export-oriented model based on production of natural resources, is evidence of hidden imbalances in the Russian economy.

As mentioned above, growth in investment declined in 2004. This trend could be noted across numerous industries, especially in the export-oriented sector. Amongst causes for this phenomenon are the previously mentioned crisis of confidence in the state, capital outflow, and the mini-crisis in the banking system.

There was a slowdown in the growth of capital investment in the fuel and energy complex, in which the largest investment

<sup>35</sup> The monetization of Russia's economy remains low. The standard of developed market economies is 70%-100%. According to Troika-Dialogue, in 2004 the monetization ratio of the Eastern European countries with transition economies, which had gone through painful economic restructuring and a high inflation period, was as follows: Latvia – 25%, Bulgaria – 27%, Estonia – 30%, Poland – 38%, Hungary – 40%, and Slovenia – 40%.

**Table 5. Money Supply, Economic Growth, and Inflation Rate (% , YOY)**

Goskomstat, CBR

projects over the past years had been undertaken. This is primarily related to higher political risks, as well as to the increased fiscal burden on the oil sector, which has become a counterincentive for production development. There was a reduction of investment in the oil-production industry (total investment was RUR 141.3 billion in the first nine months of 2004, which was 6% lower than the same period of 2003). Investment in the gas industry was also reduced (97.8% in the first three quarters of 2004, as compared with the same period of 2003), as it was in the non-ferrous metallurgy industry (95%). Capital investment was reduced in the food industry (82% in comparison with the same period of 2003), medical, publishing and several other industries.<sup>36</sup> Due to such changes, the industrial share in total capital investment decreased to 42.6% in the first nine months of 2004, which gives a more diversified picture of investment than witnessed in recent

years. The share of investment in transport increased (by 19% – 2.5% less in comparison with the previous year) as did that of telecommunications (by 6.9% in the context of an impressive growth of 53.8% in comparison with the previous year). Growth of capital investment was reduced in construction (by 17% in comparison with the same period of 2003), which was a direct result of the financial system glitch that reduced the growth in loans issued for a certain period.

The share of companies' own capital increased in the investment structure. During the first nine months of 2004, the share of bank loans rose to 7.7% (5.2% in 2003), however, state capital investment fell to 17% (according to MEDT information, they were financed to 95.5%).

Similar to previous years, gross savings (32.6% of GDP in 2004, 29.6% of GDP

in 2003) exceeded gross accruals (21.4% of GDP in 2004 and 20.5% of GDP in 2003). Amongst the main investment obstacles, one can find, as in the past, high administrative barriers, insufficient protection of investors' and entrepreneurs' rights, weaknesses of the banking system, and imperfect means of turning savings into investment. As of the year's end, the previous years' situation repeated: The gap between savings and investment in the Russian economy was approximately 11% of GDP.

Accumulated foreign investment in the Russian economy was USD 82 billion as of the end of 2004. According to Rosstat data, foreign investment was USD 40.5 billion, which was 36.4% higher than in 2003. The main investors were Cyprus, the Netherlands, Luxembourg, Germany, the UK, the US, and France. These countries accounted for 80.7% of the total accrued foreign investment and 77.6% of FDI. It ought to be noted that, despite the substantial growth in direct investment (138.9% as compared with 2003), these countries' share in total foreign investment remained at a relatively low level of 23.3% (22.8% in 2003), and 45.8% in the total accumulated investment.

It should also be mentioned that a high inflation rate entails relatively high interest rates, which has a negative effect on the ability to attract investment to the low-profit manufacturing industries and to other non-export sectors.

Thus, under the conditions that have evolved, Russia's economy has certain investment resources; however, with the current risk level and varying return rates for different economic activities, it does not have enough projects with invest-

<sup>36</sup> At the same time capital investment grew in several industries: in the coal industry – by 156.5%; in forestry, woodworking, paper and pulp industries by 113%; in light industry by 115.2%; and in the chemical and petrochemical industries by 107.2%. However, capital investment in the said industries accounts for a relatively small share of total capital investment, determining their generally small impact on the dynamics of the industrial indicators. According to CMAKP estimates, the share in the investment growth as of the first nine months of 2004 of the export-oriented sector was 34%; of natural monopolies – minus 2%; of manufacturing industries – minus 11%; of telecommunications – 55%; of utilities – 24%; and other industries – minus 1%. Hence, one can draw the conclusion of the low distribution rate of investment from the export-oriented natural-resources sector to other sectors. The experience of the past few years has shown that, although high revenues resulted in higher investment, their total volume was insufficient and their structure did not fully match economic needs with regard to modernization and diversification.

ment appeal. At the same time the problem of obsolete fixed assets (particularly in manufacturing industries) has not been resolved, re-emphasizing the need for both modernization of Russia's economy, as well as structural reforms.

One should also emphasize that true modernization of Russia's economy has not yet begun. Current labor productivity levels are many times lower than in the majority of developed countries. Large numbers of enterprises continue to operate in Russia, whose operational methods and the organizational level hardly differ from those of the Soviet period, when equipment was not

renewed for years and no investment was made in new products and new technologies. There have been insufficient incentives for modernization or closure of these inefficient enterprises. The competition necessary to establish such incentives has also been inadequate in numerous industries.

*The Russian economy registered high growth rates in the past year; however, some of the trends in its socioeconomic development and projections of international market prices contend that the economic growth rate is likely to slow in the next few years. It is worrisome that the unpredictability of government actions has*

*become one of the factors negatively impacting business activities in the previous year. Applying pressure to business and the lack of protection of ownership rights were detrimental to the business climate and the country's economy, and contributed to growth in capital outflow. Investment activities were somewhat lower in the past year; however, the diversification of capital investment increased by a small margin. At the same time total investment is insufficient to expect significant improvement of competitiveness or reduction of the economy's dependence on energy exports over the next few years. Comprehensive restructuring of the socioeconomic system continues to be a vital issue for Russia.*

## Legislation

Legislation supporting economic reforms took place against the backdrop of significant changes in the governmental system in 2004. The beginning of the year witnessed the restructuring of the executive branch. By presidential decree, a new three-tier federal executive system, composed of federal ministries, federal services, and federal agencies, was established in March. Said restructuring was part of the administrative reform targeted primarily at raising the efficiency of government operations. Governance and control functions were divided during the reform. *The Law on the Civil Service*, which established the legal, organizational, and economic basics of the civil service on both federal and regional levels of the Russian Federation, was also adopted during the reform. The stated objective of the law was the reduction of corruption within government agencies.

Cardinal changes were introduced to the government structure. Firstly, procedures for appointing the heads of regional entities of the Russian Federation replaced direct elections. The highest officials of regional entities were elected before; now

they are to be ratified by the legislative assemblies of regional entities pursuant to nomination by the president. It is in this context that the procedures and terms for appointing a candidate to the top executive position of a Russian regional entity, and the procedures for the candidate's ratification by a corresponding assembly have been adopted. The conditions under which the president of the Russian Federation shall appoint the acting head of a regional entity of the Russian Federation were set, and the reasons and procedures for the suspension and removal of such officials from office were elaborated.

Measures were adopted to enhance the efficiency of counter-terrorist operations and ensure Russia's national security. With a view to barring would-be terrorists to the Russian Federation, the government has been instructed to adopt measures to strengthen control over the issuance of visas by Russia's diplomatic and consular offices abroad, as well as to streamline procedures for travel of Russian citizens to the countries with which Russia has effective agreements on entrance without visas.

Measures against money laundering have been strengthened. Significant amendments enhancing control over financial transactions have been introduced to legislation. Changes have been introduced to the banking sector: The CBR has established identification requirements for persons serviced by a credit organization, as well as the persons in whose interest a client undertakes transactions, e.g., on the basis of an agent agreement, agency contract, commission, trust, etc.

Besides the aforementioned amendments, changes have been introduced to the regulation of banking activities targeted at safeguarding depositors' interests and enhancing confidence in the banking system through the establishment of a depositor's insurance system for Russian banks. *The Law Concerning Insurance of Natural Persons' Deposits with Banks of the Russian Federation* became effective, subordinate acts stipulating the deposit insurance system were adopted. Standards were approved, targeted at strengthening the responsibility of heads of credit organizations for the timely adoption of measures

to prevent bankruptcy of those credit organizations, for raising the efficiency and the transparency of the bankruptcy procedure for banks, and for granting additional supervisory functions to the CBR to oversee problem banks. The *Law on Credit History* was adopted, stipulating what type of information may be gathered, for which reasons it may be gathered, and its storage and use.

The reforms impacted other financial markets as well. Amendments to the *Law on Insurance* entered into force at the beginning of the year. The stated objectives of the amendments were to streamline the government's regulation of insurance activities and liberalize the insurance market (with the concurrent strengthening of certain requirements for participants in insurance activities). In effect, insurers were divided in accordance with their specialization. Insurers involved in property insurance are no longer entitled to offer life insurance. In addition, access to the insurance market was facilitated for insurers with foreign capital. However, the law has provisions restricting the development of the insurance market, in particular, those establishing a closed list of types of insurance activities.

Measures have been adopted to enhance the protection of the rights of the participants in the securities market. Recourse procedures with respect to funds of a professional participant in the securities market and those of its clients have been set. Tighter disclosure requirements have been established for participants in the market. The corporate legislation has been improved further, in particular, pertaining to procedures for distribution of dividends and the protection of shareholders' rights.

There have been changes in the regulation of intellectual property. The *Law Concerning Copyrights and Allied*

*Rights* has been amended to effect changes in the term of the copyright and the safeguards thereof, as well as in the authorized use of intellectual property rights.

Amendments have been introduced to antimonopoly regulations. The explanation of procedures for determining the dominant position on commodity markets is particularly relevant.

Numerous actions have been taken in restructuring the electric power industry. Requirements have been established with respect to the information that must be disclosed by entities in the wholesale and retail electric power markets, as well as to the procedures, methods, and terms of disclosure; procedures have been set for the adoption of resolutions on granting access to the federal wholesale power market to power-intensive consumers as wholesale power market entities. However, the decision to postpone one of the key actions in restructuring the power sector till 2006 was adopted at the year-end.

The legislature focused on establishing an affordably priced housing market. The *Housing Code* was adopted, and the *Law Concerning Issuing Mortgage Securities*, the *Civil Code*, the *Law Concerning Mortgages*, and the *Law Concerning State Registration of Ownership Rights on Real Estate and Transactions Therewith* were amended. Additionally, provisions protecting "good-faith" real estate buyers were added to the legislation.

Adoption of the new *Urban Construction Code* requires special attention. Its provisions regulate relations in urban planning, regulation of urban construction, design, construction, and restructuring of real estate. The code has increased the responsibility of the participants within the construction market.

Legislation on land was further improved also. The long-awaited *Law Concerning Transferring Land Plots Between Different Categories* was adopted. The law settled legal relationships originating from the resolution of questions pertaining to a change in the earmarked use of land plots. The law established the list of documents and the procedures for their compilation, as well as procedures for the adoption of decisions on transferring land plots between different categories. Additionally, the interdiction to pledge agricultural lands owned by agricultural organizations, peasants' farms, and individual land plots was lifted. The mortgage of agricultural lands introduces the mechanism of providing long-term loans for agricultural production and the law can be viewed, in general, as yet another step forward in land turnover in Russia. However, certain positions taken on this issue by the Constitutional Court should not go unnoticed. In particular, the legislation provisions interdicting the placement of land plots in the Russian Federation into the ownership of foreign and stateless citizens, and foreign legal entities were recognized by the court as not contradicting the Constitution of the Russian Federation.

*Thus, upon the face of it, one might regard the amendments introduced into legislation during the year as highly favorable. However, the objectives declared in adopting such laws are not always implemented consistently. The quality of the laws leaves much to be desired. To some extent, this can be explained by errors and the sometimes-insufficient qualification of legislators, who are not always capable of envisaging certain consequences of the law's enforcement. In some cases, it is due to the result of a compromise of proposals made by different lobbying parties. All this brings about problems in enforcement of the law and in judicial practice.*

# Taxes and Customs

The main objectives of the tax reforms in 2000 – 2004 were to reduce taxes by a significant margin, to simplify the tax system, and to improve the tax legislation and administration. The achievements in reforming the tax system are evident and have been duly recognized. The reduction of the tax burden improved financial conditions for enterprises, and aided in building domestic investment capabilities and raising household income. It contributed to the improvement of the investment climate of the Russian economy and to an increase in business activity.

In the mid-term, the strategic objective of the tax reform is to establish a fair, neutral, and effective tax system, in which fiscal functions and incentives for economic activities will be merged successfully. The tax system must ensure the balanced nature of government finance and low administrative costs both for the fiscal services and the taxpayer.

Streamlining tax laws continued in 2004, namely, amendments were introduced affecting individual taxes, and a chapter regulating Water Tax was added to the *Tax Code*.

Tax rates were amended. The list of goods to which the VAT rate of 0% was applied was broadened to include oil, including stable gas condensate, and natural gas exported to CIS-member countries. This measure is based on the generally accepted international practice of levying VAT pursuant to the destination principle. At the same time the tax rates on the production of mineral resources were raised. The tax rates on securities

transactions were reduced (from 0.8% to 0.2% of par value), the VAT rate was reduced (from 20% to 18%), and Sales Tax was abolished.

Amendments pertaining to the creation of an affordable housing market through reducing realtors' and investors' costs, including investment in mortgage and municipal bonds, were adopted. The chapter "On Land Tax" was added to the section entitled "Local Taxes" of the second part of the *Tax Code of the Russian Federation*. The Land Tax was established as a local tax in order to provide a revenue source for local budgets.

The UST rate has been reduced as of 2005<sup>37</sup> and the list of entrepreneurial activities subject to Unified Presumptive Tax has been broadened. The said measures are intended to create incentives for the growth and further legalization of household income. In the next few years the system of Property Taxes will be reformed; legal acts regulating Inheritance and Gift Tax, Real Estate Tax, and Land and Water Tax will become effective; the procedures for levying VAT will be improved; and the taxation of natural resources will be amended.

The taxation system should not undergo cardinal changes in the next few years, although it is essential to improve it, as well as to amend tax policies that slow economic growth and block the growth of a stable and favorable economic climate.

Customs Service reform is part of the reforms undertaken to integrate Russia's economy into the world economy at

favorable conditions, as well as to modernize fiscal rules and procedures in regulating foreign economic activities. Reform of the Customs Service will provide for harmonizing the customs control rules with international ones, help build the investment attractiveness of Russia's economy, establish incentives for conducting foreign economic activities, and improve export conditions.

The new *Customs Code* became effective in 2004. Following the pattern of the *Kyoto Protocol*, the legislative base of customs control is based on the risk analysis concept, which creates conditions for transition from the current inefficient and rigid system of total customs control to an up-to-date, flexible, and rational service concentrating resources in the areas requiring maximal customs control, as well as complying with WTO requirements to a higher degree than previous legislation.<sup>38</sup>

The first year of operations in accordance with the new rules has shown the weaknesses in the legal environment. The new procedures for providing customs services (customs brokers, carriers, and operators of provisional warehouses) have resulted in a reduction in the number of participants in the business in question, which in effect has created a new administrative obstacle and the danger of excess capital concentration in the sector, thus allowing companies to use their dominant position for price fixing.

The code in effect does not define the notion of "customs fees"; neither does it

<sup>37</sup> As of 2005 the effective UST rate (contribution tariffs for the mandatory pension insurance included) was reduced through the establishment of the following UST rates: 26% for income below RUR 280,000, 10% for income from RUR 280,000 to RUR 600,000, and 2% for income above RUR 600,000 per employee.

<sup>38</sup> It is noteworthy that, currently, due to the approaching final rounds of Russia's negotiations on accession to the WTO, it will be essential to modernize the customs legislation because, after accession to the organization, amendments to the legislation on foreign economic issues might become part of Russia's obligations and Russia will have to abide by international standards in fulfilling them. In particular, amendments are required in the sphere of assessing the customs value of products, and to several other issues.

<sup>39</sup> In particular, problems arise due to the insufficient knowledge by Russian customs officers of international record keeping.

provide a list of their types. It also does not define the procedures for accessing the amounts to be paid for customs clearance or supporting services for the storage of goods crossing the customs border of the Russian Federation. This was the reason for introducing amendments to the *Customs Code of the Russian Federation* in order to initiate provisions for levying customs fees. Another relevant reason for introducing amendments was the need to harmonize domestic customs legislation with generally accepted international standards.

Besides improved regulation, administrative responsibility for violations in the financial and customs spheres was increased.

The Customs Service continues to be one of the most opaque spheres, both within the governmental system, as well as in the economy in general. Numerous methods employed by the Customs Service have become obsolete and result in high transaction costs of customs procedures.<sup>39</sup> In order to provide for qualitative improvement in Customs Service operations, the informational infrastructure must be improved at an accelerated rate, as it has an impact on various spheres of the Customs Service operations.<sup>40</sup> This will enhance the efficiency of control over customs operations and ensure the transparency and predictability of customs actions to business.

*Tax reform will likely be completed within the next few years. If the stated objectives are implemented, it will result in the establishment of a lower tax burden, the streamlining of the tax system and the tax administration, and reduction of risks and costs to the economy. However, at this time, significant problems have arisen in the tax administration that undermine competitive equality and increase investment risks. Although the customs legislation was modernized significantly in the past few years, it still does not fully comply with WTO requirements. In this context the legal base pertaining to fiscal fees and foreign trade should be further improved with a view to reduce costs and commercial risks to business and raise the efficiency of regulating business activities in Russia's economy.*

## Banking System and Financial Market

The reform of the banking sector is being carried out in order to increase its sustainability, potential, and functionality. The banking system suffered significant losses following the 1998 crisis. Equity and assets abruptly shrank. People's confidence in banks was undermined. Macroeconomic stability and a high rate of economic growth in the post-crisis period have contributed to the rapid development of the banking sector, owing to the rehabilitation of the settlement system, an increase in income and savings, and the growth of demand for investment resources.

The CBR is striving to improve the transparency and reliability of the banking system, creating increased confidence in the system and a lower level of risk inherent to financial operations. With that in mind, work is underway to improve and create legislation governing collateral,

bankruptcy, improved bank regulation, credit bureaus, and other areas.

However, the Russian banking system's structural problems remain unresolved. Transformation of savings into investments and reallocation of resources from highly profitable industries to less successfully developing sectors with greater demand for loans and higher credit risks is evolving on a more modest scale than necessary. There is an imbalance in matching assets and liabilities in terms of deposit and loan maturities with the majority of banks and the entire system in general. This fact reflects a lack of confidence in the Russian banking system on the part of potential depositors. In recent years the banking business has become less profitable in most areas (e.g., transactions with foreign currency, interest, and securities), primarily due to the increased competition within the sector.

In 2004, the *Strategy for the Development of the Russian Banking Sector for 2004 and in the Period Ending in 2008* was adopted. The goals and objectives of the initial strategy were adjusted subject to the trends in the development of the banking system and the increased role of the state in recent years.

The following key results are expected from the development of the banking sector: a significant increase in its functional role in the Russian economy and enhanced financial stability and transparency. The parameters<sup>41</sup> of the Russian banking sector will gradually approximate the indicators of banking systems in a number of emerging market economies, which are the most advanced in building modern market relations. However, if existing trends in the development of the sector persist (i.e., the strengthened role of the government in

<sup>40</sup> As a useful innovation, the introduction of electronic declaration of goods at more than 50 customs posts in the beginning of 2005 should be noted.

<sup>41</sup> According to the *Strategy for the Development of the Russian Banking Sector for 2004 and in the Period Ending in 2008*, by 2009 the parameters of the banking sector will be as follows: assets/GDP – 56% – 60%; equity/GDP – 7.0% – 8.0%; loans/GDP – 26% – 28%.

the financial system, increased political risks, administrative pressure), the goals of the reform will be achieved only partially. In such case, it is highly probable that the Russian banking sector will retain many of its systemic deficiencies.

There was more tension within the Russian banking system in 2004 than in prior years. Similar to other sectors of the national economy, the tension was more likely caused by administrative factors rather than the economic environment. High global commodity prices and a decent rate of economic growth in Russia supported sufficient liquidity of the financial sector, contributing to further development of the retail loan and mortgage markets.

However, 2004 saw no serious changes in the structure of the Russian banking segment. The number of commercial banks remains very large and little or no increase in the concentration of capital was noted. The selection of banks eligible for depositor's insurance system became a landmark event, though this process caused no surprises. Irrespective of rather stringent CBR requirements, all major credit institutions were admitted to the insurance system, and the number of participating banks exceeded 500 by the end of the year.

The story of the year in the Russian banking sector was the revocation of licenses from a number of banks accused of money laundering and the chain of events that followed. In May 2004, the CBR revoked the licenses of Sodbusinessbank and Credittrust, and accused them of money laundering, stating that there were similar claims against other credit institutions in the country. However, no specific legal entities were named, which led to mutual suspicions among the various players in the Russian financial sector, with several different black lists being circulated. The situation was aggravated by the pres-

ence of major national banking institutions on these lists, leading to closure of inter-bank lending limits.

Tension in the Russian financial markets reached its peak in late June and early July 2004, when some banks' settlement problems became known. Lack of maturity balance in the loan portfolio and closure of limits by leading credit institutions resulted in the banks' defaulting on a number of payments. The market (primarily individual depositors) effectively started to panic. Problems began to arise in withdrawing cash from accounts and ATMs. Most of the banks, albeit not without difficulty, could handle the strain. This helped avoid a chain reaction of banks declaring bankruptcy and gradually the situation eased.

The "banking crisis," the term used by many experts to describe the situation, did not entail disastrous consequences,<sup>42</sup> such as the downfall of the national currency, an excessive liquidity gap, or plummeting stock markets, all of which were common to the crises of the late 1990s. Still, there were negative consequences, primarily in the shape of increased capital outflow. To a very significant extent, the fault rests with the CBR, certain actions of which were not well thought through. Firstly, the CBR did not admit responsibility for statements on the existence of a list of suspect banks. Secondly, the CBR refrained from action in the situation with some problem banks much longer than befits the principal regulator, instead of explaining to the market players and the community what was going on, in order to help stabilize the situation. Such lack of prompt action became the administrative factor that fuelled the "banking crisis."

In 2005, the full-scale application of IFRS in the banking system will begin, marking an important step on the way

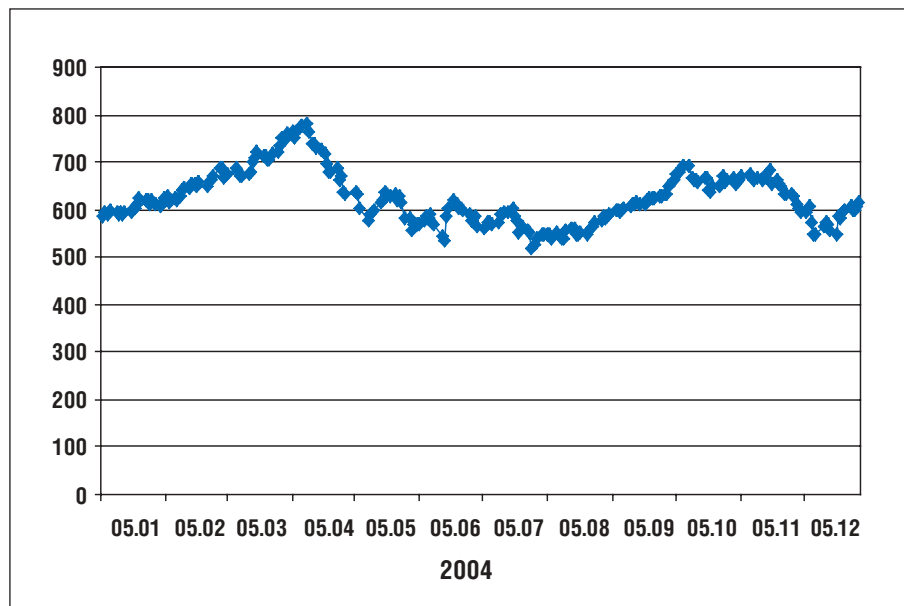
to mitigating risks in the financial system, increasing the operational transparency and investment appeal of Russian banks. However, the CBR's timely development of methodological guidelines and educational efforts remain very much the issue. Nevertheless, one can only welcome the financial reporting reform being launched in the entire sector of the Russian economy and hope that the introduction of modern reporting standards in other sectors of the economy will proceed without significant delays in comparison to the government's previously developed plans.

In 2004, government reform seriously affected the financial sector of the Russian economy. In place of the Federal Commission for the Securities Market (FKTB), the Federal Service for Financial Markets (FSFR) was established, with new leadership and the prospect of becoming a mega-regulator of the national financial system. Because of the lengthy process of establishing the FSFR and delays in appointment of its head, in 2004 the newly-established service did not have time to make any serious progress in further developing the national stock market. Still, players on the securities market viewed the leadership change in the supervisory authority favorably. After the FSFR took steps to meet the professional market participants halfway by canceling a number of unnecessarily stringent decrees passed by predecessors, the market operators stopped expecting unpleasant surprises from the regulator.

Oleg Vyugin, head of the FSFR, commented with justification that the market should move towards increasing the range of instruments traded and developing the termed securities segment (trading in derivatives), because capitalization growth will otherwise be restrained and

<sup>42</sup> There was a temporary decrease of confidence with the banking system in general, and small- to medium-sized private deposits in particular. A certain group of depositors hastened to transfer their savings to major state-controlled or foreign banks. The rate of lending in the economy slowed slightly.

**Table 6. RTS Index in 2004**



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the market will remain purely speculative. Certain harm to the development of the Russian securities market is done by issuers' mass placement of their securities, in the form of receipts, on foreign stock exchanges. However, the FSFR's capability to influence the situation is extremely limited, in that the legislative barriers will not produce the desired effect, but will rather create problems for companies in raising capital.

As far as the Russian stock market in 2004 is concerned, the first quarter saw a definite upward trend resulting in the growth of the RTS index as of April 12 by 37.8% since the beginning of the year, closing at the historic maximum of 781.55, with a daily record of 785.52. However, the negative development of the situation in the two areas key to the stock market – power industry reform and the events surrounding YUKOS – resulted in the subsequent decline of stock quotes. Consequently, RTS index growth at year's end was only 8.3%.

The stock market growth at the beginning of the year was largely a result of the active purchase of shares in regional elec-

tric power companies and RAO UES of Russia, which were supposed to be used as payment instruments at auctions to sell wholesale generating companies (OGK). However, when the idea of using both shares and cash as payment instruments at the auctions took hold at both the level of the government and the individual ministries, the market began to dump the "electric power" securities. In June the situation was aggravated by the statement of the prime minister that the decision on the procedure of OGK auctions would be postponed until the end of the year.

The market was saved from a heavy fall at the end of the year by interest on the part of stock exchange players in Gazprom after the decision on merger with Rosneft had been made. If carried out successfully, the transaction would have brought the liberalization (namely the lifting of restrictions on purchase of securities by non-residents) of the gas monopoly closer, plus it was Gazprom that most of the market players viewed as the eventual new owner of Yuganskneftegaz.

In 2004, the opinion gained strength that the government had no clear strategy for further developing the Russian

financial system, and that actions of government officials were inconsistent. Although certain progress is visible in the banking sector from year to year, the situation with the stock market is worse. While a large inflow of export revenue helps maintain a fairly decent rate of national economic growth, the problems remaining in the securities market and the banking, pension, and insurance sectors are less evident, although they seriously hinder an increase in foreign investment. In the future, the harm from unresolved problems will gather momentum; without adhering to the policy for developing the financial sector, Russia will begin to lose its investment appeal, even in comparison to other emerging markets.

*In general, the banking system remained stable in 2000 – 2004, with its functional role in the economy having increased. In many parameters (size of assets, loans, borrowing, capital, and lending volume) the banking system not only met, but exceeded pre-crisis levels. One could forecast that the growth rate in the banking sector will continue over the next few years, regardless of more intense competition and reduced profitability of many traditional types of banking activity. The causes of destabilization seen in the banking sector in the second quarter of 2004 are related to the fundamental discrepancies in the Russian economic system, and also are an indication of the "growing pains" of the banking sector. In 2004, financial markets were unstable. The reasons for that lay in fluctuating preferences of economic agents, which were caused by increased risks related to uncertainties of the government's actions in the economy, banking sector instability in the second quarter of 2004, intense growth of banks' foreign assets, and changes in the trend of the nominal ruble rate.*

# Electric Industry Reform

The goals of the reform of the electric industry are to increase the efficiency and investment appeal of the industry and reduce the costs for consumers of utilities services while reliably satisfying consumer demand. The industry requires radical restructuring to become attractive for investment, efficient and reliable in the long term.<sup>43</sup>

Unlike 2003, which saw such landmark changes in the electric industry as the launch of the “5-15 Market” and the adoption of the *Law Concerning the Electric Industry*, 2004 was more of a year for steady, gradual development, with no radical changes to be seen.

Throughout the year, the competitive free trade sector launched in November 2003 (the “5-15 Market”) operated successfully. As of December 1, 2004, 108 participants had signed on to the trading system; of utmost importance is that 35 of them are entities independent of RAO UES of Russia. By the year's end, the proportion of the free trade sector was approximately 8% of the total consumption in European Russia and the Urals (areas engaged in the free trade sector).

A study was begun for a new approach to the regulated segment of the wholesale market, proposing the transition to a system of regulated long-term contracts containing the price formula, primarily dependent on forecast price indices. Such transition will help make electricity tariffs more predictable, attracting investment to the electric industry and industries represented by major electricity consumers.

During 2004, the scheduled division of the regional electric companies by type of activity and the establishment of new electric industry entities continued. The restructuring of the regional electric companies (AO Energos) includes two subsequent phases. The first phase involves splitting the companies by type: generating, grid, and distribution; the second phase involves the combination of the newly established companies into inter-regional entities with single core activities (generation, transportation, or distribution). As of December 1, 2004, projects to reform 52 AO Energos had been approved. The process of division by type of activity has already started in most of the AO Energos and state registration of a number of new companies created by spin-off from AO Energos was completed. Thus, the separation of vertically integrated electric companies into competitive entities and natural monopolists is proceeding apace, as proposed by the reform strategy.

Significant steps were made towards creating wholesale and territorial generating companies (OGK and TGK, respectively) in 2004. For instance, the board of directors of OAO RAO UES of Russia approved the configuration plan for TGKs and accelerated plans for the addition of regional generating assets to them on a lease basis. Also, decisions to establish all six OGKs have been approved, and two of them have received state registration. In addition, the Russian government signed an instruction to establish a single Hydro-OGK, which will incorporate all hydro-generating assets earlier planned for allocation among four wholesale generating companies.

Establishment of infrastructure facilities in the electric industry continued, including creation of inter-regional transmission and distribution grid companies, and transfer of dispatching functions from AO Energos to regional dispatching entities, which are divisions of OAO SO-CDU UES.

Another important event of the last year was the restructuring of parent company OAO RAO UES of Russia itself, designed to transition the company from its previously existing functional structure, which focused primarily on preventing crises in the electric industry, to a divisional structure oriented towards sustainable functioning of the electric system. The new structure of the company includes a corporate center responsible for general strategic issues of the company's development, a reform management center in charge of all the processes of reform underway in the electric industry, and business units that manage the routine operation of subsidiaries under their supervision.

Investors were to a certain extent disappointed with the government's lack of resolve with regard to making a final decision on the procedure and timing of the sale of generating assets.<sup>44</sup> At the end of the year, however, the government, though omitting to respond to these key issues, clearly emphasized its commitment to the reform of the electric industry. According to government statements, RAO UES of Russia must cease to exist by the end of 2006, which means that a new structure of the electric power market will have to be put in place by that time.

<sup>43</sup> Currently, the electric industry remains one of the few sectors of the economy where government regulation of prices still exists. This has resulted in the continued, inertial growth of tariffs against the background of inefficient performance of the industry and weak attraction of private investment. This prevents the development of the industry, leading to an increased number of dilapidated production facilities and hindering the introduction of state-of-the-art technologies, which may adversely affect the sustainable development of the industry in the long term. The situation inherently necessitates the timely reform of the electric industry.

<sup>44</sup> Among the key challenges in the reform of the power industry are numerous conflicts of interest, manifesting themselves in the huge number of discussions on the reform accompanying the development of the necessary laws and regulations, and the incredible resistance that the draft laws must surmount in the process of becoming law.

As of today, it may be stated that regardless of the many problems<sup>45</sup> and obstacles related to reforming such a complex industry, the implementation of the transformation process continues as planned. Great hopes are vested in 2005, during which most of the new entities of the electric industry will have to be established, the rules for the sale of wholesale and territorial generating companies defined, and development of the competitive sector of the wholesale market continued.

*Delay in completing the reform of the electric industry will have a negative*

*impact in terms of both the late launch of the electricity market and the growth of the tariff burden on Russian electricity consumers due to retention of regulated tariffs undeterred by competition. It should be noted that the liberalization of the electric industry without provision of competitive conditions will result in a high concentration of production and a surge in electricity prices, which will not provide sufficient incentive to invest in the electric industry on a large scale, and which will prevent the economy from growing. It should also be noted that without attracting investment in the*

*electric industry, there is a real threat of a shortage in generating capacity in the long term (after 2010), which will also result in a drastic increase in electricity prices. At the same time, there is still uncertainty as to the reforms in the gas industry and the housing and utilities sector, both closely related to the electric industry. To some extent this may reduce the efficiency of the electric industry reform. By all appearances, the reform of the electric industry is sure to be the most painstaking in the process of restructuring the Russian economy, although it must in any case be done.*

## WTO

For the past decade, accession to the WTO has been one of the strategic tasks Russia has set for itself. Membership in this organization will radically change the conditions of Russia's foreign economic cooperation. This step will help create more beneficial terms<sup>46</sup> for positioning Russian goods and services, and financial and human capital on the global market. It will also enhance the investment appeal of the national economy and ensure more favorable terms for protection of consumer rights.

The negotiation process has sped up since 2001, having almost reached the final stage. Russia has done impressive preparatory work to join the WTO, having brought much legislation into full or partial compliance with the WTO requirements.<sup>47</sup>

The current stage of the process includes bilateral discussions with WTO members on specific terms of granting access to suppliers of certain products and services from member countries to the Russian markets, on agriculture, and non-tariff barriers. By March 2005, 26 rounds of negotiations had been completed within the working group on Russia's accession to the WTO. Significant progress was made during these negotiations, including agreements being reached on disputed standpoints with such crucial opponents as EU, China, and US.

An outstanding issue is piracy in Russia, a very serious matter for individual copyright holders – regardless of nationality – and for the country as a whole. Without strong copyright protection, companies and industries are unable to reach their full potential.

Manufacturers, distributors and sellers of pirated digital products (CDs, DVDs, CD ROMs) from Russia's growing number of unregulated CD plants are the largest copyright violators, and because of lax enforcement of copyright laws the problem has significantly worsened in the past few years. Piracy rates are exceptionally high in Russia. This situation must be addressed – both to save a floundering local industry and to achieve compliance with the WTO/TRIPS obligations. Development of laws and practices consistent with WTO standards will also remove a major obstacle to Russia's WTO accession.

In most cases, between 80% and 90% of negotiating positions have been settled,<sup>48</sup> so there is a good chance that the negotiation process will be accomplished within the next year; however,

<sup>45</sup> Significant uncertainty remains with regard to the timeframe of implementing the key measures of the reform, which would create a totally new economic environment in the electric power industry, including the issue of full liberalization of prices in the wholesale and retail electricity markets.

<sup>46</sup> So far, the Russian economy has gained little from the potential reallocation of labor and capital in the global economy. For the past 15 years it has been donating to other economies, which is confirmed by the sustainable outflow of capital and relocation of a significant number of skilled and educated professional abroad. Russian exports face considerable difficulties and restrictions to enter new markets.

<sup>47</sup> These include a new version of the *Customs Code*, *Laws Concerning Currency Regulation and Currency Control*, *Concerning Fundamentals of State Regulation of Foreign Economic Activity*, *Concerning Special Protective, Anti-Dumping*, and *Compensation Measures in Importation of Goods*, *Concerning Customs Tariff*, as well as amendments to laws regulating a number of other issues.

<sup>48</sup> Positions on the agricultural produce market, aircraft, cars, and a number of other goods and services remain unsettled. In addition, participants in the negotiation process are critical of excessive requirements to imported goods in the area of non-tariff measures (alcohol, pharmaceuticals, etc.), as well as sanitary, phyto-sanitary, and certain other standards. <http://www.wto.ru/russia.asp?f=dela&t=11>

this is a political decision to a large extent, so there is a probability of delay in reaching a decision on Russia's accession to the WTO.

It should be noted that changes in the trade regime forecast in relation to the accession to the WTO will not lead to significant changes in the tariff system, and no materially adverse effect is expected for the Russian economy in general. Of critical importance will be the competitive edge of companies at the micro-level, and their ability to adapt to the open-market environment. The key trends of economic development will be determined by the overall progress of the economy, not factors related to Russia's accession or non-accession to the WTO.

Experts believe that the industries that will suffer most significantly following the country's accession to the WTO in terms of import vs. domestic production will include meat and dairy, microbiology, chemicals and pharmaceuticals, and car manufacturing. It should be noted, however, that the products of the car manufacturing industry lie within a narrow competitive range, and will continue to become less attractive to consumers whether or not accession to WTO takes place – if income continues to grow and the ruble continues to appreciate.

*The key long-term objectives of the Russian government include further successful integration into the global system of labor division and assistance in the*

*structural rebuilding of the economy as critical stipulations for the stability of the economic system and acceleration of economic growth. In order to successfully integrate into the global economy and to enhance foreign economic cooperation and trade, Russia must participate in the global system of legal economic regulation, including, inter alia, WTO membership. It appears that most of the conceptual issues causing differences between Russia and WTO-member countries have been settled. The remaining issues belong more to the political domain. It should again be stressed that the existing differences with WTO-member countries will be ironed out if liberal reforms to the Russian economy are comprehensively accomplished and the investment climate improves.*

## Conclusion

The Russian economy and society are entering a part of their history that demands responsible decisions. The existing model of economy, oriented towards the export of natural resources, will continue to develop as long as global market conditions remain favorable; however, its growth rate is declining and it is unstable in the longer term. There are social problems, which threaten the future of the country and society, unless conditions are created in the immediate future to enhance the well-being of the population, overcome poverty, and secure conditions for human capital development.

Generally, the past year saw little or no significant progress with regard to improving the entrepreneurial and investment climate in the country, nor of strengthening the mutual trust

between the business community and the government. Business is still cautious of the government's policies, and any negative trends (problems in the banking sector discovered this summer, negative information concerning redistribution of property, or even rumor and speculation in that respect, as well as inefficient measures aimed at fighting corruption and other criminal phenomena) adversely affected entrepreneurial investment activities.

Should the conservative trend prevail (as is presently the case), there may be attempts to postpone the reforms until later, since macroeconomic and financial stability, given high oil prices in the global market, do not provide appropriate incentives for resolute reform actions on the part of the authorities, nor do they motivate different government structures to reach compromise.

As has been the practice, most reforms in Russia are implemented as a response to the worsening condition of the economic system, rather than being implemented proactively. And this carries the risk of further slowing the process of reforms in Russia in the near future.

There is currently a window of opportunity to promote reforms, which has been created by the beginning of the political cycle, the high level of popular confidence with the president's actions, and the lack of noticeable political opposition to any government actions whatsoever. It appears that the Russian leadership has sufficient responsibility to take advantage of this opportunity to make important (albeit sometimes unpopular) decisions on reforms, as these are in the interest of long-term national development.



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