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Regional Issues, Banking Reform and Related Credit Risk in Russia

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Executive summary

The last decade of the past century has been dominated by growing decentralization in Russia, both in economic and political terms. The major factors driving decentralization were the weakness of the federal government and of President Yeltsin, as well as the poor performance of the federal budget. As a consequence of decentralization, economic policy in Russia was increasingly determined at the regional level, resulting in economic fragmentation and in numerous barriers to the movement of goods and production factors. Although the economic upturn and the relative political stability which returned to the country with the election of President Putin have halted the separatist regional trends, interregional economic barriers are still substantial.

The enormous disparities across Russian regions observed nowadays are partly linked to the inherited economic structure and the varying ability of different branches to respond to the shocks of transition, but also to the policies of regional administrations. On the one hand, raw materials extraction and exporting continue to bring most revenues, benefiting the few richly endowed regions. On the other hand, whereas in many areas of central Russia a still unreformed and uncompetitive manufacturing sector (including defence production) is a major factor behind depressed incomes, some regions have been relatively successful in their restructuring efforts, often via creating an attractive investment environment. The 'core' area in terms of attractiveness for investors includes the axis Moscow – St. Petersburg, as well as the axis stretching from Moscow eastwards. The regions possessing the highest investment potential and offering the minimal investment risk in 2002 can be summarized as follows.

Regions ranking the highest in terms of investment potential		*Regions ranking the lowest in terms of investment risk*	
1	*City of Moscow*	*1*	*Novgorod region*
2	*City of St. Petersburg*	*2*	*City of Moscow*
3	*Moscow region*	*3*	*Moscow region*
4	*Khanty-Mansi autonomous area*	*4*	*Yaroslavl region*
5	*Sverdlovsk region*	*5*	*Belgorod region*
6	*Samara region*	*6*	*Orel region*
7	*Krasnoyarsk territory*	*7*	*Nenets autonomous area*
8	*Nizhny Novgorod region*	*8*	*City of St. Petersburg*
9	*Republic of Tatarstan*	*9*	*Republic of Tatarstan*
10	*Krasnodar territory*	*10*	*Leningrad region*

Over the period following the 1998 crisis, the Russian banking sector has recovered substantially, with assets, market capitalization, and the volumes of both deposits and loans all rising in real terms. However, banking assets still correspond to just 39% of GDP – much below the levels observed in most Central European transition countries. The banks' capitalization of 6% of GDP, the volume of credit to the real economy of 15% of GDP, and the volume of household deposits of 10% of GDP are all signs of the sector's under-development. The bulk of loans is extended to raw materials' exporters, whereas smaller enterprises' access to credit is often restricted. In addition, the role of bank loans in financing fixed capital investment is negligible. All this points to the inability of the banking sector to provide efficient financial intermediation in Russia.

On the one hand, this is due to the narrow deposit base – a legacy of the 1998 crisis and the long-standing capital flight, which may have resulted in a cumulated outflow of some USD 250-300 billion. Most households still prefer to keep their savings in foreign cash, although the developments of recent months could be interpreted as a sign of a possibly coming turnaround. Also, it is hoped that the implementation of a deposit insurance scheme starting from 2005 will be helpful in attracting private deposits.

On the other hand, lending is constrained by the numerous legislative and regulatory deficiencies, such as the impossibility to enforce a collateral, the cumbersome regulations accompanying lending to small businesses, the absence of credit bureaus, etc. Although the Central Bank seems to be committed to enacting the necessary changes and has elaborated a comprehensive programme of reforms accompanied by a strengthening of the banking supervision, this is not going to be a smooth process. In particular, the planned transition to IAS will entail a number of problems. Besides, although the state will probably succeed in selling off its numerous stakes, the sector will remain uncompetitive as long as Sberbank, which now accounts for 67% of private deposits and is the only bank present in all Russian regions, dominates. In Russian circumstances, a way to encourage competition is to promote the consolidation of the more than 1300 banks, most of which are tiny and essentially represent treasuries of affiliated industrial enterprises. The interest of foreign banks to enter the Russian market seems to be limited so far, notwithstanding several liberalization measures undertaken recently. Disagreement over the degree of openness of the banking sector remains, along with the level of prices of energy, a major stumbling block in Russia's WTO negotiations.

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JEL classification: *G2, O5, P2, R1*

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I Regional structures in Russia and the regional credit risk rating

1 Evolution of 'centre–regions' relations in the context of political developments in the post-Soviet Russia

1.1 Features of the federative state structure

One of the ideas underlying the efforts of liberal forces (who were in power in Russia in the early 1990s) to accelerate the disintegration of the Soviet Union has been the conviction that a smaller country was easier to reform. However, the Russian Federation itself, having a territory of 17 million square kilometres and a population of 145 million, is an extremely big and diverse country. According to the constitution adopted in 1993, Russia has a complex federative structure, consisting of 89 'subjects of federation', including 21 national republics, 49 regions (oblasti), 6 territories (krais), 1 autonomous region, 10 autonomous areas (okruga) and 2 cities of federal importance: Moscow and St. Petersburg. This structure, with all its borders, is almost identical to the territorial structure inherited from the Russian Soviet Federative Socialist Republic (RSFSR), which was a part of the USSR. Most national republics are situated in the Northern Caucasus, the Volga area or Southern Siberia. Originally, national republics and autonomous areas were formed according to the ethnic principle; despite that, only in 7 national republics and 2 autonomous areas does the titular nation exceed 50% of the population, and in 12 republics and 2 autonomous areas ethnic Russians represent less than 50% of the population.[1] Autonomous areas tend to be smaller than republics in terms of population. The remaining 'subjects of federation' – regions and territories – reflect a merely administrative division, with territories being normally larger than regions, and located on the periphery of the country.

From now on, for the sake of convenience, the 'subjects of federation' will be referred to simply as 'regions' in a broad sense. Since 2000, all regions are grouped according to the geographical principle in seven 'federal districts', created in order to facilitate the governance of the country.[2] Tables 2 to 8 of the Appendix give an overview of the federal structure of the country and present some general and economic indicators, indicators of living standards, as well as data on budget performance, foreign trade and investment by region. Table 2 demonstrates that regions vary by an enormous degree when it comes to both population and economic potential, the two extremes being Moscow (with its population of 10.4 million and a gross regional product, GRP, of USD 55.6 billion) and the

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1 Over 100 nationalities live in present-day Russia, but ethnic Russians constitute some 83% of total population.

2 There are seven federal districts: Central (with the centre in Moscow), Northwestern (St. Petersburg), Southern (Rostov-on-Don), Volga (Nizhny Novgorod), Ural (Yekaterinburg), Siberian (Novosibirsk), and Far Eastern (Vladivostok).

Evenki autonomous area in Siberia (with a population of 18 thousand and a GRP of USD 31 million).

Although the federal constitution stipulates equal status of all regions, they enjoy different degrees of autonomy. National republics are entitled to pass own constitutions and elect presidents – a privilege not enjoyed by other regions. In turn, 9 (out of 10) autonomous areas, though being separate subjects of federation, constitute at the same time a part of another (larger) region: either oblast' or krai. The subordination of autonomous areas to another region is a legacy of the Soviet territorial structure. It has created considerable legislative chaos with plenty of room for interpretation as far as power and budgetary relations between the involved territorial units are concerned. De facto, these relations are regulated by individual power-sharing agreements, as are (in many cases) the relations between the federal centre and the regions. Depending on the terms of the power-sharing agreement, the actual degree of autonomy allocated to the region varies considerably, complicating the federal structure of Russia still further.

1.2 Decentralization under Yeltsin

The last decade of the past century has been dominated by growing decentralization in Russia, both in economic and political terms.

Originally, political decentralization took its roots as early as 1990 in the appeal of Boris Yeltsin to the regions, 'Take as much sovereignty as you can'. At that time, Yeltsin was the chairman of the Russian Supreme Council (i.e. the RSFSR parliament), which had just declared the republic's sovereignty from the Soviet Union. Initially, the deliberate effort of the Russian leadership to strengthen the regions was aimed at undermining the powers of the USSR leadership, including President Mikhail Gorbachev. Later on, during most of the 1990s, this policy helped Yeltsin and the weak federal government to find support among the regional elites represented in the Federation Council (the upper chamber of the parliament)[3] and thus to counterweight the opposition-minded Duma (the lower chamber).

As separatist movements were gaining momentum, two regions – Tatarstan and Chechnya – abstained from signing the Treaty of the Federation on 31 March 1992. Instead, Tatarstan – the economically strong Moslem republic on the Volga – held a referendum in which the majority supported the idea of the republic's sovereignty, and the Tatar constitution adopted in November 1992 declared the republic 'a sovereign state and a subject of international law'. Neither did it participate in the all-Russia parliamentary elections and the constitutional referendum in December 1993, following the controversial

[3] Each of the 89 'subjects of federation' sends to the Federation Council two representatives – from the legislative and the executive branch of power, respectively. Therefore, the Council has 178 members.

dissolution of the parliament by President Yeltsin in September 1993.[4] Although the new constitution approved at the referendum provided equal status to all 89 subjects of the Russian Federation, in reality the relationship between the federal centre and the regions was increasingly regulated by individual power-sharing agreements. The republic of Tatarstan was the first to sign such an agreement in February 1994, providing extensive powers to the regional political elite, including preferential rights for the use of natural resources, to retain a substantial portion of collected tax revenues, pursue an own foreign economic policy and engage in international activities.[5] Several other republics soon followed suit, among them Bashkortostan, Yakutia-Sakha, North Ossetia-Alania and Udmurtia.

The proliferation of power-sharing agreements concluded between ethnic republics and the federal centre was a recognition of the weakness of the latter, but it also proved a successful tool to dampen the nationalist and separatist aspirations of the former.[6] However, soon afterwards the federal centre embarked upon signing power-sharing agreements even with the Russian-dominated administrative regions *(oblasti)*, who demanded an equal status with the national republics. Sverdlovsk region governor Eduard Rossel was at the forefront of this movement, and it is little wonder that Sverdlovsk region became the first *oblast'* to sign a bilateral treaty with Moscow in January 1996. The popularity of Rossel and his substantial influence even at the federal level were largely due to his position of advocating the so-called 'regional associations', aimed at restoring at the sub-federal level inter-regional economic ties, many of which had been lost in the wake of the USSR break-up. In the early 1990s, regional associations (12 such associations had been formed) had been encouraged by Moscow – until they began to be perceived as a threat to the existing territorial structure of the country. This was especially the case with the Greater Urals association, of which Eduard Rossel was the leader, and which he tried to transform into a sovereign Urals Republic. The idea of such a republic had been approved in a Sverdlovsk region referendum in April 1993 by more than 80% of voters.[7]

Overall, between 1994 and 1998, 47 agreements regulating the division of powers between the federal and regional political elites were signed – either with the national republics or with the economically strong Russian-dominated regions. A particularly large number of such agreements was signed during 1996, as the federal centre was seeking the support of regional authorities in the coming presidential elections, which promised (and indeed turned out) to be difficult for the incumbent president. Tolerated by Moscow,

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4 See Vardomskiy (2000).

5 See Osteuropa-Institut München (1999).

6 Chechnya is an obvious exception to this statement, as it became *de facto* independent immediately following the break-up of the USSR in 1991. It was not until the end of 1994 that the federal centre decided to fight the Chechen separatism, launching a long-lasting conflict which continues up to now.

7 See Nelson and Kuzes (2003).

the legislation of many regions became increasingly incompatible with federal laws. By 2000, the constitutions of 19 republics (out of 21), 29 regions (out of 49) and 4 autonomous areas (out of 10) had provisions contradicting the federal constitution or other federal laws.[8] The constitutions of some republics (Bashkortostan, Yakutia-Sakha, North Ossetia-Alania, Tyva and Ingushetia) explicitly stipulated that the power-sharing agreement between the respective republic and the federal centre enjoys priority over the Russian constitution. These agreements varied in their terms, but typically provided the region with the right to impose own taxes and levies and pursue an own foreign and foreign economic policy. Besides, many regions unilaterally set the share of tax payments to the federal budget, depriving the federation centre of a substantial part of its revenues (for diverging regional economic policies, see sections 2.2 and 2.3).

Tatarstan has generally remained a front-runner when it comes to the degree of the region's independence from Moscow. It has been active in strengthening its ties with Islamic countries, such as Turkey, the United Arab Emirates, Jordan and Egypt (where the Tatar president Mintimer Shaimiev was received as head of a sovereign nation-state), and has also initiated contacts with several international organizations. In the course of the 1990s, it opened 16 missions abroad and signed over 50 various international agreements on economic co-operation, trade, science, technology, culture or education. An agreement on friendship and cooperation concluded between Tatarstan and Abkhazia in 1994 provoked a harsh reaction from the federal centre, as it was out-of-line with the official position of Moscow vis-à-vis Georgia.[9] In 1999, the State Council of Tatarstan voted for a declaration criticizing the Russian decision to send peacekeeping troops to Kosovo – a declaration also supported by Presidents Rakhimov (of Bashkortostan) and Aushev (of Ingushetia). Tatarstan also refused to send conscripts from its territory to both Kosovo and Chechnya. Later the same year, as the prospects of re-integration between Russia and Belarus appeared more realistic, both Tatarstan and Bashkortostan claimed that they would demand a status of fully-fledged members in the new union, should the latter materialize.

The considerable shift in the balance of power in favour of the regions observed over the 1990s had its implications for the political process at the federal level as well, particularly after the federal centre had been further weakened by the 1998 crisis. In 1999, when the dangers of the looming disintegration of the country became apparent to the federal authorities, the Russian parliament passed a law stipulating the priority of federal laws over the power-sharing agreements and the Treaty of the Federation. However, in practice, nothing has changed; on the contrary, several regions passed additional legislation contradicting federal laws. Also, the year 1999 saw the rise of the left-of-the-centre political

8 See Schneider (2000).

9 See Sharafutdinova (2003).

formation called 'Fatherland-All Russia', led by two of the most powerful Russian governors: Yuri Luzhkov (mayor of Moscow) and Mintimer Shaimiev (president of Tatarstan), as well as by the popular former prime minister Evgeni Primakov. In 1999, many other governors opted to join this coalition, which was often predicted to win the parliamentary elections in December 1999 and the presidential elections in March 2000. The political turnaround came unexpectedly in autumn 1999 with the foundation of the 'Unity' party, which was masterminded by forces close to President Yeltsin and his 'family' and was designed to promote the then unknown prime minister Vladimir Putin to presidency, thus ensuring the continuation of Yeltsin's policies. Needless to say, the subsequent developments showed the success of 'Unity' at the parliamentary elections and of Putin at the presidential elections, which, coupled with the improved economic performance, brought about a profound reshuffling of relations between the regions and the federal centre.

1.3 Re-centralization under Putin

1.3.1 First attempts of re-centralization

One of the priorities announced by the new president Vladimir Putin in 2000 was the creation of a uniform all-Russia legal and economic space, indispensable for raising the transparency of the country's bureaucracy and conducive to economic growth. In order to achieve this goal, the federal centre could not but encroach on the powers of the regional political elites.

A major reform initiated for this purpose in May 2000 was dividing the country into seven 'federal districts', each district headed by a 'plenipotentiary representative' appointed by the president (presidential 'envoy' for short). Although there was nothing new about the institution of presidential envoys as it stands (Article 83 of the Russian constitution contains a respective provision), their powers have been considerably re-defined. Under President Yeltsin, presidential envoys had existed in each 'subject of federation', but had had very little influence on things happening in the region. This time, a presidential envoy was supposed to supervise the whole federal district and was particularly charged with strengthening the federal vertical of power, ensuring the compatibility of federal and regional legislations, facilitating the economic development of the district, and coordinating the federal offices of power. In addition, the presidential representatives became members of the federal Security Council.[10] Five of the seven envoys selected by the president had their background in the military or other 'power ministries', initially raising concerns about a possibly coming dictatorship both among the liberal part of the Russian society and

[10] The Security Council is chaired by the President and includes, apart from presidential representatives, the speakers of both parliament chambers, vice prime ministers and power ministers.

abroad.[11] These concerns were re-enforced by the fact that the newly formed federal districts almost coincided with the long-existing military districts. However, subsequent developments have proved the pessimists to be wrong.

Another move aimed at curbing the political influence of governors included the passage of a number of laws depriving them of access to the Federation Council. For governors, this implied, among other things, an automatic loss of the legal immunity enjoyed by parliament members. Instead, governors were offered membership in the newly formed ‘State Council’, which (having only advising power) presented a poor substitution to the upper chamber of the parliament. Moreover, the federal president obtained the right to fire governors, and the Duma to disband regional legislatures in certain cases, such as in those of repeated federal law violation.[12]

Although the above measures proved successful in halting the separatist and isolationist regional trends, the federal president has been unable to gain full control of the country. The performance of presidential envoys has been mixed. They were involved in a wide variety of activities, but lacked sufficient financial levers to dominate. This was partly due to the federal president himself being hesitant to give them too much power and thus jeopardize the political structure based on ‘mutual checks and balances’, the basics of which had been taken over from the times of President Yeltsin. Also, even though envoys were supposed to ensure that decisions taken at the federal level are implemented in the regions,[13] the federal ministries did not favour the idea of somebody meddling in their activities and were often reluctant to cooperate. The problem was aggravated by the fact that envoys had no formal authority over these activities and, moreover, did not possess sufficient resources to exercise their authority. Although several federal ministries, including the Office of Prosecutor, the Ministry of Justice, and the Ministry of Internal Affairs, indeed re-organized their territorial structures soon after the reform had been launched, the real impact of these changes has been limited.

In a number of regions, the presidential envoys were unable to prevent the (re-) election of governors who were at odds with President Putin. This is true, for instance, for the long-standing communist governor of the Bryansk region, Yuri Lodkin (Central federal district), and the mayor of St. Petersburg, Vladimir Yakovlev (Northwestern federal district). In the Far Eastern federal district, the presidential envoy has succeeded in removing the controversial Primorsky territory governor Vitali Nazdratenko, but proved unable to provide

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11 One of the remaining two envoys was Sergey Kirienko (to the Volga federal district), the former prime minister who had been sacked by Yeltsin during the 1998 crisis. The appointment of Kirienko was widely seen as a concession to the liberal forces, and also supposedly signalled that the fears of a coming dictatorship were baseless.

12 See East West Institute (2002).

13 In many cases, the regional structures of federal ministries had been under the strong influence of governors, often due to their under-financing from the federal budget.

sufficient support to a candidate close to the federal centre. In the Ural federal district, the presidential envoy has remained in the shade of the Sverdlovsk region governor Eduard Rossel and concentrated his efforts on fighting terrorism instead. In the Siberian federal district, the envoy failed to perform as a peace-keeping force in the oligarch struggle between the representatives of two large companies (*Rusal* and *Interros*) for the post of governor of the vast Krasnoyarsk territory, after its former governor Alexander Lebed' had perished in a helicopter crash in 2002.[14] In turn, the presidential representative in the Southern federal district has reportedly contributed a lot to the favourable (for Moscow) outcome of the Chechen constitutional referendum held in spring 2003.

In 2002, substantial efforts were made by the presidential representatives to improve the coordination of power, as they were busy identifying duplication in the work of federal offices in the regions, with the objective of streamlining the overall structure. Among measures initiated by the envoys and aimed at increasing the transparency and accountability of the bureaucratic system were, for instance, the creation of 'reserves of personnel' (a pool of applicants competitively selected for future appointments to the federal agencies), encouraging civic involvement in questions of broad concern (in the Volga federal district), and measures to fight corruption (in the Urals federal district).

In the area of economy, the efforts of several envoys have borne fruit, especially in terms of attracting investments (e.g. foreign investment in the Urals federal district). Furthermore, in some cases, they were able to act more efficiently than governors, as they could put forward economic initiatives at both inter-regional and international levels. In the Central federal district, the presidential envoy has set up a district investment fund providing loans for regional and inter-regional projects at subsidized interest rates and a marketing centre to facilitate economic linkages. Similar initiatives have been recorded at the regional level as well, with envoys often serving as mediators between the governor and the federal authorities (such as in the Voronezh region). In some cases, presidential envoys have defended the rights of investors which were violated by the regional authorities.

Perhaps the most impressive were the achievements of presidential representatives in bringing regional laws in line with the federal legislation; the process was largely completed by early 2002, with more than 5800 regional laws having been cancelled or amended.[15] In many cases, the regional authorities voluntarily agreed to adjust their laws to the federal standard, whereas in others this result was achieved in court. The preferential status of some regions – notably Tatarstan and Bashkortostan – in the distribution of tax revenues has been revoked as well, although the republics have been offered other forms of financial compensation instead (more on that, see below). Also, the law on switching to the

14 *Rusal* is the biggest aluminium producer and *Interros* the biggest nickel producer in Russia.

15 See East West Institute (2002).

Latin alphabet, which had been adopted in Tatarstan in 1999, was suspended and later overruled by the Duma amendments, prescribing Cyrillic script as the only script to be used on the territory of the Russian Federation.

1.3.2 Implications of the current administrative reform

Of crucial importance for the further evolution of the 'centre–regions' relations is the latest comprehensive reform of the country's federative structure, elaborated by the deputy head of the presidential administration, Dmitri Kozak. One of the two relevant pieces of legislation – amendments to the law 'On government bodies in the subjects of federation' – entered into force on 8 July 2003, whereas the other bill – 'On local self-governance' – has been approved by the Duma in the second reading, with the third (and final) reading being scheduled for autumn 2003.

This legislative package deals with reforming the bodies of power at the regional (sub-federal) and local (municipal) levels effective from 2005 and 2006, respectively.[16] Most importantly, the package envisages the badly needed division of powers among the federal centre, regions and municipalities. According to the package, regions and especially municipalities will be granted more independence, although a number of regions will lose some privileges they currently enjoy. The law 'On government bodies in the subjects of federation' gives regions additional legislative powers in a number of areas, including the social sphere, education and health care, and will hopefully help establish a stable financial basis for the regions.[17] At the same time, some provisions of the law represent a heavy blow to the power-sharing agreements between the federal centre and the regions which mushroomed in the course of the 1990s (for details, see section 1.2). In particular, the duration of validity of a power-sharing agreement is set at ten years, although it can be renewed, provided neither party wishes to withdraw. Furthermore, the law allows to conclude power-sharing agreements between the federal centre and the region only in 'exceptional' cases, i.e. only when specific economic, geographic or other regional conditions justify the conclusion of an agreement deviating in its terms from the federal law. According to the recent statements of leading federal officials, it seems that only Chechnya may qualify as an 'exceptional' case, although the prospects for this status are as of now still very uncertain.[18] Besides, the law prescribes a possibility of transferring regional competences to federal bodies of power in cases of (a) a natural calamity, (b) misappropriation of federal subsidies, and (c) overdue debt exceeding 30% of annual

[16] Initially, the draft law 'On local self-governance' was planned to become effective in 2005 as well. The reported reason for the delay is the necessity to complete the re-shuffle of municipality borders.

[17] See *Strana.ru*, www.strana.ru, 1 July 2003.

[18] The draft power-sharing agreement elaborated recently by the acting Chechen president Akhmad Kadyrov and envisaging, among other things, a joint foreign policy and a right to open Chechen representations abroad, has triggered sharp criticism from the federal authorities.

regional budget revenues. In the latter case, a temporary external (i.e. federal) financial administration can be imposed.[19]

In turn, the draft law 'On local self-governance' defines and expands the powers of municipalities. In line with the three-tier structure envisaged in the bill, some 20 thousand new municipalities will be formed (in addition to the 11.5 thousand already existing), resulting in a 2.5 times increase in the number of municipal legislative bodies.[20] Also, municipalities will obtain the right to hire managers for the post of head of administration. For the first time, their spending obligations will be (hopefully) covered by own sources of revenues. Although at present municipalities are assigned certain shares of a number of federal and regional taxes (e.g., 2 percentage points of the federal profit tax, 50% of the regional enterprise property tax, and 60% of the sales tax),[21] and also have their own taxes (e.g. tax on advertising), in reality they are heavily dependent on discretionary transfers from the regions. A number of assets, including notably housing, land, local roads and household utilities enterprises, will be denationalized and handed over to municipalities as well.[22] Furthermore, the bill envisages a system of fiscal federalism at both municipal and sub-municipal levels (e.g. between urban and rural settlements, which are constituent parts of larger municipalities).[23]

The two laws regulating the sharing of power between the levels of government cannot become fully operational until the distribution of budget revenues is defined. For that, the Tax Code and the Budget Code will have to be amended. However, the Ministry of Finance, which was supposed to submit such amendments to the Duma before the summer vacation, has failed to do this so far.

The new legislation is part of a more comprehensive reform effort aimed at streamlining the country's administration and 'optimizing' the administration-related expenditures of the federal budget, the stated ultimate goal of the reform being to ease the bureaucratic burden on businesses. The latter is also the idea behind the occasionally re-appearing proposal, coming from the presidential administration and supported by the liberal Union of Right Forces (SPS) party, to reduce the total number of 'subjects of federation'. For instance, after a recent government session in May 2003,[24] Dmitri Kozak advocated that there should be no more than 40 regions in Russia (instead of the present 89).[25] The first

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19 See Ministry for Economic Development and Trade, www.economy.gov.ru.

20 The powers of presidential representatives might be expanded accordingly, in order to supervise municipal activities.

21 See Panskov (2002) and Alexeev and Kurlyandskaya (2003).

22 See *Strana.ru*, www.strana.ru, 28 January 2003.

23 See Ministry for Economic Development and Trade, www.economy.gov.ru.

24 See *RFE/RL Newsletter*, 2 June 2003.

25 The proposal put forward by one of the SPS leaders, Irina Khakamada, is even more radical, envisaging the creation of 12 'subjects of federation' on the basis of the 12 currently existing inter-regional economic associations.

reactions of regional officials to Kozak's proposal seem to suggest that at least regions, which are the net recipients of federal transfers, will not oppose merging with the 'donor' regions.[26] However, regional mergers are only possible on the initiative of the regions themselves, conditional on the outcome of referenda held in the regions involved, and are to be approved by the Federation Council. President Putin has also reiterated that no changes in the territorial structure of the country would be imposed from above. So far, there have been only two cases of regions (more precisely, regional political elites) expressing a mutual desire to merge: (1) the Chita region and Aginski Buryat autonomous area, and (2) the Perm region and Komi-Permyatski autonomous area. However, the mergers will take several years to complete.

2 Economic standing of Russian regions

2.1 Economic fragmentation and the pattern of disparities

Russia has inherited from the Soviet Union an economy whose regional structure is related mainly to geographic factors such as availability of natural resources, proximity to consumer markets, and distribution of population. 80% of the population living west of the Urals are largely involved in manufacturing while the remaining 20% living in the vast areas of Siberia and the Far East provide generally raw materials and intermediate products to be further processed in the western parts of the country. Within the European part, the centre and northern territories are clearly dominated by industry whereas the Northern Caucasus and the so-called 'Black Soil' region (southern part of the Central federal district bordering Ukraine), which enjoy more benign climatic conditions, have a higher share of agriculture.

The transition shock that hit Russia in the 1990s, with its price liberalization, massive cuts of subsidies, and opening markets to foreign competition, had different effects on the individual regions, bringing about an increase in the already substantial economic divergence which has accompanied the above-mentioned political divergence. The existing economic structure played a decisive role in the adaptation of a particular region to the new environment, but the policy of the regional administration over the years of transition mattered as well.

The pattern of economic disparities across the Russian regions can be derived from the various indicators presented in Table 3 of the Appendix. The most relevant indicator for our

[26] For instance, the governors of the 'recipient' Voronezh (Central federal district) and Pskov (Northwestern federal district) regions do not rule out the possibility of their regions becoming parts of larger units, including, respectively, the 'donor' Lipetsk region and the city of St. Petersburg.

purpose is Gross Regional Product (GRP) per capita,[27] the variation of which gives a picture of the enormous differences in the level of economic development. In 2001 (the most recent year for which GRP data are available), the discrepancy in nominal GRP per capita between the richest region (Khanty-Mansi autonomous area) and the poorest region (republic of Ingushetia) reached a factor of 36.7. Chechnya, which is situated next to Ingushetia, is almost certainly even worse off, but is not covered by the statistics. The enormous regional inequality in present-day Russia can be also illustrated by the following figures: just four regions – Moscow, St. Petersburg, Yamalo-Nenets and Khanty-Mansi autonomous areas – account for 34% of Russian GDP, for 31% of fixed capital investment in the country, and for 60% of generated profits.[28]

Generally, the well-off regions comprise two major types. One type is represented by regions endowed with exportable natural resources, whose generally low-value-added branches are able to stand up to foreign competition. The most notable examples are the oil and natural gas extracting Tyumen region in West Siberia (in two of its autonomous areas – Khanty-Mansi and Yamalo-Nenets – the fuel industry accounts for 84% and 96%, respectively, of total industrial output), the Komi republic (including the Nenets autonomous area) in the north of European Russia, and the republic of Yakutia-Sakha in East Siberia, which focuses on non-ferrous metals production and diamonds extraction. All of them tend to have very high GRP per capita figures, some of which exceed RUB 300,000, against the all-Russia average of around RUB 54,000.

However, the real wealth of these regions is likely to be smaller – for two reasons. First, the GRP figures by definition capture the volume of final output produced on the territory of the respective region, which does not necessarily mean that all resulting income is appropriated by its residents.[29] As soon as, e.g., net profits flow to other regions, this represents a loss of wealth to the region in question. The fact that very big companies, such as *Gazprom, Lukoil, Yukos*, etc., dominate the extraction of raw materials in Russia and have their headquarters in Moscow or near Moscow, suggests that this is indeed the case. Also, the high per capita figures partly reflect the tiny population of some of these regions, most notably the small and remotely located autonomous areas (such as the Koryak and Chukchi autonomous areas).

Second, the relatively high incomes reflect the high wages compensating the often severe climatic conditions, and are partly offset by the high cost of living. The data on the subsistence minimum in the fourth quarter of 2002 presented in Table 3 of the Appendix

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[27] GRP has, however, the following drawback: when summed up across all regions, it falls short of the country's GDP, as it disregards the public goods provided by the federal centre to *all* regions (e.g. national defence, foreign policy, domestic security, etc.). Needless to say, it does not take into consideration the shadow economy either.

[28] See *Strana.ru*, www.strana.ru, 29 May 2003.

[29] The issue here is analogous to the difference at the national level between GDP and GNP.

give sufficient evidence of this. No wonder that the subsistence minimum is the highest in the northernmost areas of the European part and Siberia and especially in the Far East. High transport costs, especially those for food (which has a large weight in the consumption basket), clearly play a decisive role in the price level formation here. The Koryak autonomous area, situated on the Kamchatka peninsula, appears to be the most expensive region with a subsistence minimum of over RUB 5000, against the Russian average of just below RUB 1900.

Another type of well-off regions is represented by some most advanced and generally rather centrally located areas, where structural change has been the fastest, and often with a big city as their centre of gravity. This applies in the first instance to Moscow, whose GRP per capita is three times the average Russian level (although the prices are at a level typical of many regions of the Far East). Other regions to be mentioned in this category are the city of St. Petersburg and the Vologda region in the Northwestern district; the Yaroslavl region in the Central district; the Samara, Perm and Nizhny Novgorod regions in the Volga district; and the Sverdlovsk region (surrounding Yekaterinburg) in the Ural district. Given the widespread pro-capitalist and pro-western sentiments in these regions, their administrations have generally pursued reformist and investment-friendly policies and were able to develop the services sector, which now makes up, at least partly, for the declining industrial production. Remarkably, the relatively high nominal figures translate into high real figures, since the price levels (with the important exception of Moscow) are typically quite depressed and do not differ markedly from those recorded in poorer and similarly located regions.

Finally, the well-doing republics of Tatarstan and (to a lesser degree) Bashkortostan in the Volga district represent a mixture of the two above types: on the one hand, they share the features of the advanced reformist-minded regions and have capitals with a population of over one million inhabitants; on the other hand, they are also non-negligible oil producers, which makes them somewhat similar to the regions of the first type.[30]

In turn, the badly performing regions can be broadly classified into two major types as well. One type is represented by the largely agricultural national republics and autonomous areas situated in the Northern Caucasus (e.g. Ingushetia, Adygeya and Daghestan) and in Southern Siberia (e.g. the republic of Tyva, Ust-Ordyn Buryat and Aginski Buryat autonomous areas). In some of them, the statistically captured average money income is considerably below the subsistence minimum, and average money expenditures represent only a fraction of it. These data, while being a sign of under-development, reflect also the widespread reliance on the subsistence economy. In many of these regions, the policies

[30] The oil companies controlled by the governments of these republics – *Tatneft* and *Bashneft*, respectively – are among the biggest vertically-integrated Russian oil companies and are significant oil exporters as well.

pursued by the administration have been rather conservative, not least because of the preferences of the population voting for communists (Volgograd region, Stavropol territory) or nationalists (Krasnodar territory). It is, however, difficult to establish an unambiguous causality relationship between the low level of development and the leftist-oriented public sentiments. Instead, what appears to have emerged is a vicious circle between these two phenomena. The persistent political instability in the North Caucasus – related first and foremost to the still unresolved status of Chechnya, but also to the proximity to other zones of conflict such as Abkhazia and South Ossetia – has surely had an adverse impact on the regional economies as well. Taken as a whole, the Southern federal district – which, apart from a number of national republics, also includes Russian-dominated areas and even million-sized cities: Rostov-on-Don and Volgograd – is the poorest federal district, with a per capita GRP of only half the Russian average.

The second type of poor region is represented by the belt of heavily industrialized regions around Moscow (now part of the Central Federal District). These are typically regions dominated by un-restructured and under-invested manufacturing branches, such as machine-building, often with a high share of defence industry, and lacking big cities which could have become pioneers of structural change. During the years of transition, manufacturing was hit hard, revealing its structural weakness but also the overvaluation of the rouble prior to 1998. Among the branches that suffered most are machine-building, food processing, and especially the light industry – making Ivanovo region (east of Moscow), where the light industry (textiles) still accounts for 36% of industrial production, the most depressed area in this sub-sample. The defence industry has fallen victim to the launched conversion programme, being deprived of a substantial part of state procurement contracts.[31] Many of these regions (Tula, Ryasan, Ivanovo, Bryansk),[32] along with some areas in the Southern and in the Volga districts, still form the so-called 'red belt', i.e. the area governed by 'red' (communist or pro-communist) forces, although the recent efforts of the federal centre to promote the replacement of 'red' governors have borne fruit in a number of cases (e.g. in the Voronezh region). The well-doing Moscow, Lipetsk and Yaroslavl regions are exceptions to the general pattern: the former benefits greatly from its proximity to the capital, the latter has achieved considerable progress in structural reforms (more on that, see section 3.3.2.), whereas the well-being of the Lipetsk region crucially depends on the performance of the giant metallurgical plant located on its territory.[33]

[31] One example of a heavily military-biased region is Kaliningrad region, the westernmost exclave of Russia on the Baltic coast.

[32] See *RFE/RL Newsletter*, 10 June 2003.

[33] The same is largely true for Vologda region, where another huge metallurgical plant, *Severstal*, is located.

2.2 Regional economic policy

The regional economic fragmentation of Russia has undoubtedly been aggravated by the diverging economic policies (or the lack of these) of the individual 'subjects of federation'. Economic policy in Russia was, and to a great extent still is, largely determined at the regional level – another manifestation of the decentralization process.

A number of empirical studies have demonstrated that the 'law of one price', which would be indicative of efficient inter-regional commodity arbitrage, generally does not hold in Russia.[34] This runs against Article 8 of the Constitution, which stipulates uniformity of economic space and free movement of goods, services, capital and labour. Among the frequently mentioned reasons for that are the poor transport infrastructure and the high degree of market monopolization, not least due to criminal activity.[35] However, the primary reason for the failure of the 'law of one price' is the still pervasive regional protectionism, which was particularly fostered by the financial crisis of 1998, with many regions imposing price controls for the main foodstuffs, accordingly limiting or prohibiting their exports to other regions, and some even planning to introduce their own currency. To give just a few examples, Krasnoyarsk territory established at that time extensive price controls on basic goods, the Voronezh region was rationing essential foodstuffs and banned the export of local produce to other regions, while the Komi republic restricted banking activities.

Nowadays, while regional border controls are no longer an issue,[36] local producers are often protected against competition by the various benefits extended by regional authorities, most notably by subsidies, tax benefits, subsidized credits, etc.[37] Also, regional governments sometimes reserve government procurement contracts for favoured enterprises which are based in their region. The degree of price regulation varies across regions, but most regions regulate the prices of basic foodstuffs and pharmaceuticals – products falling under federal price regulation acts. Yakutia-Sakha is even regulating the prices of *all* products and services. As for regional subsidies, the bulk of them is being allocated to agriculture and food processing, as well as to 'one-factory' towns in order to avoid the negative social consequences of a factory's closure. Such subsidies are particularly characteristic of Tatarstan and Bashkortostan, which have negotiated a special status among the Russian regions. Although regulated by federal laws, the collection of customs duties and licensing appear to be subject to considerable discretion on the part of regional authorities as well. For a number of commodities – such as vodka – regional

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34 See e. g. Gluschenko (2002).

35 Anecdotal evidence suggests that it is common for regional mafia structures to offer 'protection' to local producers – and that not only against racketing by competing mafia groups, but also against the competition on the part of producers from other regions.

36 See OECD (2003).

37 Most remaining state-owned industrial enterprises are also run at the regional (or local) level. The important exceptions are fuels, energy, defence industry and the railways.

markets are almost completely isolated. Several regions, including the Leningrad and Pskov regions, Altai and Krasnoyarsk territories, and the Komi republic, are using revenues from excise duties on alcohol products to subsidize their production.

Importantly, insufficient arbitrage is characteristic not only of goods, but also of labour.[38] The limited labour mobility reflects first of all widespread administrative barriers, especially the so-called *propiska* – internal visa required by regional authorities to obtain the right of residence. Although *propiska*, which dates back to Soviet times, is formally illegal under the federal law, it is still widely applied. In the city of Moscow, *propiska* regulations are especially restrictive. The right of residence for people from other regions crucially depends on the 'construction of dwellings', which means in practice that in order to become a resident of Moscow, one has to buy a flat. The registration of businesses established by 'non-residents' (or with the participation of 'non-residents') is more difficult as well. Besides, in January 1999, the Moscow administration stated that local labour force enjoy priority over foreign and 'non-resident' workers in the construction industry. Many other regions impose restrictions on the movement of labour as well. For instance, in Krasnodar territory the right to stay depends on the observance of 'norms of floor space per person', which is assessed by the regional migration commission. In the Magadan region, the local administration decides over the right to reside of people from other regions on the basis of an invitation from the employer, and the Belgorod region has introduced quotas for migrants from other parts of Russia.[39] In addition to administrative regulations, labour mobility is further hampered by housing shortages and liquidity constraints: people from the poorest regions often cannot leave simply because they are unable to finance the cost of moving, not least because of wages being paid in non-cash form. Some empirical studies suggest that up to one third of Russian regions may thus be locked in 'poverty traps'.[40]

2.3 Fiscal developments and inter-budgetary relations

Regional economic inequality in Russia would be much less pronounced if there were an efficient system of fiscal federalism, which would diminish the inter-regional differences in per capita budget levels and thus narrow the resulting discrepancies in living standards. But, as opposed to the growing fiscal decentralization during the 1990s, there is evidence of a reversal of this trend in the past few years. The Budget Code envisages a 50:50 distribution of fiscal revenues between the federal centre and the regions; however, in reality this proportion is not being observed, and the actual distribution of revenues between the levels of budget varies from year to year (see Table 4 of the Appendix). The

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[38] Inter-regional mobility of capital is limited too, as in most cases investors decide whether to invest in their region or abroad.

[39] See RECEP (2002). Interestingly, these policies resemble regulations applied to *foreigners* in some EU countries.

[40] See Andrienko and Guriev (2003).

main factors shaping the actual distribution are, first, the constantly evolving political landscape, especially the changing nature of power relations between the centre and the regions, and, second (and more recently), the ongoing overhaul of the country's tax system.

Under President Yeltsin, regional budgets did receive non-negligible transfers (usually in the tune of 2-3% of Russian GDP) from the federal centre, which, starting from 1995, were channelled largely through the 'Fund for Financial Assistance to Regions' (FFAR) established a year earlier. In addition, while 75% of VAT revenues were allocated to the federal budget, the regions were receiving 'compensating' transfers in return.[41] However, the system of fiscal federalism was not fully implemented (or implemented on a case-to-case basis), proved to be chaotic and arguably even contributed to the aggravation of regional inequality in Russia.[42] In 1993, regional authorities were allowed to introduce own taxes, in order to be able to meet the rising spending commitments. There was no clear definition of spending obligations of budgets at different levels of government, and the transparency of spending was often unsatisfactory. At the root of fiscal decentralization at that time were the political weakness of the federal centre and its long-lasting inability to collect enough revenues and/or adjust expenditures accordingly. By 1996, the share of actually collected taxes plunged to 65% of the planned volume. The erosion of the federal tax base was, on the one hand, due to the economic decline and massive tax evasion; on the other hand, it was also the consequence of concessions granted to (some) economically strong regions. The 'sovereign' republics of Tatarstan and Bashkortostan enjoyed particular tax privileges: in 1993 they did not transfer *anything* to the federal budget, in 1992 just 0.1% of collected taxes, and in subsequent years much less than other regions. For instance, in 1998, Tatarstan and Bashkortostan transferred to the federal budget 11.1% and 17.8% of collected taxes, respectively (as compared to the Russian average of 37.1%).[43] In turn, the Tomsk region (part of the Siberian federal district) suspended transfers of collected taxes to the federal budget during the 1998 crisis until a new federal government was formed. By 1998, the share of federal government revenues had plunged to its low of 12.4% of GDP, whereas expenditures, though having declined as well, still amounted to 18%. As can be seen from Table 4, federal deficits during most of the 1990s were persistently high (reaching 10% of GDP in 1994), while the performance of regional budgets was much more balanced, with deficit never exceeding 1.5% of GDP.

As arrears on payments to the federally-owned enterprises and inter-budgetary transfers were accumulating, the federal authorities were increasingly eager to delegate spending

41 Generally, the easier-to-administer indirect taxes (VAT, excises and customs duties) were either fully or predominantly assigned to the federal budget, while the more 'problematic' personal income tax went mainly to regional budgets.

42 See Dolinskaya (2002).

43 See Vardomskiy (2000).

responsibilities to the regions, most notably subsidies to enterprises and social spending (including education and health care). As a result, whereas the share of the consolidated government in GDP stayed roughly constant during the 1990s (revenues of close to 30% and expenditures of well above 30%), its composition changed in favour of the regions. The share of the regional budgets in the consolidated budget increased in terms of both revenues[44] (from 43.2% in 1992 to 52.5% in 1998) and expenditures (from 40.2% in 1992 to 55.8% in 1997).

However, the general economic recovery which set in following the 1998 crisis and Mr. Putin's accession to presidency in 2000 brought about a reversal to the above trend. As soon as 1999, the federal budget performance improved markedly, and since 2000 it has been invariably in surplus. Initially, this turnaround was driven by an abrupt fall in federal expenditures in real terms due to an outburst of inflation following the 1998 devaluation. As a result, in 1999 the federal budget expenditures stood at a mere 13.8% of GDP and remained at a similarly depressed level in 2000 and 2001. But it is also a rapid increase in revenues that has contributed crucially to the improved performance of the federal government, especially since 2001. First, the budget was replenished by the higher export tariffs on energy carriers introduced in response to the rise in the world prices. Second, a tax reform package was adopted, which was not least aimed at strengthening the federal budget at the expense of regions, in order to shift the balance of power back to the centre and re-install fiscal federalism. Most notably, in 2001 the well-collected VAT was *fully* re-directed to the federal level (instead of 85% in April 1999 to December 2000 and 75% prior to April 1999),[45] whereas regions were assigned 99% of the newly introduced 13% flat personal income tax in 2001 and 100% of it in 2002. Also, in 2002 the unified social tax (used to finance the Pension Fund) was re-directed from the off-budgetary fund to the federal budget, thereby statistically inflating the latter. Last but not least, the privileged position of a number of regions regarding the distribution of tax revenues between the levels of government has been scrapped.

As a result of these developments, starting from 1999 onwards, the share of the regional budgets (without federal transfers) in consolidated revenues was steadily falling and reached a historical low of 37.4% in 2002. However, their share in consolidated expenditures remained stubbornly high (more than 50%) up until 2002, only falling somewhat in 2002. Thus, while the federal government was doing progressively better, the fiscal position of regions has markedly deteriorated. The regional budgets recorded small surpluses in 1999 and 2000, but were in deficit in 2001 and especially in 2002 (see Table 5 of the Appendix), and that notwithstanding the growing transfers from the federal budget.

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44 Without federal transfers.

45 See Panskov (2002).

Over the past few years, the system of fiscal federalism has been markedly upgraded. 1998 witnessed the adoption of the 'Concept of reforming inter-budgetary relations until 2001', followed by the 'Programme of budget federalism development until 2005'.[46] As of now, there are five federal funds serving the purpose and somewhat correcting the recent partial re-distribution of fiscal revenues in favour of the federal centre. In 2002, total federal transfers to regional budgets stood at RUB 319 billion, corresponding to 15.5% of federal budget expenditures, or 2.9% of GDP. About half of this sum represented transfers from the long-standing FFAR, which are aimed at levelling the differences in regional per capita budget revenues. However, the criterion for eligibility and the volume of these transfers has become more transparent: it is defined as per capita 'tax potential' (calculated on the basis of GRP), adjusted for the region-specific volume and cost of essential public expenditures. In 2002, 71 Russian regions (out of 89) qualified for transfers from FFAR, the biggest recipients being Daghestan, Altai and Primorsky territories, and a number of other backward regions, mostly from the Northern Caucasus, Siberia and the Far East.[47]

Another four (though smaller) funds set up in the past few years include the Compensation Fund (compensating regions for various social benefits enacted at the federal level), the Regional Development Fund (RDF), the Fund for Co-financing of Social Expenditures (FCSE), and the Fund for Regional Finance Development (FRFD). Transfers from RDF are carried out within the framework of the federal targeted development programmes for Tatarstan and Bashkortostan – notwithstanding their already quite high development level. (These programs were initiated in order to compensate these two republics for their readiness to give up the preferential tax regime they enjoyed prior to 2001.) In turn, FRFD channels resources from the World Bank to finance regional budget reforms.[48] Besides, regions receive transfers as compensations for occasional upward revisions by the federal parliament of the official minimum wage, leading to an automatic rise in salaries of all public employees, the bulk of which are paid from regional budgets.[49] The implementation of those regional budgets which are most dependent upon federal transfers[50] is carried out by regional branches of the federal treasury system.

In 2003, the volume of federal transfers to regions is scheduled at RUB 336.7 billion, or 2.6% of projected GDP, with several new channels of financial assistance due to become

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46 See Maximova (2002).

47 The 18 regions *not* receiving these transfers include the city of Moscow, Yaroslavl region, Lipetsk region, Komi republic, Nenets autonomous area, Vologda region, Leningrad region, city of St. Petersburg, Bashkortostan, Tatarstan, Orenburg region, Perm region, Samara region, Sverdlovsk region, Tyumen region, Khanty-Mansi and Yamalo-Nenets autonomous areas, and Krasnoyarsk territory.

48 See Greffe (2001).

49 One such revision occurred in 2002, when the minimum monthly wage was raised from RUB 300 to RUB 450 (USD 15). However, another adjustment (to RUB 600), which was due to become effective in October 2003, has been blocked recently by the Federation Council on fears that regional budgets will not be able to cope.

50 There were 31 such regions in 2002 and 29 regions in 2003 – see Institute for the Economy in Transition (2003a).

operational in addition to the ones already existing. This is partly due to the abolition of road users' tax (assigned to regions) as of 1 January 2003, and to the re-allocation of excise taxes on tobacco and alcoholic beverages. While some of the additional transfers are compensations for the losses in excise collection,[51] others largely represent subsidies to household utilities and increased financial assistance to the so-called 'closed territories', including the space exploration base in Baikonur (now a part of Kazakhstan).[52] On top of that, the sharing of some other taxes was modified effective from 2003 as well. Thus, the federal share of excises on gasoline, diesel fuel and fuel oils has been lowered from 100 to 40%, the land tax has been fully assigned to regions (instead of 85% before), and the profit tax has been partly re-directed to regions as well (more on that, see section 3.1).

Further losses for the regions are anticipated as a result of the abolition starting from 2004 of the 5% sales tax, which is fully allocated to regional budgets. Not all regions impose this tax, and 54% of total sales tax revenue raised across Russia in 2002 were collected in just three regions: Moscow, Moscow region and St. Petersburg.[53] Although the abolition of the sales tax was envisaged by amendments to the Tax Code as early as 2001, the move has recently become a subject of considerable controversy. Consequently, finance minister Kudrin has announced recently that in order to compensate the resulting losses (which may total RUB 60-100 billion),[54] the government might consider revising in favour of the regions the distribution of the tax on small businesses, the excise taxes on gasoline and alcohol, and the profit tax.[55] Also, regions might be allowed to retain the tax revenues collected in excess of the planned volumes.[56]

The federal government calls for a further centralization of public finances in Russia. According to finance minister Kudrin, the ten most successful Russian regions account for 60% of consolidated tax revenues, whereas in many others there is an acute shortage of cash to fulfil spending obligations, primarily in the area of social payments. A specific issue to be addressed is the federal support of depressed regions. A bill defining economically 'depressed' regions and containing an explicit formula for calculating the volume of federal transfers was approved by the Duma in the second reading in March 2003. According to the definition contained in the bill, a region is considered 'depressed' if its output in the basic sectors of the economy has declined by more than two thirds in the past twelve years. However, the government opposes the bill, claiming this definition is too generous.

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[51] Only regions where tobacco excise accounted in 2001 for more than 1% of tax revenues and excise on alcohol products exceeded 10% of tax revenues in the first eight months of 2002, are eligible for these compensations.

[52] See Institute for the Economy in Transition (2003a).

[53] See Institute for the Economy in Transition (2003b).

[54] See *Finansovye Izvestiya*, 28 May 2003.

[55] See *Strana.ru*, www.strana.ru, 9 June 2003.

[56] Currently, all tax revenues in excess of the planned volume are being appropriated by the federal government.

Indeed, according to the definition, 70 Russian regions would reportedly qualify as depressed.[57]

3 Regional credit risk rating

3.1 Investment policies

As already mentioned, although the initial conditions (particularly the inherited economic structure) were crucial in determining the regions' ability to respond to the shocks of transition, it has also been the policy pursued by the regional authorities which increasingly mattered. In fact, there seems to be an inter-dependence between a region's economic performance and its attractiveness for investments. According to most surveys, legislative risk is perceived to be the most important risk type in assessing investment alternatives, hence the importance of regional legislation and of proper law enforcement is crucial.

No wonder that the past few years have witnessed rising competition between Russian regions to attract investment, and foreign investment in particular.[58] This development was partly encouraged by the adoption of the federal law on foreign investment in 1999, which authorized regional authorities to pass (within the scope of their competence) legislation supporting investment, including the powers to grant benefits and guarantees, to finance projects, and to provide other means of support. By now, eleven regions have elaborated long-term comprehensive programmes for social and economic development, aimed at identifying the region's potential advantages and shortcomings, and outlining the key issues to be tackled in order to boost the regional economy. 81 regions have adopted regional laws on investment activity, the laggards being mostly backward autonomous areas of Siberia and the Far East. The most liberal investment laws have reportedly been adopted in Tatarstan, St. Petersburg, Leningrad, Novgorod and Yaroslavl regions. The centrepiece of regional investment legislation are tax incentives, or tax benefits, which typically apply to investors during the pay-off period of investment projects and in some cases also beyond this period (although very often the maximum length of an investment project is specified as well). Besides, the amount of benefits is often linked to the size of investment. According to the federal law, benefits can only be granted with respect to taxes collected at the regional and local levels (most often these are property taxes, land tax, sales tax, and tax on small businesses), but also to the 'regional' share of the 24% profit tax. (As of 1 January 2003, the 'regional' share of profit tax was raised from 14.5 to 16 percentage points.)[59] True, regional authorities enjoy now less freedom to extend profit

[57] See *RFE/RL Newsline*, 14 March 2003.

[58] An example is the long-standing struggle between the city of St. Petersburg and the Leningrad region for the construction of a new port on the Baltic sea.

[59] Another 2 percentage points are allocated to local budgets, and the remaining 6 percentage points to the federal government.

tax concessions than before. Prior to 2002, they were free to grant profit tax concessions with respect to the entire share allocated to the regional budget, but a minimum rate was set at 10.5 percentage points (p.p.) in 2002 and raised further to 12 p.p. in 2003. The move was intended to compensate regions for the losses resulting from the abolition and the re-direction to the federal budget of a number of other taxes (for details, see section 2.3), but at the same time it effectively reduces the regions' manoeuvring room to compete for investments.

A typical pre-requisite for obtaining preferential tax treatment is the separate accounting of the investment project. However, the latter is not always the case: for instance, in the Komi republic tax concessions apply to all activities of a firm if the sales from an investment project exceed 65% of the firm's total receipts. In turn, the Krasnodar region allows investors to write off their arrears on tax payments to the regional budget on activities not related to the investment project after five years of non-payment, provided all clauses of the investment agreement have been respected.[60]

Most regions treat domestic and foreign investors equally or proclaim that foreign investors receive legal treatment not less favourable than national investors. The exceptions include e.g. Yakutia-Sakha, Tatarstan, Bashkortostan, and Perm region, where FDI-related benefits are a part of regional legislation. There is no legal base for the registration of enterprises with foreign investment at the federal level, and in some regions they are registered according to regulatory acts and prescriptions of the regional administration. The length of the registration procedure varies by region, e.g. from 3 days in the Novgorod region to 21 days in the Ryasan region. Before 2000, a number of regions (Ingushetia, Kalmykia, Altai) used to offer tax benefits to off-shore companies, mostly engaged in imports of foreign consumer goods. Some studies suggest that such beggar-your-neighbour policies had a double-sized adverse effect on other regions which were (a) short of tax revenues, and (b) faced competition from foreign-produced commodities. The Kaliningrad region is a special case, as it obtained the status of special economic zone by federal law in 1996, implying, among other things, considerable reductions in trade barriers.

Apart from tax incentives, many regional governments provide guarantees against a possible deterioration of regional or even federal legislation for the pay-off period of projects, committing themselves to reimbursing the resulting losses incurred by investors. The most recent typical measures aimed at improving the regional business climate include extending discounts on rents and covering from the regional budget interest payments for credits used to finance investment projects.[61] Two thirds of the regions have

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[60] See RECEP (2002).

[61] As of early 2003, the latter was true for Novgorod, Yaroslavl, Belgorod, Kaliningrad, Astrakhan and Kemerovo regions, as well as Komi republic, Altai republic, and Krasnoyarsk territory.

reportedly created catalogues of investment projects, and some have published regional cadastres of investment sites.

A separate issue is the legal treatment of small businesses whose annual sales are below RUB 15 million (USD 500,000) and who have less than 100 employees. Although the registration and licensing of small businesses is regulated by federal law,[62] a simplified procedure is allowed and indeed being used in several regions, such as the Nizhny Novgorod region and Chuvash republic. Also, in some regions, in addition to the compulsory registration procedure, there is voluntary registration in the so-called 'register book of subjects of small entrepreneurship'. In a number of cases, such registration gives priority or is even indispensable for obtaining concessions and privileges from regional authorities. However, the process of 'voluntary' registration may be quite cumbersome, and often additional documents are needed, including presentation of financial accounts. Russian laws allow small businesses to use simplified systems of accounting, reporting and taxation, and tax burden on them was further eased in 2003 in the wake of the ongoing tax reform. Small businesses opting for this taxation regime are exempted from the standard set of taxes (profit tax, VAT, sales tax and enterprise property tax) and, in addition, may choose between income and profits as taxation base.[63] Similar to the profit tax, the tax on small businesses is shared between the levels of budget, with regions and municipalities receiving 15% and 45% of tax revenues, respectively. At present, regional laws reportedly undergo the necessary adjustments in response to the new legislative framework enacted at the federal level, but many regions used to grant benefits with respect to the regional share of the tax. These benefits typically include lower rates and privileged payment procedures, and often vary by industry and taxpayer category (the privileged groups are, e.g., veterans of the Afghan war and disabled). Also, regions are free to introduce on their territories a 15% 'tax on imputed income for specific types of activities', which may be applied to a range of service businesses enlisted in the Tax Code, such as small-scale retail trade, small-scale catering, and car transportation and service.[64]

3.2 Attractiveness for investment

The protracted economic decline in Russia prior to 1999 was accompanied by falling investment in fixed capital and very low inflows of FDI, often contrary to the speculative portfolio investment. This was due to the persistent political instability under President Yeltsin, serious mistakes in the policies pursued (most notably, in the fiscal and foreign exchange policies), and the general lack of confidence in the domestic economy. Although

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[62] The federal legislation prohibits regional and local authorities to introduce additional requirements for the registration of small businesses.

[63] A 6% tax on income or, alternatively, a 15% tax on profits of small businesses is levied – see Institute for the Economy in Transition (2003a).

[64] Similar to the tax on small businesses, two thirds of this tax are retained by consolidated budgets of the regions.

the economy has picked up markedly in the past few years, the inflow of foreign direct investment remained disappointing: at the end of 2002, the cumulated inward FDI stock in Russia amounted to a mere USD 22.5 billion.[65] In addition, its distribution among Russian regions has been strikingly unequal. Not only did individual regions differ by a large margin in terms of FDI inflows in a particular year, but, for a given region, these inflows fluctuated widely over time as well – a natural consequence of the low absolute levels.

Those regions that have a considerable investment potential and present low investment risks have managed to attract nearly all FDI coming to Russia. Table 7 of the Appendix presents the ranking of individual Russian regions in terms of both investment potential and investment risk, assessed according to the methodology elaborated by the rating agency RA Ekspert in 2002. In line with this approach, both investment potential and investment risk indices are calculated as weighted averages of a number of indicators, whereby the weights of individual indicators are determined from expert surveys.

The investment potential is assessed on the basis of eight criteria, including the quality of labour force, regional market size, the quality of infrastructure, the availability of productive capacities, the regional potential for innovations, financial solidity, institutional setting, and the availability of natural resources. As can be seen from Table 7, Moscow ranks highest in terms of investment potential (and, remarkably, it also ranks highest in all components of the investment potential except for natural resources), followed by St. Petersburg and Moscow region. Generally, most of the ten leading Russian regions in terms of investment potential in 2002 represent the advanced centrally located industrial regions (the three above-mentioned plus the Samara, Sverdlovsk, Nizhny Novgorod regions, and the republic of Tatarstan), generally performing well in terms of market size, productive capacity and institutional setting, although sometimes lagging behind in infrastructure. In turn, the high rankings of the Khanty-Mansi autonomous area and Krasnoyarsk territory are driven by their natural riches.

Another important factor is investment risk, which is estimated on the basis of seven different types of risk: legislative, political, social, economic, financial, criminal, and ecological. Here, although Moscow, Moscow region and St. Petersburg still rank among the ten top regions, their advantage vis-à-vis other regions is by far not as pronounced as in the case of investment potential. In fact, number one of the ranking is the Novgorod region and number four is the Yaroslavl region, both of which have adopted a liberal investment legislation and offer a stable social climate. Among the ten top regions, the Shaimiev-ruled Tatarstan ranks number one in terms of political risk, whereas the politically turbulent St. Petersburg, with its everlasting infighting between the mayor and the legislative assembly, has only rank 84.

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65 Estimate by Hunya and Stankovsky (2003).

The intersection of spatial patterns of the two above criteria for assessing the investment environment gives evidence of the formation of an advanced 'core' area in terms of attractiveness for investors. This area notably includes the axis Moscow – St. Petersburg (including the Moscow, Leningrad, Novgorod and Yaroslavl regions, but also to some extent the Vologda and Tver regions), as well as the axis stretching from Moscow eastwards (including the Vladimir and Nizhny Novgorod regions and the republics of Chuvashia and Tatarstan). Still, the city of Moscow, due to the high living standards of its population and the huge market size, has been since 2000 an absolute leader in attracting FDI, accounting for nearly 38% of total inflow in 2002 (see Table 8 of the Appendix).[66] Remarkably, Moscow has also recorded the highest FDI *per capita* inflow (disregarding the very high per capita figures in the energy-rich Nenets and Yamalo-Nenets autonomous areas and Sakhalin, which are due to the very low population): the latter stood at USD 177 in 2002, six times the Russian average (USD 28). In the first quarter of 2003, it accounted for 41.6% of total FDI inflows, followed by the Sakhalin (22.7%) and Moscow regions (11.2%). Taken together, these three 'subjects of federation' accounted for 75.5% of total FDI inflows into Russia.

On the other hand, poor and backward regions are understandably the least attractive for investors. Thus, all national republics of the Northern Caucasus (except Adygeya), as well as the Altai republic, Tyva republic, and a number of remote autonomous areas failed to attract any FDI in 2002, and some of them in fact did not attract any FDI in the whole period 1999-2001 either.

3.3 Case studies: St. Petersburg and the Yaroslavl region

In the following, we present two case studies of Russian regions which represent rather different patterns of development. One of the regions – the city of St. Petersburg – has a reputation in the world as a major Russian city, its cultural capital and the former capital of the Russian empire. However, the performance of the city in attracting investment and in restructuring its economy since the start of the transition has been mediocre, contributing to the still depressed living standards of its population. In turn, the other region – the Yaroslavl region in the central part of European Russia – gives an example of a relatively successful transformation, largely due to the policies of regional authorities aimed at attracting investment and promoting structural change.

[66] In 1999, though, Moscow was number two (behind Sakhalin) in terms of attracted FDI.

3.3.1 St. Petersburg

Located on the easternmost edge of the Baltic Sea, St. Petersburg is a 'European' metropolis with a population of 4.6 million, the second biggest Russian city and the third biggest 'subject of federation' in terms of regional product. At the outset of transition, a number of factors seemed to point to a prompt adjustment of the city to the new market environment. The important advantages included proximity to Western Europe, thus creating potential for cross-border trade and investment; a relatively diversified economic structure;[67] the presence of a seaport, which became the country's sole outlet to the Baltic Sea after the break-up of the USSR; and, last but not least, the reformist-oriented city administration (the St. Petersburg mayor in the first half of the 1990s, Anatoli Sobchak, enjoyed at the federal level popularity as a leading liberal politician). At the same time, the city inherited an outdated industrial base, a heavy weight of defence industry, a clearly under-developed transport infrastructure, and its housing was in dismal condition.[68]

Over the 1990s, the policies of the city authorities were changing, as it became increasingly obvious that the city was lagging behind in attracting investment, particularly foreign investment, badly needed in order to restructure its economy – notwithstanding all the above-mentioned advantages. Since 1998, the city administration has enacted a number of investment laws, including laws 'On state support of investment activities in St. Petersburg' and 'On investment in real estate in St. Petersburg'. The city administration has provided tax benefits to investors and banks supporting investments; guaranteed investors 10% of the cost of the investment project or 25% of the funds borrowed by the investor to complete the investment project; granted discounts on rents (including an up to 25% discount during the design of the investment project site, and a 40% discount on the lease of the investment project's site under construction), and offered co-financing for some types of projects.[69]

However, the inflow of foreign investment has been disappointing so far. Although the potential for investment is extremely high (in most of its components, it is the second highest in Russia), the city ranks only 8th in terms of investment risk, largely on account of the very high criminal and political risks (where the city ranks number 75 and number 84, respectively). The performance of the city's economy has been mixed, although some branches were given a considerable boost. The annual inflows of FDI into the city never

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[67] St. Petersburg is a leading producer of heavy machinery (including turbines, turbo-generators, tractors, excavators, and nuclear-powered equipment), while other major industries include electrical equipment, chemicals, pharmaceuticals, textiles, tobacco, furniture, and paper. It also has a major shipbuilding industry.

[68] Shared apartments (so-called 'communal apartments'), mostly located in the historical centre, are still very common in St. Petersburg.

[69] See BISNIS, www.bisnis.doc.gov.

exceeded USD 300 million,[70] and since 1999 they have actually been declining (being replaced by the ever-growing volumes of portfolio investment). In 2002, St. Petersburg attracted just USD 84 million of FDI, which represented a mere USD 18.5 per capita – ten times less than in Moscow and four times less than in the Leningrad region. Very often foreign companies preferred to invest into the Leningrad region (the area surrounding the city of St. Petersburg, which is a separate 'subject of federation'), rather than into the city itself.[71] This allowed them, on the one hand, to benefit from the market potential and the qualified labour force of the city, and on the other hand, to avoid the city's administrative barriers and the related corruption. As a result, by October 2002, the cumulated FDI stock per capita in St. Petersburg (USD 230) was considerably below the level in Leningrad region (USD 378). Total FDI stock in St. Petersburg stood at a mere USD 1.06 billion, nearly 30% of which (USD 295 million) represented FDI into food processing industry, followed by trade and catering (USD 157 million). Food processing industry has been developing the fastest, especially after the 1998 devaluation which made the imports of foodstuffs from abroad unaffordable. The leading St. Petersburg-based food companies include *Baltika* (brewery accounting for 23% of the Russian beer market), *Petro* (tobacco), *Liviz* (alcohol beverages), *Petmol* (milk products), and a number of others. The telecommunications sector (*Northwest Telekom*, *Peterstar, Metrocom*) has been developing fast as well, whereas the big machine-building (*Elektrosila, Leningrad Metallic Plant*) and ship-building (*Admiralteyskie Verfi*, *Baltiyskiy Plant*) plants now increasingly benefit from the reviving procurement contracts from the state (often related to defence), as well as from the demand of big private companies (e.g. ships for *Lukoil*).

Still, many other sectors are performing badly, suffering from under-investment. Particularly disappointing have been the developments in tourism, which (along with financial services) was viewed by Sobchak's administration as the future backbone of the city's economy. Given the tremendous architectural and cultural heritage of the city, the inflow of tourists remains disappointingly low. In 2002, the ratio of the number of tourists to the city population stood at 0.6, a tiny fraction of the levels observed in other major European culturally rich cities (such as Paris, Vienna, Barcelona or Rome).[72] Although an important boost both to the city's image and the city's infrastructure has been given by the recent grandiose festivities related to the celebration of the city's 300th anniversary (a total of RUB 40 billion, or USD 1.3 billion, was reportedly spent on the preparations), the room for improvement of tourist infrastructure is still considerable. While a number of high-class hotels have been reconstructed and built anew during the 1990s, medium-priced hotels are

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[70] The data here and hereafter stem from the St. Petersburg Statistical Office (Petrkomstat) and the Institute for the Economy in Transition.

[71] An example of this is *Ford Motor Company* (USA), which has invested USD 150 million into the construction of an assembling line of Ford Focus in Vsevolozhsk, a northeastern suburb of St. Petersburg.

[72] See *Ekspert*, No. 41, 2002.

still nearly absent. (This is to a great extent due to the cumbersome registration procedures for hotels.) Transport problems are increasingly a source of concern as well: unlike Moscow, St. Petersburg still lacks a circular road, so that all cargo transit passes through the city centre, and traffic jams are mounting, despite the relatively small number of cars. The relative backwardness of the city in terms of investments (and, consequently, the level of development) is largely due to the policies of the St. Petersburg mayor, Vladimir Yakovlev, who defeated Mr. Sobchak in 1996 and was re-elected in 2000, despite the efforts of the federal centre to prevent his re-election. The economic policies pursued during his tenure used to protect local businesses from competition coming from other regions, particularly in construction, insurance, the energy sector and trade, and hampered, among other things, the penetration of big Moscow-based companies into St. Petersburg's markets. However, the situation is likely to change in the short run. After Vladimir Yakovlev stepped down in June this year (having been offered the post of vice prime minister in the federal government), the next elections are scheduled for September 2003. The presidential representative in the Northwestern federal district, Valentina Matvienko, who enjoys support of the federal centre, is almost certain to win these elections. The city will likely become more open to the influence from Moscow, which under present circumstances will prove beneficial for the city.

3.3.2 Yaroslavl region

The Yaroslavl region is situated in the central part of European Russia, bordering the Moscow region from the North-East. With a territory of 36 thousand sq. km and a population of 1.4 million, it is a medium-sized Russian region. The administrative and economic centre of the region is Yaroslavl, a city of some 600 thousand population and rich in historical traditions. The city was founded as early as the 11th century and became by the 17th century the second biggest city in Russia, after Moscow.

The region inherited from the Soviet times an industrial structure with well-developed manufacturing, albeit with a high share of production of intermediate products and (as in most other regions) the defence industry. The major industrial branches are machine-building, chemicals and petrochemicals, and the food processing industry, accounting together for 71% of regional industrial output in 2001. There are also two oil refineries and an oil pipeline stretching westwards towards the Baltic Sea coast (now part of the Baltic Pipeline System).

Given the lack of major exportable natural resources on the territory of the region, the administration of governor Anatoli Lisitsyn (in power since 1991) has been stimulating economic growth in the region via a set of policies designed to attract investment. In 1994, a specialized unit within the regional administration in charge of investment policies was formed, and 1996 witnessed the adoption of the regional law 'On state support of investment activity'. The law, among other things, exempted investors from the regional property and profit taxes, and envisaged a wide range of subsidies. In 2000, the region enacted the 'Concept of developing the attractiveness for investment until 2003', while in 2001 another law 'On stimulating economic development' was passed. Interestingly, according to this law, investors are eligible for subsidies from the regional budget if they commit themselves in advance to paying a minimum lump-sum to the regional budget. For already operating companies, this lump-sum is set equal to the profit tax actually paid to the regional budget the year before, but for newly established businesses, it is set at zero. If the profit tax to be paid by a company to the regional budget in the new year exceeds this lump-sum, the company qualifies for receiving a subsidy of up to 80% of the difference, which is to be invested into the business.[73] Besides, the region extends investment tax credits to big companies and covers interest rates on loans taken by small and medium-sized businesses to finance investment projects. According to RA Ekspert, the Yaroslavl region now ranks fourth best in Russia in terms of investment risk, and that primarily because of the low 'legislative risk' involved.

Benefits are granted on a selective basis, and the regional administration has compiled a list of projects to be actively promoted. Among the projects enjoying priority are the development of tourism and regional infrastructure, as well as a number of projects in agribusiness, radio electronics, the oil and petrochemical sector, power engineering, ship-building, the textiles industry, and consumer goods.[74] As far as tourism is concerned, the region has greatly benefited from co-operation with the German development organization GTZ within the framework of a programme embarked upon in 1999 and focusing on the construction of hotels in the historically rich Pereslavl, Rostov and Uglich districts. It is hoped that in the future tourism will account for up to one third of regional budget revenues. Other major infrastructure projects include the recently completed international airport and a new bridge over the Volga currently under construction.

The policies started bearing fruit already in 1996-1997, when the regional economy was boosted thanks to two big foreign investment projects: by *Kodak* (USA) taking over the photo-paper-producing *Slavich* plant in Pereslavl, and by the *Baltic Beverages Holding* (Sweden) investing into the *Yarpivo* brewery. Among other major investors are *General Electric* (USA) and *Aero Support Corporation* (Canada), which produce airplane engines at the *Rybinsk Motors Company*; *Eurobach* (France) producing varnishes and paints at *Lakokraska*; and *Tracosa* (Belgium) dealing with milk-processing. Although the region was severely hit by the 1998 crisis (industrial production fell by 8% in 1998), the subsequent

[73] See *Ekspert*, No. 8, 2003.

[74] See BISNIS, www.bisnis.doc.gov.

recovery has been rapid. Industrial production was up 26% in 1999, 17% in 2000 and 11% in 2001 (the respective growth rates for Russia as a whole were 11%, 12% and 5%). A number of further investment projects were attracted by the region in 2002, notably by *Kodak* (USD 17 million) and the *Baltic Beverages Holding* (USD 55 million, making total foreign investment into *Yarpivo* between 1996 and 2002 reach USD 120 million). As a result of successful re-structuring measures, by 2001 the Yaroslavl region managed to reach the second highest GRP per capita in the Central federal district (behind Moscow), standing at close to RUB 52,000 (USD 1780). The figure may not be impressive in an international comparison, nor does it even come close to Moscow standards. However, against the background of the generally depressed pattern observed in the neighbouring regions, this is a clear success story, and the prospects are good as well.

Summary

The last decade of the past century has been dominated by growing decentralization in Russia, both in economic and political terms. The major factors driving decentralization were the weakness of the federal government and of President Yeltsin, as well as the poor performance of the federal budget. As a consequence of decentralization, economic policy in Russia was increasingly determined at the regional level, resulting in economic fragmentation and in numerous barriers to the movement of goods and production factors. Although the economic upturn and the relative political stability which returned to the country with the election of President Putin have halted the separatist regional trends, interregional economic barriers are still substantial.

The enormous disparities across Russian regions observed nowadays are partly linked to the inherited economic structure and the varying ability of different branches to respond to the shocks of transition, but also to the policies of the regional administrations. On the one hand, raw materials extraction and exporting continue to bring most revenues, benefiting the few richly endowed regions. On the other hand, whereas in many areas of central Russia a still unreformed and uncompetitive manufacturing sector (including defence production) is a major factor behind the depressed incomes, some regions have been relatively successful in their restructuring efforts, often via creating an attractive investment environment. The 'core' area in terms of attractiveness for investors includes the axis Moscow – St. Petersburg, as well as the axis stretching from Moscow eastwards. The regions possessing the highest investment potential and offering the minimal investment risk in 2002 can be summarized as follows.

Regions ranking the highest in terms of investment potential		*Regions ranking the lowest in terms of investment risk*	
1	City of Moscow	1	Novgorod region
2	City of St. Petersburg	2	City of Moscow
3	Moscow region	3	Moscow region
4	Khanty-Mansi autonomous area	4	Yaroslavl region
5	Sverdlovsk region	5	Belgorod region
6	Samara region	6	Orel region
7	Krasnoyarsk territory	7	Nenets autonomous area
8	Nizhny Novgorod region	8	City of St. Petersburg
9	Republic of Tatarstan	9	Republic of Tatarstan
10	Krasnodar territory	10	Leningrad region

II The Russian banking sector

1 Present structure of the sector

According to statistics provided by the Central Bank of Russia (CBR), the Russian banking sector consisted of as many as 1332 banks as of 1 July 2003. However, most of these banks are very small and essentially represent the treasury departments of affiliated industrial enterprises. The main features of the sector's structure are its high concentration and an under-developed branch network. In April 2003, the five biggest banks accounted for 45%, and the fifty biggest banks for 74% of total assets of the banking sector (see Table 12). In addition, half of all banks are concentrated in Moscow and the Moscow region (see Table 11). On 1 July 2003, there were 3261 banking branches in Russia, implying that, on average, every bank operates a network consisting of 2.4 branches, and each banking branch serves some 44 thousand people – reportedly 20-25 times more than in developed economies.[75] Despite that, according to CBR statistics, the number of branches has decreased by 65 since January 2003.[76] Also, the average figures disguise the fact that most banks do not have any branches at all, whereas the largest state-owned bank, *Sberbank*, with its vast network of 1124 branches is represented in all regions.

The existing structure of the Russian banking sector is to a large extent the legacy of the 1998 crisis and the role of the banking sector in it. The biggest Moscow-based banks

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75 See *Finansovye Izvestiya*, 7 May 2003.

76 See *Gazeta.ru*, www.gazeta.ru, 23 July 2003.

suffered most from the crisis, since they had been investing heavily in rouble-denominated short-term government bonds (GKOs), often financed by borrowing in foreign currency. Therefore, the measures announced by the Russian government and the CBR on 17 August 1998 effectively represented a double blow to them. While the government's default on GKOs scrapped the bulk of the banks' assets, the widening of the exchange rate 'corridor' and the subsequent rouble devaluation raised their liabilities dramatically, and the massive withdrawal of funds by depositors was another contributing factor. As a result, many big banks became insolvent following the crisis, whereas small and medium-sized banks (which were much less involved in the GKO business) generally survived and even strengthened their position.[77]

According to CBR statistics, on 1 January 1999 there were 70 credit organizations with a combined *negative* capital of RUB 41 billion (USD 2 billion), whereas the total capitalization of the banking system at that time stood at USD 3.7 billion. To revive the banking system, the Central Bank outlined a bank restructuring programme, aimed at the rehabilitation of a core group of banks and at the liquidation of a large number of non-viable banks. As a result of the programme, some 400 banks (out of nearly 1500 at that time) were supposed to close their doors. For this purpose, the Agency for Restructuring Credit Organizations (ARCO) with a charter capital of RUB 10 billion was established in March 1999, and later the same year a Bank Restructuring Law was adopted.

However, the actual implementation of the bank restructuring programme proved highly controversial. On the one hand, by 2002 the bank restructuring programme was largely completed, and the number of banks with negative capital dropped from 70 in early 1999 to just 1 in early 2003. The licence of one of the two remaining big insolvent banks, *SBS Agro,* which had a negative capitalization of RUB 57 billion, was revoked in January 2003,[78] statistically leading to a one-time jump of total banking system capitalization. On the other hand, the funds allocated to ARCO were often misappropriated (e.g. in 1999 it extended a loan to the well-doing *Alfabank* to develop its branch network), and asset-stripping by the owners of troubled banks was reportedly outrageous, leading to a mushrooming of the so-called 'bridge banks'. Examples are plenty and include *Rosbank* (successor to *Oneximbank*), *Impeksbank* (successor to *Rossiyskiy Kredit*) and *Menatep St. Petersburg* (successor to *Menatep*).

At present, several major types of banks in Russia can be distinguished, which we briefly outline below.

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77 See Ippolito (2002).

78 See *Gazeta.ru*, http://www.gazeta.ru, 28 May 2003.

One group is represented by the 23 state-owned and state-controlled banks. *Sberbank,* majority-owned by the CBR,[79] is by far the biggest bank in Russia by nearly all measures (see Table 13). It accounts for 27% of banking assets, 19% of banking capitalization, and 67% of retail deposits, benefiting from the implicit state guarantee on attracted deposits. The bank is also a major lender in the country (some 30% of the credit market), although it is often criticized for its allegedly non-commercial and politically motivated lending policies. As already mentioned, it has a wide branch network and is the only Russian bank present in all regions. The bank owes its special status to the Soviet past, when it was specially designed to accumulate household savings. (Along with *Sberbank*, there were a few other specialized banks, each allocated an own area of responsibility: industry, agriculture and foreign economic relations.) The second largest bank – *Vneshtorgbank* – is state-owned as well, although its ownership was transferred from CBR to the federal government in autumn 2002 with a view for subsequent privatization. Originally, the bank was created by the government of the Russian Federation (then still part of the Soviet Union) in order to service its foreign trade. There are also a number of banks controlled by regional authorities. Examples are the *Bank of Moscow*, controlled by the Moscow administration, and *Uralsib*, controlled by the government of Bashkortostan.

Another important group is represented by the large private banks, many of which survived the crisis, be it under the same name or a new one, because they belonged to financial-industrial groups (FIGs) – oligarchic structures which typically had their other assets in export-oriented industries, notably energy and metals. The alliance between industrial and the banking capital is still strong, and examples are numerous. Thus, *Alfabank* is a part of *Alfagroup* (shareholder in the newly created oil giant *TNK-British Petroleum*), *Rosbank* is related to *Interros* (nickel and aluminium), *Investment Bank Trust* is related to *YukosSibneft* (oil), *Gazprombank* is related to *Gazprom* (natural gas), *Zenit* is related to *Tatneft* (oil), *Petrokommerz* is related to *Lukoil* (oil), *Promstroybank* is related to *Severstal* (ferrous metallurgy), etc. However, the nature of the relationship between the industrial and the banking parts of a FIG has changed since the 1998 crisis. Whereas in former times banks served primarily as a tool of revenue generation from speculation with securities and not least as a lever of influence on the government, now they are rather viewed as sources of finance to the well-performing industrial business. There are also a number of big private banks which are not a part of any FIG (e.g. *MDM Bank*).

The penetration of foreign banks is quite low. Combined, they only accounted for some 8% of the banking system capitalization in early 2003.[80] In April 2003, there were 128 banks with participation of foreign capital, 29 of which were fully foreign-owned (see Table 14),

[79] The CBR has a 61% stake at *Sberbank*.

[80] See *Finansovye Izvestiya*, 7 May 2003.

and another 9 had a foreign-owned majority stake. The city of Moscow is the location of all but three fully foreign-owned, and of all majority-owned foreign banks (see Table 15). *Citibank* and *Raiffeisenbank Austria* are the biggest fully foreign-owned players in the market, ranking 11th and 12th, respectively, in terms of assets under control. Besides, *Mezhdunarodnyi Moskovskiy Bank*, partly owned by the *HVB* group and leading the market of enterprise deposits, ranks 8th. For a long time, there was a 12% cap on the aggregate participation of foreign capital in the Russian banking system, but in November 2002 this ceiling was lifted and foreigners were allowed to trade Russian banking stock without restrictions.[81] Also, at the end of 2001 foreign banks were allowed to open branches in Russia, and the minimum capital requirement for newly opened foreign banks was lowered from EUR 10 million to EUR 5 million – the level applied to domestic banks. Still, the purchase of bank equity by foreigners requires an authorization by the CBR. Besides, a stake exceeding 20% of a bank's capital is subject to approval by the competition authorities,[82] and the overall sentiments with respect to attracting foreign capital into the banking sector are generally cool. Disagreement over the degree of openness of the banking sector remains, along with the level of prices of energy, a major stumbling block in Russia's WTO negotiations.

2 Banking sector and financial intermediation

After a protracted period of economic decline which ended in the crisis of 1998, the Russian economy has since shown an impressive recovery, with an average growth rate of 6% per year, a strong external surplus, and recently also an encouraging rebound in investment. However, an important constraint to further growth prospects remains the under-developed banking sector which, despite certain improvements in the past few years, still largely fails to perform its essential function of channelling savings into productive investments.

Over the period following the 1998 crisis, the Russian banking sector has recovered substantially, with assets, market capitalization and the volumes of both deposits and loans all rising in real terms. In April 2003, banking assets were 32%, banks' capitalization 39%, the volume of loans to non-financial (including foreign) enterprises 81%, household deposits 32%, and balances of enterprises in banks 79% higher in real terms than in July 1998 (see Tables 9 and 10 of the Appendix). However, the Russian banking assets, standing at USD 144 billion in April 2003, still correspond to just 39% of GDP – approximately the level of early 1999, and much below those observed in most Central European transition countries or India and Brazil (60-100%). Besides, the assets are calculated according to Russian Accounting Standards (RAS), which may overstate their

[81] See Chowdhury (2003).

[82] This regulation applies to domestic buyers as well.

actual value. On the other hand, the CBR figure does not include data on the commercial activities of the state-owned *Vneshekonombank*.[83]

In turn, the total capitalization of Russian banks stood at USD 21.6 billion (5.9% of GDP) on 1 April 2003. Since the 1998 crisis, it has doubled as a share of both GDP and banking assets. In the first quarter of 2003 alone, it grew by 11% in real terms, reaching 15% of assets by the end of the period. Most big banks have comfortable two-digit capital adequacy ratios, although this is often due to the widespread practice of 'capital inflating' (more on that, see section 3.2).

An encouraging sign is that the growth of assets has been accompanied by an improving loan performance. The share of bad loans in the consolidated loan portfolio of banks has been falling continuously, from 17.3% in 1999 to 5.6% in April 2003. Besides, profitability has risen dramatically as well. While banks reported losses in both 1998 and 1999,[84] the sector showed profits in subsequent years, with return-on-equity (ROE) reaching 8% in 2000, 19.4% in 2001 and 18% in 2002. True, the rise in profitability is partly attributed to the recent changes in the Russian tax legislation. In particular, the corporate profit tax has been cut and streamlined at the same time. Prior to 2002, non-financial enterprises were subject to a profit tax of 35%, but for banks, it was higher and stood at 43%. Since January 2002, a uniform profit tax of 24% is applied to both banks and non-financial enterprises, thus reducing incentives for FIGs to report profits as coming from non-financial activities. In 2002, 96% of banks showed profits. However, the profitability of banking business is lower than in industry, making the sector relatively unattractive for both foreign and domestic investors.

2.1 Directions of lending

2.1.1 The role of banks in providing finance to enterprises

Available data give evidence of a shift in the banks' priorities in the past few years as compared to the pre-crisis pattern. In the hyper-inflationary environment of the early 1990s, the bulk of banking profits was generated from transactions with foreign exchange. The reason was that in an environment where keeping rouble balances was costly even in the very short run, exchanging roubles into foreign currency for saving purposes and back into roubles for transaction purposes was a casual transaction for both businesses and households. Later, in the mid-1990s, banks were crediting the government at very attractive interest rates, whereas the rest of the economy was essentially 'crowded out' and

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[83] See Bank of Finland, 'Russian and Baltic economies: the week in review', No. 19, May 2003. *Vneshekonombank*, dating back to the Soviet past (when it was servicing the USSR's foreign trade), is a state-owned bank which also handles the sovereign foreign debt.

[84] In 1998, the banking sector reported losses of -28.6%, measured in return-on-equity terms.

suffered from a credit crunch, leading to a dramatic proliferation of barter and other non-monetary forms of payment.

The situation appears to have changed after the 1998 crisis, with banks increasingly willing to lend to the real economy, claims on which now account for nearly two thirds of total domestic credit. In 2002, 94% of Russian banks were reportedly lending to the real sector.[85] The total volume of loans extended to domestic non-financial enterprises has been steadily growing since 2000 and reached USD 54 billion, or 15% of GDP, by April 2003.[86] This corresponds to 38% of banking assets (a clear improvement against the 26% on the eve of the 1998 crisis), although this share varies widely by region from 10% to 80%.[87] Also, the relative increase in the banks' loan portfolio has been accompanied by a corresponding reduction in the share of securities held by banks (from 32% to 22% of the banks' assets). *Sberbank* accounts for 30% of credits to the real economy, followed by *Alfabank,* which has a share of around 5%.

The maturity structure of loans has been improving, too. In April 2003 long- and medium-term loans (with maturity over one year) accounted for a third of the total credit volume to the private sector – against only 18% in 2001.[88] However, in reality the share of long-term loans is likely to be higher due to the common practice of 'ever-greening' short-term loans: on the one hand, this is aimed at maintaining flexibility in re-negotiating the contract terms, on the other hand, it is also a tool to manipulate the liquidity indicators.[89] Sometimes, though, the scheme is believed to disguise the non-performing nature of loans.

In spite of the improvements, the role of bank loans in fixed capital formation is still negligible. According to CBR statistics, in 2002 only 3.9% of fixed capital investment in the country was financed by bank loans – in contrast to 48.6% financed from enterprises' 'own funds'. Besides, some 40% of credits are extended to exporters of raw materials and represent essentially 'intra-FIG' credits.[90] The high exposure towards raw materials exporters is particularly characteristic of the biggest banks, while credits to manufacturing enterprises are reportedly extended first of all by the banks from the middle part of the top-100 list. The access of manufacturing branches to banking credit is still fairly limited, explaining the investment shortage in these branches, which is estimated at USD 5-10 billion.[91]

85 See Institute for the Economy in Transition (2003a).

86 In developed countries, total credit to the real sector amounts on average to 40% of GDP. However, it exceeds 100% in the USA, and 150% in Germany, Japan and Singapore – see RECEP (2002).

87 See Simanovsky (2003).

88 See World Bank (2003).

89 See Ministry for Economic Trade and Development, 'Predlozheniya Minekonomrazvitiya RF po realizatsii Strategii razvitiya bankovskogo sektora', and Renaissance Capital (2002).

90 See *Finansovye Izvestiya*, 24 September 2002.

91 See RECEP (2002).

Some of the constraints to lending are of an institutional nature. One important obstacle is the absence of formalized procedures for the registration and enforcement of collateral – a legislative drawback which has been widely debated recently, but which remains still unresolved. Given this, banks are using various schemes to secure their lending. One widespread scheme involves the creation of affiliated (leasing) companies, which lease fixed assets to the real borrower. Thus, formally, a credit contract is being substituted by a leasing agreement, upon expiration of which the equipment typically becomes the property of the borrower. The advantage of leasing is that the bank retains its ownership rights during the whole duration of the leasing agreement. Despite the fact that leasing fees typically exceed lending rates, borrowers are often interested in the scheme because of the tax benefits.[92]

Also, to some extent, enterprises are compensating the shortage of domestic bank credit by raising funds in domestic and international capital markets. In fact, in 2002 the domestic bond market was booming. In January 2003, the face value of outstanding corporate bonds (both rouble- and foreign currency-denominated) stood at USD 7.2 billion, compared to only USD 2.5 billion a year before.[93] In addition, there is mounting evidence of the Russian private sector borrowing abroad. On 1 January 2003, Russian liabilities to foreign banks stood at USD 39.5 billion,[94] the same level as a year earlier. However, two important aspects of a shift in the structure of liabilities should be mentioned. First, loans taken abroad are increasingly long-term: during 2002 the share of long-term credits rose by 9 percentage points and reached 56.7% of the total. Most probably, this reflects a mismatch between the long-term borrowing needs of the economy and the inability of the domestic banking system to provide long-term loans, not least because of the effectively short-term nature of a substantial part of the banks' liabilities (more on that, see next section). Second, the share of the non-financial private sector in total borrowing abroad increased by 11.5 percentage points during 2002, and this solely at the expense of the banking sector, whose share plunged by 13.3 percentage points. This welcome development points to a more direct financial intermediation of foreign funds to domestic borrowers, without Russian banks serving as intermediaries. This became possible after numerous restrictions on cross-border banking were lifted in October 2001. Prior to that, in order to take a credit from abroad, most Russian residents (except domestic banks with certain types of licences) needed to obtain an approval from the Central Bank.[95] As a result of this development, by January 2003 the share of the non-financial private sector reached

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[92] Certain types of equipment, such as highly specialized equipment, equipment used in the food industry, and computers are unlikely to become the subject of lease – see *Izvestiya Bank*, 28 February 2003.

[93] See World Bank (2003).

[94] Out of this stock, 35% are liabilities to Germany, 10% to Switzerland, and another 10% to the USA.

[95] Besides, since 1 October 2001 an unrestricted operation of foreign accounts by private individuals is allowed – see Central Bank of Russia, 'Vystuplenie pervogo zamestitelya predsedatelya Banka Rossii A.A. Kozlova na XII s'ezde Assotsiatsii Rossiyskih Bankov'.

58.4% of total Russian liabilities to foreign banks.[96] This corresponds to USD 23.1 billion, or 45% of what the sector owed at that point to *domestic* banks. Still, borrowing from abroad is confined exclusively to the 'blue chips' companies, and half of the reported increase is accounted for by a single borrower, *Gazprom*. Smaller Russian companies are left with no choice but to take credits at home, if at all.

2.1.2 Lending to households

The volume of credits to households in Russia has been rising even faster than that to enterprises (albeit from a very low base) and stood at USD 5 billion, or 1.4% of GDP, in April 2003. Most of this volume is consumer credit, the bulk of which is provided by *Sberbank* (over 50%), is rouble-denominated (some 80%) and has a maturity of more than one year (72% in December 2002). However, the market is still in its infancy. Only 20% of Russian citizens have reportedly bank accounts, and only 9% have asked for credit in the past ten years, of which 5% actually got it.[97]

Retail banking in Russia is severely constrained by its low profitability (standing at just 2-3% in real terms) and the tiny number of branches of most banks, except *Sberbank*. However, the situation might start changing soon. Among the banks which stated an expansion to the regions as their strategic priority are e.g. *Alfabank*, *Petrokommerz* and *Bank of Moscow*.[98] But the development of a wide regional branch network is hampered by the reportedly high costs of opening a new branch (in the tune of USD 250,000-300,000), as well as by the restrictive regulations of the CBR. To promote the building-up of a banking branch network, the Central Bank is planning to reduce the administrative fee charged for opening a new branch and to stop controlling the selection of key banking personnel in a newly opened branch.

However, at least in Moscow the market for consumer credit appears to be booming, largely driven by the rapid proliferation of credit cards. A number of banks (*Avtobank*, *Rosbank*, *Alfabank*, *Krediturahlbank*, *Bank of Moscow*, *Vozrozhdenie*) have pioneered offering their customers a VISA card; Mastercard is not expected to enter the Russian market before 2005. According to CBR deputy chairman Mikhail Senatorov, there are some 15 million plastic cards now circulating in Russia, and in 2002 the transaction volume on them doubled on a year-on-year basis. However, most cardholders have been issued bank cards within the framework of 'salary projects' and use them simply to withdraw cash. Less than 10% of cards are used for non-cash payments. There are 40 thousand shops in Russia which accept plastic cards as a means of payment, but they are confined to

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96 See *Finansovye Izvestiya*, 30 April 2003.

97 See *Gazeta.ru*, www.gazeta.ru, 4 July 2003.

98 See *Gazeta.ru*, www.gazeta.ru, 23 July 2003.

Moscow and other big cities. To promote the use of credit cards, some banks (*BIN Bank*, *MDM Bank*) run joint projects with retail shops, which offer a 5-10% discount on products paid by using a card.[99]

Competition in the retail segment of the banking sector seems to be growing, and a number of banks are now in the process of upgrading their retail infrastructure. *Citibank* was the first bank to set up a 24-hour customer service centre in Moscow in November 2002, followed by *BIN Bank* in February 2003. Some banks (*Russkiy Standart*, *Pervoe OVK*) compete with *Sberbank* by offering potential private borrowers the so-called 'express service', i.e. by making a decision on lending on the same day. However, the maturity of their credits is typically shorter than of those of *Sberbank*, and the costs of the credit are usually higher.[100] Car credits and credits for purchases of other consumer durables are becoming more popular as well, although an impediment are wages paid in the shadow economy. Some banks (e.g. *Raiffeisenbank Austria*) require from a potential borrower a proof of official income, while most others tend to charge higher interest rates in the case of 'shadow' incomes because of the higher risk involved. Mortgage lending is expected to take off as well, after a specialized federal agency has been set up and *Vneshtorgbank* has announced a programme of mortgage lending on very generous terms.[101] Despite the bad living conditions of many households, mortgage lending in Russia has been limited for a long time because of the virtual inaccessibility of mortgage collateral: the Civil Code does not allow the creditor to evict the mortgagor and his family members from a house or a flat, if it is 'the only acceptable place for their permanent residence'.[102] However, a law on enforcing collateralized mortgages has been adopted recently, which should give mortgage lending an additional boost.

2.2 Deposits, dollarization and capital flight

Despite some encouraging developments recently, the lending capacity of the banking system is constrained by the shortage of long-term sources of finance, notably of retail deposits. CBR statistics show that, although the stock of household deposits has been on the rise in the past few years and reached USD 36 billion in April 2003, it still represents less than 10% of the Russian GDP. As already noted, the state-owned *Sberbank* accumulates as much as 67% of all household deposits, while its closest competitors, *Bank of Moscow* and *Alfabank*, are lagging far behind, each accounting for just above 2% of the total volume. Besides, the apparently favourable structure of deposits may be

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[99] See *Izvestiya Bank*, 28 February 2003.

[100] See Institute for the Economy in Transition (2003a).

[101] These conditions include 20 years maturity, a 15% nominal interest rate, and the maximum value of the loan amounting to 70% of the cost of the real estate to be purchased.

[102] See Avraamova (2001).

misleading: while time deposits with a maturity over one month accounted for 82.4% of the total in April 2003 (of them, 39.1 percentage points representing maturities over one year), the Russian Civil Code allows depositors to withdraw their funds from a bank anytime, irrespective of the terms of the contract. This is a source of instability for banks, which makes their lending decisions more difficult, especially on long-term loans.

The general problem behind the low level of deposits is the low level of confidence in the banking system – a legacy of the 1998 crisis and of institutional deficiencies such as the absence of a deposit insurance, except in the state-owned *Sberbank*. The consequences of this are manifold, but the most dramatic one is capital flight in its various forms. Although the domestic savings ratio stood at 32% of GDP in 2002[103] (a high level by international standards), fixed capital formation was only 15.2% of GDP, meaning that in net terms, Russia remains a net creditor of the rest of the world.

Part of the capital flight is carried out by households. Household savings are below 5% of GDP, and 80% of them were until recently typically used to buy foreign cash, mostly US dollars.[104] The volume of foreign cash held by Russian households is tentatively estimated at USD 20-50 billion, a level comparable to the level of private deposits in banks. However, even more pronounced has been the capital flight facilitated by Russian companies, in the first instance by large exporters, and that despite the restrictive surrender requirement for export proceeds imposed by the Central Bank, which stood until recently at 50% and was even higher in previous years. The schemes aimed at avoiding the repatriation of funds back to Russia were numerous and typically included under-statement of exports, over-statement of imports, as well as fake contracts for services provided by foreigners.[105] Over most of the years of transition, capital flight from Russia is estimated to have been in the tune of some USD 20 billion per year, resulting in a cumulated outflow of as much as USD 250-300 billion. Last but not least, Russian banks tend to lend abroad in net terms even those resources which they manage to attract. The *net* international investment position of the Russian banking sector, though generally declining since early 2001, stood at around USD 6 billion in April 2003.[106]

The lack of confidence in the domestic currency (and probably, the domestic economy in general) is also reflected in the still high level of 'dollarization'. Around one third of banking assets, one third of loans to enterprises and one third of household deposits are denominated in foreign currency (see Table 9). At the same time, the choice to keep

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103 Preliminary estimate – see IMF (2003).

104 See RECEP (2002).

105 For instance, according to CBR chief Sergei Ignatiev, in 2002 alone Russian banks transferred abroad some USD 5 billion as payment for marketing services delivered by foreigners, representing most probably a form of capital flight – see *Gazeta.ru*, www.gazeta.ru, 23 April 2003.

106 See RECEP (2003).

balances in foreign currency can hardly be rational, given that the interest rates on dollar deposits (7-8%) are much below the rouble-denominated interest rates (12-15%), while the nominal RUB/USD exchange rate in the past year has been remarkably stable at around 30-31 roubles per dollar.

In the course of the first half of 2003, the rouble has even somewhat appreciated against the dollar, owing partly to the dollar's general weakness and resulting in its partial substitution by the euro as a means of saving. As recently as early 2002, euro-denominated deposits were offered by just a handful of Russian banks, but they have become quite common since then. In January-April 2003, the euro reportedly accounted for 35% of domestic sales of foreign cash and for 60% of cash currency imports (the respective figures in 2002 were 30% and 20%).[107] Still, interest rates offered for euro deposits are 1-2 percentage points lower than for dollar deposits (5-6% against 7-8% for similar maturities), probably reflecting the expectations of a depreciation of the former.

However, the more fundamental factors behind the stability of the rouble (and that also vis-à-vis the euro) are the high world market prices for the main items of Russian exports and the subsiding capital flight. CBR estimates suggest that the volume of capital flight from Russia might have fallen to USD 11 billion in 2002, and the Bank anticipates that in 2003 Russia will experience – for the first time in its new history – a net inflow of capital which might total USD 2 billion.[108] Another possibly encouraging sign is the fact that rouble deposits, including enterprise deposits, were rising somewhat faster than foreign currency deposits in the first quarter of 2003. This has already given rise to optimistic predictions by several officials, including CBR chairman Sergei Ignatiev, that Russia might finally have reached a de-dollarization stage. If the latter proves to be true, we are witnessing a process of the revival of confidence in the domestic currency. However, whether this revival will also translate into higher confidence in the banking system, will largely depend on the success of the large-scale reforms of the sector envisaged by the CBR and dealt with in the next section.

3 The main directions of the banking reform

In the past few years, there has been growing awareness on the part of the authorities that the inability of the banking system to provide efficient financial intermediation in Russia represents an important constraint to the country's growth prospects. To address the issue, at the end of 2001 the government and the CBR put forward 'The Strategy of Development of the Banking Sector of the Russian Federation',[109] which outlined the key priorities for the

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107 See Bank of Finland, 'Russian and Baltic economies: the week in review', No. 27, July 2003.

108 See *Gazeta.ru*, www.gazeta.ru, 27 July 2003.

109 See Central Bank of Russia, www.cbr.ru.

sector’s development for a five-year period. In particular, the strategy specified the following priorities:

– enhancing the stability of the banking sector, thus minimizing the risk of systemic banking crises;
– ensuring the main function of banks to channel savings into investments;
– raising the sector’s credibility, particularly in the eyes of depositors;
– increasing legal protection of depositors and other creditors; and
– combating the involvement of banks in illegal activities.

In line with the stated objective of bringing the key indicators of the sector closer to those of advanced transition economies, the strategy targeted an increase in the banking assets to 45-50% of GDP (from 35% at that time) and of the volume of credit to the real sector to 18-20% of GDP (from 13%). The strategy sought to achieve its objectives largely through relevant changes in legislation, including amendments to the Civil Code and a number of other laws, such as ‘On banks and banking activities’, ‘On banking regulation of credit organizations’ and ‘On the restructuring of credit organizations’. On top of that, improvements in prudential regulations were envisaged.

It seemed that the chances for a broadly-based banking reform in Russia were particularly good at that point. On the one hand, two important factors speaking in favour of success are the commitment of the banking authorities and the cooperation of the Duma in passing the necessary legislative changes. Besides, the chances for success rose sharply with the change in the CBR leadership in March 2002. The long-standing CBR chairman Viktor Geraschenko, who had been (re-) appointed after the 1998 crisis and was well known for his conservatism, was replaced by Putin’s reform-minded ally Sergei Ignatiev. In addition, two other reform-oriented figures – Oleg Vyugin and Andrei Kozlov – became his deputies in charge of monetary policy and bank supervision, respectively. On the other hand, the owners of the big Russian banks appeared to be interested in reforms, particularly in raising the overall transparency of the business, which for reasons of the ‘prisoners’ dilemma’ can only be enforced from ‘above’.

An update of the CBR’s vision of the banking sector reform and of the sector’s future structure was presented by deputy CBR chairman Andrei Kozlov at the International Banking Congress, which took place in June 2003 in St. Petersburg. According to Kozlov, as a consequence of reforms, in ten years (in 2013) the Russian banking system will consist of five to six big ‘systemic banks’, several dozens medium-sized banks present in the CIS markets, another several dozens offering a wide range of financial services in the domestic market, and several dozens specialized banks offering e.g. retail and mortgage lending, whereas the remaining small banks will mostly deal with small and medium-sized enterprises.

However, by the time of writing this report (mid-2003), the majority of reform initiatives appear to have been stalled. While several important steps have been made recently in the area of foreign exchange regulation (most notably, the lowering of the surrender requirement for export proceeds from 50% to 25% and allowing private individuals to export up to USD 10,000 in cash without supporting documents), the progress in structural reforms has been more limited.

In the following, we address the most important aspects of the current banking reform in Russia and present evidence of the varying progress achieved so far in their implementation.

3.1 Deposit insurance scheme

As already mentioned, the reluctance of many Russian households to keep their savings in banks instead of US dollar cash at home is often attributed to the absence of a deposit insurance scheme (DIS). Besides, it is argued that the absence of a DIS makes depositors prone to panic if they have reasons to doubt the financial stability of the institution whom they have entrusted their savings. This, in turn, is a source of uncertainty for the banks: the effectively short-term nature of their liabilities makes extending long-term loans more difficult or even impossible.

It is hoped that the widely discussed introduction of a deposit insurance scheme will prove helpful in solving the above problems. Besides, it will be conducive to creating a competitive environment in the banking sector. At present, the only bank enjoying an implicit state guarantee for private deposits is the state-owned *Sberbank*, which thus possesses an important (and unfair) competitive advantage vis-à-vis the other market participants.

It was President Yeltsin who first called for a system of guaranteeing retail deposits back in March 1993, urging to prepare a corresponding draft law within a month's time. However, no further progress was achieved at that time, and the issue was raised again only in March 2000 by President Putin. Two years later, in 2002, a draft law 'On the insurance of retail deposits held in Russian banks' was prepared by the government and the CBR, which was submitted to the Duma in early 2003. The details of the scheme envisaged in the bill are as follows.

Starting from 1 January 2005, banks participating in the scheme will pay 0.15% of their average quarterly deposits[110] into an insurance fund operated by ARCO. In addition, the

[110] The 0.6% annual premium envisaged in the legislation appears to be high against the 0.03-0.27% applied in the USA and up to 0.2% in most European countries having *ex ante* a deposit insurance – see Fantini (2003). However, with the relatively weak bank supervision, the risk of bank failure in Russia may be much higher as well.

state will initially contribute USD 100 million to facilitate the building-up of the fund, and will make up for any deficit the fund might run into in the initial period of its existence. Only selected banks meeting the tough prudential standards of the CBR (which have to be announced yet) will be allowed to participate in the scheme, while those not qualifying will have to give up their licences to deal with private deposits. Therefore, the introduction of the DIS might result in a consolidation of the banking sector. Foreign-owned banks will be excluded from the scheme as well. *Sberbank* will join the scheme only in 2007, although it will start paying premiums already at the beginning of 2005.[111] The draft law envisages a 100% insurance for deposits of up to RUB 20,000 (some USD 645) and a 75% insurance for deposits of up to RUB 120,000 (some USD 3,870). According to estimates of the Ministry for Economic Development and Trade, these provisions will allow some 85% of depositors to recover their deposits before the start of a bankruptcy procedure.

The implementation of the deposit insurance scheme is likely to have another very important implication. Namely, it will facilitate a change of the current Civil Code provisions allowing depositors to withdraw their funds anytime, because the DIS will drastically reduce incentives for such pre-mature withdrawals. More specifically, the Central Bank has advocated a legislative provision requiring depositors to give a 30-days advance notice on the withdrawal of their deposits. These measures, if implemented, may prove an important stabilizing factor in ensuring a long-term nature of the banks' liabilities.

Although the adoption of the law on the DIS was initially expected to be finalized by spring 2003, this has not been the case. The readings of the bill in the Duma have been delayed repeatedly – last time until September 2003. There has been a wide array of explanations in the Russian mass media as to the reasons for the delay. On the one hand, the delay may be due to powerful vested interests, including those of *Sberbank*, whose competitive advantage will be eroded in case the DIS is implemented. However, some private banks seeking to avoid the tougher prudential requirements of the Central Bank might be interested in delays as well. Finally, the political dimension might play a role. The Duma deputies may be reluctant to pass the DIS legislation before the parliamentary elections in December 2003, fearing that a possible run-up on *Sberbank* will destabilize the situation and affect the outcome of the elections. Should the latter explanation be true, one should not expect the DIS legislation to be finalized before the winter of 2004. In any case, the introduction of the DIS will require numerous changes to a number of other laws, including 'On the restructuring of credit organizations', 'On non-commercial organizations', 'On bankruptcies of credit organizations', and of the Civil Code.

[111] See *Gazeta.ru*, www.gazeta.ru, 15 April 2003.

3.2 Prudential regulations and bank supervision

As suggested by economic theory, implementing a deposit insurance scheme necessarily requires a toughening of prudential regulations and proper monitoring of banks by the supervising authorities. The reason is that without proper monitoring and provided a deposit insurance scheme is in place, there is a strong incentive for banks to engage in risky lending. While bank owners will strongly benefit in case a risky investment pays off (since rewards may be high), the failure of such an investment will not have dramatic consequences for them, since losses will be covered by the DIS. Hence the need for appropriate prudential regulations and an adequate banking supervision. The issue is of particular relevance for Russia, whose track record in this respect has so far been modest at best. Indeed, the poor and often corrupt auditing of banks was one of the major factors contributing to the financial crisis. Prior to 1998, no licence was required for auditing in Russia, and the first expert committee on banking audit was set up by the Central Bank only in 1998.

Part and parcel of strengthening banking supervision, as envisaged by the CBR, is switching from the current principle of 'form over substance' to 'substance over form'. The latter issue has been widely debated in Russia in the past few years. In particular, the CBR has repeatedly been reproached with excessively sticking to the formal procedures of supervision rather than focusing on the economic meaning behind the financial indicators submitted by the bank. At the same time, goes the argument, the real thing to be checked is the quality of the management and internal control in a bank, and their implications for the level of risk exposure.

One aspect of the reform which is supposed to facilitate the above change in the supervision philosophy is the planned transition to International Accounting Standards (IAS). At present, financial reporting in Russia is done according to the domestic standards set by the CBR and often referred to as 'Russian Accounting Standards' (RAS). The difference between the two systems is substantial and, even more importantly, cannot be summarized in a set of technical conversion rules. Instead, the main difference appears to lie in the underlying philosophy: while RAS are based on largely formal criteria, IAS are primarily driven by considerations of economic 'substance'. The most pronounced differences reportedly lie in the areas of loan provisioning and valuation of securities and investments.[112]

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[112] The following example borrowed from Renaissance Capital (2002) illustrates the underlying difference. According to RAS, a loan extended by a bank to an enterprise and formalized by a loan contract is accounted as a loan, but if it is formalized as a purchase by the bank of a promissory note of the enterprise, it will be accounted as a purchase of security. Instead, IAS would treat both cases equally, reporting the transaction as a loan. In turn, this transaction would qualify as a purchase of security according to IAS if there is a liquid secondary market for such a promissory note and the bank has acquired the note for trading purposes.

A recent (July 2003) press release by the CBR states that, starting from 1 January 2004, Russian banks will produce their financial statements in the IAS version, while transformation rules are to be published before the end of the year. The use of IAS will become compulsory only starting from 2005, and Russian Standards will be in parallel use until the beginning of 2006. While a number of big Russian banks already use IAS, the switch might be painful for small banks, not least because of the higher costs involved. Also, starting from 2004, an independent external auditor will have to approve the banks' financial statements.[113] The transition is expected to be accompanied by numerous problems, as there is a shortage of qualified auditors who would have to check the financial statements of over 1300 Russian banks. Like most other reform initiatives in the banking sector, the switch to IAS will make indispensable a number of legislative changes and amendments, including those to the Russian Civil Code. (For instance, the Civil Code treats private time deposits as 'demand deposits', so that the IAS rules will require them to be reported as 'demand deposits' as well – counter to the economic meaning and to common sense.)[114]

Another measure aimed at strengthening the 'substance' component of banking supervision is the recently launched campaign to reveal the true capital adequacy of the Russian banking system. As already noted above, most banks, including the big ones, have two-digit capital adequacy ratios,[115] although this is often due to the widespread practice of 'capital inflating'. The latter usually occurs via lending to related parties which use the borrowed funds to purchase the creditor's equity. The Central Bank tentatively estimates that at least 60% of the 100 biggest Russian banks might have 'inflated' their capital, and the latter is believed to be particularly the case with banks having a statutory capital of around USD 50 million.[116] The campaign is also intricately linked to the CBR's requirement to disclose the banks' 'real owners' (this information is to be provided by the banks themselves). In April 2003 the CBR embarked upon a large-scale examination of 'suspicious' banks. By 27 June, around 60 banks were reportedly checked, and half of them were found to have 'inflated capital'. Interestingly, only two of these banks have denied the charges, and their cases will be considered by the Bank Supervision Committee (BSC) of the CBR in due course. Also, the emission of shares by banks is to be approved by the BSC, and the primary criterion for approval is the transparency of capital. In around 30% of cases, the BSC puts a ban on equity emission, and one of the most often quoted reasons is the presence of 'capital inflating'.[117]

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113 See Bank of Finland, 'Russian and Baltic economies: the week in review', No. 30, July 2003.

114 See Ministry for Economic Trade and Development, 'Predlozheniya Minekonomrazvitiya RF po realizatsii Strategii razvitiya bankovskogo sektora'.

115 In fact, 30% of Moscow -based banks reportedly have capital adequacy ratios well above 20%.

116 See *Finansovye Izvestiya*, 24 September 2002.

117 See *Izvestiya*, 27 June 2003.

In addition to the higher transparency of banking capital, financial stability of the system is to be ensured via tougher minimum capital requirements imposed by the CBR. It is argued that most of the 1335 Russian banks are too small to be stable and exploit economies of scale. Most banks are highly specialized, and only few (such as *Alfabank* and *MDM Bank*) have ambitions of becoming universal financial institutions à la the US-based *Citigroup*, offering a wide range of services at both retail and corporate levels. Besides, so far there have been very few bank mergers, reportedly due to the complicated regulatory framework for mergers and acquisitions.[118]

Within the framework of the strategy's implementation, the CBR has already raised the minimum capital requirement for *newly created* banks to EUR 5 million (from EUR 100,000), and this requirement will be extended further to *all* operating banks effective from 1 January 2007. Parallel to that, a minimum capital adequacy requirement of 10% of the bank's assets will be set, the violation of which will result in revocation of the bank's licence. This capital adequacy requirement will be applied starting from 2005 to all banks with a statutory capital below EUR 5 million, but will be extended to all credit organizations in 2007.[119] In April 2003, only 440 credit organizations in Russia (one third of the total number) had a statutory capital exceeding EUR 5 million, although they accounted for 96.5% of the total statutory capital of the sector.

Consolidation in the banking sector is also to be fostered through simplified regulations on mergers and acquisitions. A recent instruction by the CBR reduces the processing time of applications for mergers from six to four months, and to three months in the case of applications for acquisitions.[120]

3.3 Other reforms

3.3.1 Privatization and demonopolization

Competition policy in the banking sector is an area which has been almost fully neglected so far. Meanwhile, the formation of an efficient system of financial intermediation in Russia crucially depends on the creation of a competitive environment. The current domination of the two state-owned banks – *Sberbank* and *Vneshtorgbank* – in most segments of the sector is presumably a source of misallocation of funds in the economy.

In line with the stated goal of reducing the state's presence in the domestic banking system, the 'Strategy of banking sector development' calls for privatizing the banks' equity

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[118] See RECEP (2002).

[119] See Central Bank of Russia, 'O Strategii razvitiya bankovskogo sektora Rossiyskoi Federatsii'.

[120] See *Finansovye Izvestiya*, 4 July 2002.

held by the state. At present, the state reportedly holds majority stakes in 23 banks[121] and minority stakes in over 500 banks, in addition to stakes in the five foreign-based subsidiaries.[122] Also, according to the 'Strategy', no new state-owned banks will be set up, although the development banks *Russian Development Bank* (RBR) and *Russian Agricultural Bank* (RSB) will be preserved.

The strategy envisages a different treatment of the three big state-owned banks – *Sberbank*, *Vneshtorgbank* and *Vneshekonombank*. *Sberbank*, which is the backbone of the banking infrastructure in the country, particularly in its less developed regions, will remain to be majority-owned by the CBR at least until it enters the DIS (that is, until 2007, according to the current schedule). *Vneshekonombank* is to be split into two parts: a state-owned bank in charge of servicing the sovereign foreign debt, and a commercially lending part. Finally, *Vneshtorgbank* is scheduled for a partial privatization, although the government will retain a stake in it in order to 'exert influence on the bank's policies'. Up to 20% of the bank is planned to be sold to the EBRD, a tentative agreement with which was reached at the end of 2002. There are also plans to merge *Vneshtorgbank* with the commercial assets of *Vneshekonombank*, and the process has already been launched.

3.3.2 Lending to small and medium-sized enterprises

The model of the Russian banking sector development outlined by deputy CBR chairman Andrei Kozlov at the above-mentioned banking congress in St. Petersburg in June 2003 envisages that the overwhelming majority of banks will specialize on crediting small and medium-sized enterprises (SMEs). However, at present, this pattern seems to be far away from reality. While big Russian corporations are increasingly borrowing both domestically and abroad, the access of small and medium-sized enterprises to credit is still severely restricted. Only some 20 Russian banks are reportedly actively lending to SMEs, and the volume of loans is negligible. This is to a large extent due to the institutional peculiarities, which make extending credits to small businesses a difficult and costly undertaking. In particular, bankers complain about the cumbersome procedures, which were originally tailored for big loans but which are to be observed also when lending to SMEs.

In a reform initiative supported by the CBR and aimed at facilitating lending to small and medium-sized enterprises, a draft law has been elaborated and submitted to the Duma earlier this year. The bill deals with loans to SMEs amounting to no more than RUB 300,000 (about USD 10,000). Most importantly, it envisages the possibility of extending credits in cash form, i.e. without opening an account with the lending bank;

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121 See Chowdhury (2003).

122 These banks are *Moscow Narodny Bank* (London), *Eurobank* (Paris), *Ost-West-Handelsbank* (Frankfurt), *Donau Bank* (Vienna), and *East West United Bank* (Luxemburg) – see *Finansovye Izvestiya*, 14 May 2003.

allows the calculation of minimal reserves for credits extended to SMEs on the basis of their combined end-of-the-month value; and eases the cancellation of non-performing loans to SMEs from the balance sheet of the lending bank without resorting to court. (At present, the non-performing nature of a loan, i.e. the inability of the borrower to pay back, has to be proven in court, often with high costs involved, which for small credits often exceed the loan value.)[123]

3.3.3 Credit bureaus

A hampering factor in the development of the banking business (particularly of its retail segment) is insufficient information about the quality of the borrower, which leads to the well-known problems of adverse selection and moral hazard. Meanwhile, a tool widely used in other countries to reduce the problem of information asymmetry are credit bureaus, which accumulate information on individual borrowers (provided by banks) and make it available to other potential lenders.

Although there are a few credit bureaus operating at the regional level (e.g. in St. Petersburg, Saratov and Samara), at the federal level they are still missing, and a working group charged with the elaboration of a respective law concept was set up in September 2002. According to the bill submitted to the Duma, credit bureaus would only publicize data on 'bad' borrowers – a concept advocated by many banks, who are unwilling to share the information on 'good' borrowers with their competitors. It is not clear, however, whether the bill will be approved, as it has been subject to sharp criticism by the Central Bank.[124] Under any scenario, according to Andrei Kozlov, one should not expect credit bureaus to appear before three to four years from now.

Summary

Over the period following the 1998 crisis, the Russian banking sector has recovered substantially, with assets, market capitalization and the volumes of both deposits and loans all rising in real terms. However, banking assets still correspond to just 39% of GDP – much below the levels observed in most Central European transition countries. The banks' capitalization of 6% of GDP, the volume of credit to the real economy of 15% of GDP, and the volume of household deposits of 10% of GDP are all signs of the sector's under-development. The bulk of loans is extended to raw materials exporters, whereas smaller enterprises' access to credit is often restricted. In addition, the role of bank loans in financing fixed capital investment is negligible. All this points to the inability of the banking sector to provide efficient financial intermediation in Russia.

[123] See *Finansovye Izvestiya*, 27 June 2003.

[124] ibid.

On the one hand, this is due to the narrow deposit base – a legacy of the 1998 crisis and the long-standing capital flight, which may have resulted in a cumulated outflow of some USD 250-300 billion. Most households still prefer to keep their savings in foreign cash, although the developments of the recent months could be interpreted as a sign of a possibly coming turnaround. Also, it is hoped that the implementation of a deposit insurance scheme starting from 2005 will be helpful in attracting private deposits.

On the other hand, lending is constrained by the numerous legislative and regulatory deficiencies, such as the impossibility to enforce a collateral, the cumbersome regulations accompanying lending to small businesses, the absence of credit bureaus, etc. Although the Central Bank seems to be committed to enacting the necessary changes and has elaborated a comprehensive programme of reforms accompanied by a strengthening of banking supervision, this is not going to be a smooth process. In particular, the planned transition to IAS will entail a number of problems. Besides, although the state will probably succeed in selling off its numerous stakes, the sector will remain uncompetitive as long as *Sberbank*, which now accounts for 67% of private deposits and is the only bank present in all Russian regions, dominates. In Russian circumstances, a way to encourage competition is to promote the consolidation of the more than 1300 banks, most of which are tiny and essentially represent treasuries of affiliated industrial enterprises. The interest of foreign banks to enter the Russian market seems to be limited so far, notwithstanding several liberalization measures undertaken recently. Disagreement over the degree of openness of the banking sector remains, along with the level of prices of energy, a major stumbling block in Russia's WTO negotiations.

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Appendix

Table 1

Selected economic indicators

	1998	1999	2000	2001	2002 1)	2002	2003	2003	2004
						1st quarter		forecast	
Population, th pers., end of period	146693	145925	145185	144321	144079	.	.	143500	143200
Gross domestic product, RUB bn, nom.	2629.6	4823.2	7305.6	9039.4	10863.4	2267.7	2900.4	12900	14900
annual change in % (real)	-5.3	6.4	10.0	5.0	4.3	3.0	6.9	5.0	4.5
GDP/capita (USD at exchange rate)	1844	1339	1785	2141	2403	.	.	.	.
GDP/capita (USD at PPP - wiiw)	5490	5950	6720	7260	7690	.	.	.	.
Gross industrial production									
annual change in % (real)	-5.2	11.0	11.9	4.9	3.7	2.6	6.0	5	5
Gross agricultural production									
annual change in % (real)	-13.2	4.1	7.7	7.5	1.7	5.5	1.1	.	.
Goods transport, bn t-kms	3147	3315	3480	3592	3793	918	.	.	.
annual change in %	-3.3	5.3	5.0	3.2	5.6	4.1	.	.	.
Gross fixed investment, RUB bn, nom.	407.1	670.4	1165.2	1599.5	1660.5	254.4	330.0	.	.
annual change in % (real)	-12.0	5.3	17.7	8.7	2.6	1.2	10.2	6.9	7.1
Construction output total									
annual change in % (real)	-5.0	6.0	17.0	9.9	2.7	2.6	13.6	.	.
Dwellings completed, th units	387.7	389.8	373.4	381.6	395.8	53.9	59.5	.	.
annual change in %	-9.9	0.5	-4.2	2.2	3.7	22.5	10.4	.	.
Employment total, th pers., average	63812	63963	64327	64710	65650	65100 2)	64400 2)	.	.
annual change in %	-1.4	0.2	0.6	0.6	1.5	2.8 2)	-1.1 2)	.	.
Employment in industry, th pers., average	14162	14297	14543	14692	14768	.	.	.	.
annual change in %	-5.0	1.0	1.7	1.0	0.5	.	.	.	.
Reg. unemployed, th pers, end of period	1929.0	1263.4	1037.0	1122.7	1309.0	1269.8	1628.0	.	.
Reg. unemployment rate in %, end of period	2.7	1.7	1.4	1.6	1.8	1.8	2.3	.	.
LFS - unemployment rate in %, average 3)	13.5	13.0	10.5	9.1	8.0	8.4	9.1	7.5	8
Average gross monthly wages, RUB	1051.5	1522.6	2223.4	3240.4	4426.0	3838.7	4794.3	.	.
annual change in % (real, gross)	-13.3	-22.0	20.9	19.9	16.6	17.2	10.8	.	.
Retail trade turnover, RUB bn	1077.0	1848.2	2416.2	3151.5	3861.7	845.9	1036.2	.	.
annual change in % (real)	-3.5	-6.3	8.8	10.6	8.9	8.9	8.4	.	.
Consumer prices, % p.a.	27.6	85.7	20.8	21.6	16.0	18.0	14.6	14	10
Producer prices in industry, % p.a.	7.1	58.9	46.6	19.1	11.7	7.2	19.4	15	10
Central government budget, RUB bn									
Revenues	325.9	615.5	1132.1	1590.7	2202.2	472.4	581.0	.	.
Expenditures	472.2	666.9	1029.2	1325.7	2046.0	364.3	490.0	.	.
Deficit (-) / surplus (+)	-146.3	-51.4	102.9	265.0	156.2	108.1	91.0	.	.
Deficit (-) / surplus (+), % GDP	-5.3	-1.1	1.4	2.9	1.4	4.7	3.3	.	.
Money supply, RUB bn, end of period									
M1, Money	342.8	526.8	879.3	1192.6	1499.2	1106.3	1513.9	.	.
M2, Money + quasi money	628.6	984.9	1560.0	2122.7	2843.6	2137.7	2991.0	.	.
Refinancing rate of NB % p.a., end of per.	60	55	25	25	21	25	18	.	.
Current account, USD mn	219	24616	46839	34959	32807	6761	11481	27000	25000
Current account in % of GDP	0.1	12.6	18.0	11.3	9.5	9.2	12.5	6.7	5.7
Gross reserves of NB, excl. gold, USD mn	7801	8458	24264	32542	44054	33179	51790	.	.
Gross external debt, USD mn	189200	178600	161400	150800	152100	149900	153500	.	.
Exports total, fob, EUR mn 4)	66467	70820	113672	113448	113172	24635	28352	117000	118000
annual change in %	-13.3	6.5	60.5	-0.2	-0.2	-11.0	15.1	3	1
Imports total, cif, EUR mn 4)	51798	37061	48552	60025	64049	14090	14211	65000	70000
annual change in %	-18.4	-28.5	31.0	23.6	6.7	15.2	0.9	2	8
Average exchange rate RUB/USD	9.71	24.62	28.12	29.17	31.35	30.78	31.66	32	34
Average exchange rate RUB/EUR (ECU)	11.06	26.24	26.03	26.13	29.65	26.98	33.98	35	37
Purchasing power parity RUB/USD, wiiw	3.26	5.54	7.47	8.60	9.80	.	.	11.2	.
Purchasing power parity RUB/EUR, wiiw	3.55	6.04	8.19	9.42	10.60	.	.	.	.

Notes: 1) Preliminary. - 2) Based on Labour Force Survey data. - 3) In 1998 data refer to October. - 4) Based on balance of payments statistics, including estimate of non-registered trade. Converted from USD to EUR using the ECB EUR/USD foreign exchange reference rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

Table 2

Selected indicators, by region

	Territory	Population	GRP	Fixed capital investment
		Oct. 2002	2001	2002
	thous. sq. km	thousand	RUB bn	RUB bn
Russian Federation	**17075.4**	**145182**	**7831.4**	**1758.7**
			% of total	*% of total*
Central Federal District	**650.7**	**37991**	**32.90**	**22.82**
Belgorod region	27.1	1512	0.69	0.58
Bryansk region	34.9	1379	0.41	0.23
Vladimir region	29.0	1525	0.57	0.49
Voronezh region	52.4	2379	0.81	0.84
Ivanovo region	21.8	1149	0.28	0.16
Kaluga region	29.9	1041	0.43	0.41
Kostroma region	60.1	738	0.30	0.32
Kursk region	29.8	1236	0.49	0.55
Lipetsk region	24.1	1213	0.65	0.59
Moscow region	47[1)]	6627	3.41	3.41
City of Moscow	.	10358	20.72	11.68
Orel region	24.7	861	0.39	0.27
Ryasan region	39.6	1228	0.56	0.38
Smolensk region	49.8	1051	0.49	0.60
Tambov region	34.3	1180	0.43	0.28
Tver region	84.1	1473	0.65	0.80
Tula region	25.7	1676	0.71	0.52
Yaroslavl region	36.4	1368	0.91	0.72
Northwestern Federal District	**1677.9**	**13986**	**9.65**	**10.02**
Republic of Karelia	172.4	717	0.43	0.62
Republic of Komi	415.9	1019	1.14	1.27
Arkhangelsk region	587.4	1336	0.87	1.12
incl. Nenets autonomous area	176.7	42	0.16	0.71
Vologda region	145.7	1270	0.89	0.71
Kaliningrad region	15.1	955	0.40	0.37
Leningrad region	85,9[2)]	1671	1.03	1.33
City of St. Petersburg	.	4669	3.52	3.61
Murmansk region	144.9	893	0.75	0.50
Novgorod region	55.3	695	0.36	0.31
Pskov region	55.3	761	0.26	0.18
Southern Federal District	**589.2**	**22914**	**7.76**	**9.20**
Republic of Adygeya	7.6	447	0.09	0.10
Republic of Daghestan	50.3	2584	0.40	0.31
Republic of Ingushetia	19,3[3)]	469	0.06	0.03
Chechen Republic	.	1100	.	.
Kabardian-Balkar Republic	12.5	901	0.27	0.20
Republic of Kalmykia	76.1	292	0.15	0.26
Karachaev-Cherkess Republic	14.1	440	0.09	0.12
Republic of North Ossetia-Alania	8.0	710	0.19	0.15
Krasnodar territory	76.0	5124	2.35	3.82
Stavropol territory	66.5	2731	0.93	0.98
Astrakhan region	44.1	1007	0.47	0.73
Volgograd region	113.9	2703	1.16	1.06
Rostov region	100.8	4407	1.60	1.43

(Table 2 continued)

Table 2 (continued)

Volga Federal District	**1038.0**	**31158**	**17.92**	**16.33**
Republic of Bashkortostan	143.6	4103	2.38	2.96
Republic of Mariy El	23.2	728	0.20	0.15
Republic of Mordovia	26.2	889	0.31	0.36
Republic of Tatarstan	68.0	3780	2.79	3.24
Udmurt Republic	42.1	1571	0.88	0.59
Chuvash Republic	18.3	1314	0.43	0.43
Kirov region	120.8	1504	0.56	0.31
Nizhny Novgorod region	76.9	3524	2.14	1.54
Orenburg region	124.0	2178	1.15	0.89
Penza region	43.2	1453	0.44	0.40
Perm region	160.6	2824	2.37	2.11
incl. Komi-Permyatsky autonomous area	32.9	136	0.03	0.03
Samara region	53.6	3240	2.61	2.08
Saratov region	100.2	2669	1.15	0.97
Ulyanovsk region	37.3	1382	0.52	0.30
Ural Federal District	**1788.9**	**12382**	**15.45**	**20.82**
Kurgan region	71.0	1020	0.32	0.19
Sverdlovsk region	194.8	4490	2.74	2.17
Tyumen region	1435.2	3266	10.45	16.60
incl. Khanty-Mansi autonomous area	523.1	1433	7.17	8.63
incl. Yamalo-Nenets autonomous area	750.3	507	2.39	7.00
Chelyabinsk region	87.9	3606	1.93	1.87
Siberian Federal District	**5114.8**	**20064**	**11.28**	**8.04**
Republic of Altai	92.6	203	0.07	0.06
Republic of Buryatia	351.3	981	0.39	0.34
Republic of Tyva	170.5	306	0.06	0.03
Republic of Khakassia	61.9	546	0.25	0.13
Altai territory	169.1	2607	0.82	0.56
Krasnoyarsk territory	2339.7	2966	3.04	1.85
incl. Taimyr autonomous area	862.1	40	0.03	0.09
incl. Evenki autonomous area	767.6	18	0.01	0.07
Irkutsk region	767.9	2582	1.62	1.01
incl. Ust-Ordyn Buryat autonomous area	22.4	135	0.04	0.02
Kemerovo region	95.5	2900	1.48	1.23
Novosibirsk region	178.2	2692	1.36	0.84
Omsk region	139.7	2079	0.89	0.68
Tomsk region	316.9	1046	0.82	0.97
Chita region	431.5	1156	0.47	0.32
incl. Aginski Buryat autonomous area	19.0	72	0.02	0.02
Far Eastern Federal District	**6215.9**	**6687**	**5.03**	**5.92**
Republic of Sakha (Yakutia)	3103.2	948	1.28	1.36
Primorsky territory	165.9	2068	0.94	0.70
Khabarovsk territory	788.6	1435	1.05	1.01
Amur region	363.7	903	0.50	0.73
Kamchatka region	472.3	359	0.29	0.18
incl. Koryak autonomous area	301.5	25	0.04	0.03
Magadan region	461.4	183	0.20	0.16
Sakhalin region	87.1	547	0.61	1.45
Jewish autonomous region	36.0	191	0.06	0.05
Chukchi autonomous area	737.7	54	0.10	0.27

Notes: 1) Moscow region and the City of Moscow combined. - 2) Leningrad region and the City of St. Petersburg combined. - 3) Republic of Ingushetia and Chechen republic combined.

Source: Goskomstat, own calculations.

Table 3

Selected measures of living standards, by region

	GRP per capita [1] 2001 RUB	Average monthly money income per capita in 2002 RUB	Average monthly money expenditures per capita in 2002 RUB	Monthly subsistence minimum per capita 4th quarter 2002 RUB
Russian Federation	**53942**	**3888**	**3819**	**1893**
Central Federal District	**67827**	**5284**	**5642**	.
Belgorod region	35506	2784	2478	1576
Bryansk region	23207	2255	2034	1540
Vladimir region	29445	2062	2019	1546
Voronezh region	26566	2553	2501	1693
Ivanovo region	19236	1595	1668	1848
Kaluga region	32568	2254	2188	1771
Kostroma region	32000	2371	2217	1701
Kursk region	30997	2518	2202	1762
Lipetsk region	42195	2742	2392	1480
Moscow region	40290	3416	3354	2115
City of Moscow	156665	13668	15783	2918
Orel region	35673	2540	2347	.
Ryasan region	35831	2510	2309	1629
Smolensk region	36744	2843	2671	1694
Tambov region	28315	2648	2201	1509
Tver region	34701	2204	1932	1808
Tula region	33061	2561	2160	1496
Yaroslavl region	51912	3311	2921	1783
Northwestern Federal District	**54061**	**3848**	**3639**	**.**
Republic of Karelia	47440	3808	3112	2054
Republic of Komi	87929	5577	4451	2404
Arkhangelsk region	50910	3629	3029	2217
incl. Nenets autonomous area	303614	6442	3932	3612
Vologda region	55039	3366	2959	1859
Kaliningrad region	32768	2634	2796	1889[2]
Leningrad region	48172	2408	2271	1899
City of St. Petersburg	58980	4479	4801	2291
Murmansk region	65935	5414	4446	2800
Novgorod region	40161	2896	2661	1791
Pskov region	27073	2348	2165	1571
Southern Federal District	**26538**	**2561**	**2514**	**.**
Republic of Adygeya	15213	2102	1586	1449
Republic of Daghestan	12228	1871	1314	1420[2]
Republic of Ingushetia	10663	1172	506	1897[3]
Chechen Republic	.	.	.	.
Kabardian-Balkar Republic	23765	2379	1904	1517
Republic of Kalmykia	40356	1718	960	1637
Karachaev-Cherkess Republic	16830	2058	1540	1508
Republic of North Ossetia-Alania	20707	2429	1893	1445
Krasnodar territory	35965	2762	2997	1676
Stavropol territory	26698	2302	2688	1680
Astrakhan region	36239	3017	2730	1746
Volgograd region	33488	2612	2489	1693
Rostov region	28411	3062	3147	1715

(Table 3 continued)

Table 3 (continued)

Volga Federal District	**45051**	**2940**	**2750**	**.**
Republic of Bashkortostan	45407	3123	2759	1574
Republic of Mariy El	21291	1735	1532	1562
Republic of Mordovia	27343	2100	1554	1680
Republic of Tatarstan	57728	3177	2829	1599
Udmurt Republic	43808	2419	2188	1687
Chuvash Republic	25573	1995	1901	1621
Kirov region	29130	2382	2290	1757
Nizhny Novgorod region	47588	3168	3059	1727
Orenburg region	41286	2443	1953	1666
Penza region	23806	2107	2101	1677
Perm region	65784	3990	3602	1961
incl. Komi-Permyatsky aut. area	17660	1438	803	1707
Samara region	62998	4130	4682	1977
Saratov region	33867	2412	2084	1831
Ulyanovsk region	29444	2236	2081	1702
Ural Federal District	**97702**	**4657**	**3962**	**.**
Kurgan region	24708	2280	1910	1816
Sverdlovsk region	47842	3812	4046	2034
Tyumen region	250544	8430	5899	.
incl. Khanty-Mansi autonomous area	391738	10677	6883	3002
incl. Yamalo-Nenets autonomous area	368151	13325	8304	3138
Chelyabinsk region	42012	3039	2731	1833
Siberian Federal District	**44023**	**3210**	**3009**	**.**
Republic of Altai	28093	2396	1506	1812
Republic of Buryatia	31397	2977	2725	2024
Republic of Tyva	16367	2321	1186	1956
Republic of Khakassia	36440	2959	2868	1949
Altai territory	24509	2170	2038	1514
Krasnoyarsk territory	80237	4275	3767	2084
incl. Taimyr autonomous area	67839	5666	3570	3649
incl. Evenki autonomous area	50847	4197	3279	.
Irkutsk region	49272	3383	2977	2066
incl. Ust-Ordyn Buryat aut.area	23651	1134	496	1815
Kemerovo region	40066	3899	3142	2010
Novosibirsk region	39596	2618	3646	2086
Omsk region	33426	3184	3265	1782
Tomsk region	61185	3806	3216	1980
Chita region	31569	2307	1969	2250
incl. Aginski Buryat autonomous area	18006	1873	824	2480
Far Eastern Federal District	**58878**	**4115**	**3892**	**.**
Republic of Sakha (Yakutia)	105474	5939	4505	3091
Primorsky territory	35635	3110	3507	2603
Khabarovsk territory	57057	4330	4314	.
Amur region	42992	2666	2825	2209
Kamchatka region	64103	5643	4926	3700
incl. Koryak autonomous area	136000	5691	2975	5032
Magadan region	85386	5463	4421	.
Sakhalin region	88015	5117	4435	3351
Jewish autonomous region	25144	3027	2532	2200
Chukchi autonomous area	145522	7588	5249	.

Notes: 1) Based on population as of 2002. - 2) Third quarter of 2002. - 3) Based on the third and fourth quarters of 2002.

Source: Goskomstat, own calculations.

Table 4

Federal, regional and consolidated budgets in 1992-2002

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	in RUB billion (prior to 1998 RUB tn)										
Revenues											
Federal	3.0	25.5	81.7	232.1	281.9	343.4	325.9	615.5	1132.1	1590.7	2202.2
Regional	2.7	30.1	115.7	241.0	322.9	433.4	413.4	660.8	1065.8	1322.4	1632.6
Consolidated	5.3	49.7	172.4	437.0	558.5	711.6	686.8	1213.6	2096.7	2683.7	3515.6
Inter-budgetary transfers	0.4	5.9	24.9	36.1	46.3	65.2	52.5	62.7	101.2	229.4	319.1
Expenditures											
Federal	4.0	35.4	142.7	275.2	356.2	436.6	472.2	666.9	1029.2	1325.7	2046.0
Regional	2.4	28.2	112.6	247.0	342.8	468.1	422.4	653.8	1032.1	1330.2	1676.8
Consolidated	6.0	57.7	230.4	486.1	652.7	839.5	842.1	1258.0	1960.1	2426.5	3403.7
Inter-budgetary transfers	0.4	5.9	24.9	36.1	46.3	65.2	52.5	62.7	101.2	229.4	319.1
	as % of GDP										
Revenues											
Federal	15.8	14.9	13.4	16.2	14.0	14.7	12.4	12.8	15.5	17.6	20.3
Regional	14.2	17.6	18.9	16.9	16.1	18.5	15.7	13.7	14.6	14.6	15.0
Consolidated	28.0	29.0	28.2	30.6	27.8	30.4	26.1	25.2	28.7	29.7	32.4
Inter-budgetary transfers	2.1	3.4	4.1	2.5	2.3	2.8	2.0	1.3	1.4	2.5	2.9
Expenditures											
Federal	21.0	20.6	23.4	19.3	17.7	18.6	18.0	13.8	14.1	14.7	18.8
Regional	12.6	16.4	18.4	17.3	17.1	20.0	16.1	13.6	14.1	14.7	15.4
Consolidated	31.4	33.6	37.7	34.0	32.5	35.8	32.0	26.1	26.8	26.8	31.3
Inter-budgetary transfers	2.1	3.4	4.1	2.5	2.3	2.8	2.0	1.3	1.4	2.5	2.9
Memorandum item:											
Regional budgets as % of consolidated budget											
In terms of revenues [1)]	43.2	48.7	52.7	46.9	49.5	51.7	52.5	49.3	46.0	40.7	37.4
In terms of expenditures	40.2	48.9	48.9	50.8	52.5	55.8	50.2	52.0	52.7	54.8	49.3

Note: 1) Without federal transfers.

Source: Goskomstat, own calculations.

Table 5

Regional budgets[1) in 2002

	Revenues RUB mn	Expenditures RUB mn	Balance RUB mn
Russian Federation	**1632574**	**1676848**	**-44274**
Central Federal District	**489597**	**517973**	**-28389**
Belgorod region	10221	10546	-325
Bryansk region	8223	8404	-181
Vladimir region	10108	10059	49
Voronezh region	13408	14708	-1300
Ivanovo region	7905	7954	-50
Kaluga region	8553	8662	-109
Kostroma region	5609	5668	-59
Kursk region	7111	7279	-168
Lipetsk region	11016	9746	1271
Moscow region	60772	64115	-3356
City of Moscow	281781	304174	-22392
Orel region	5878	6109	-232
Ryasan region	9314	9467	-152
Smolensk region	6908	7056	-147
Tambov region	6991	7191	-200
Tver region	10004	10467	-463
Tula region	12016	12562	-546
Yaroslavl region	13778	13807	-29
Northwestern Federal District	**164015**	**164770**	**-755**
Republic of Karelia	7766	8269	-503
Republic of Komi	15128	16315	-1187
Arkhangelsk region	12545	12654	-109
incl. Nenets autonomous area	2205	2448	-243
Vologda region	13041	13035	6
Kaliningrad region	7781	7917	-137
Leningrad region	16623	15804	819
City of St. Petersburg	66620	65559	1061
Murmansk region	11088	11558	-469
Novgorod region	4779	4969	-190
Pskov region	6439	6241	198
Southern Federal District	**157654**	**157395**	**259**
Republic of Adygeya	3820	3748	72
Republic of Daghestan	15745	15919	-174
Republic of Ingushetia	4851	4883	-32
Chechen Republic	7555	7089	467
Kabardian-Balkar Republic	5933	6387	-454
Republic of Kalmykia	2647	2698	-52
Karachaev-Cherkess Republic	3577	3404	173
Republic of North Ossetia-Alania	5800	5841	-41
Krasnodar territory	40489	39188	1301
Stavropol territory	18066	18484	-417
Astrakhan region	6634	6973	-340
Volgograd region	16072	16423	-351
Rostov region	26464	26358	106

(Table 5 continued)

Table 5 (continued)

Volga Federal District	**268117**	**272439**	**-4322**
Republic of Bashkortostan	37505	38019	-514
Republic of Mariy El	4614	4805	-191
Republic of Mordovia	8533	9076	-543
Republic of Tatarstan	55253	55440	-187
Udmurt Republic	13942	14714	-773
Chuvash Republic	9004	9209	-205
Kirov region	9869	10193	-324
Nizhny Novgorod region	23989	24385	-396
Orenburg region	15280	15570	-290
Penza region	8558	8502	56
Perm region	24939	25714	-774
incl. Komi-Permyatsky autonomous area	1623	1595	29
Samara region	30464	30256	209
Saratov region	16342	16224	119
Ulyanovsk region	8201	8738	-537
Ural Federal District	**216185**	**218152**	**-1967**
Kurgan region	6939	6982	-43
Sverdlovsk region	35446	35826	-380
Tyumen region	23567	22901	665
incl. Khanty-Mansi autonomous area	82543	87773	-5230
incl. Yamalo-Nenets autonomous area	43141	40815	2326
Chelyabinsk region	24548	23855	693
Siberian Federal District	**190619**	**197324**	**-6706**
Republic of Altai	3686	3613	72
Republic of Buryatia	10984	11797	-814
Republic of Tyva	4503	4594	-91
Republic of Khakassia	4412	4513	-101
Altai territory	17029	17112	-83
Krasnoyarsk territory	34939	37696	-2757
incl. Taimyr autonomous area	3443	3533	-91
incl. Evenki autonomous area	2167	3193	-1025
Irkutsk region	22431	23172	-741
incl. Ust-Ordyn Buryat aut.area	1664	1655	9
Kemerovo region	25543	25699	-156
Novosibirsk region	21332	22383	-1050
Omsk region	14708	14873	-164
Tomsk region	10982	10763	219
Chita region	11696	11655	42
incl. Aginski Buryat autonomous area	1098	1073	25
Far Eastern Federal District	**121096**	**123328**	**-2236**
Republic of Sakha (Yakutia)	35582	36914	-1332
Primorsky territory	20616	20529	83
Khabarovsk territory	20512	21436	-924
Amur region	9971	10148	-177
Kamchatka region	7068	7350	-282
incl. Koryak autonomous area	1518	1764	-247
Magadan region	6646	6696	-49
Sakhalin region	9250	9472	-222
Jewish autonomous region	2399	2307	92
Chukchi autonomous area	7534	6711	823

Note: 1) Including municipal budgets.

Source: Goskomstat, own calculations.

Table 6

Foreign trade in 2001, by region

	With non-CIS		With CIS	
	exports USD mn	imports USD mn	exports USD mn	imports USD mn
Russian Federation	**84718.5**	**30393.6**	**14479.1**	**11134.3**
Central Federal District	**28572.9**	**16817.5**	**3516.5**	**3179.9**
Belgorod region	348.4	202.0	371.0	587.2
Bryansk region	75.6	64.3	41.3	117.6
Vladimir region	84.0	103.5	32.2	92.2
Voronezh region	178.2	77.8	46.0	102.6
Ivanovo region	51.8	35.0	21.7	145.6
Kaluga region	36.0	101.4	33.2	34.4
Kostroma region	76.7	12.6	14.9	1.5
Kursk region	48.5	36.2	47.5	114.6
Lipetsk region	891.6	178.4	32.1	44.8
Moscow region	1233.0	2039.7	359.4	484.6
City of Moscow	22150.5	13249.8	2264.2	1230.8
Orel region	107.6	87.4	23.6	28.0
Ryasan region	742.5	76.7	23.3	17.6
Smolensk region	405.2	112.2	14.6	21.3
Tambov region	25.0	49.0	19.2	18.1
Tver region	81.1	98.1	36.1	58.4
Tula region	789.3	82.9	69.8	43.4
Yaroslavl region	1247.7	210.4	66.5	37.4
Northwestern Federal District	**8416.8**	**6379.5**	**335.3**	**325.7**
Republic of Karelia	563.4	115.8	6.2	1.4
Republic of Komi	967.2	97.5	42.6	5.0
Arkhangelsk region	626.2	108.7	22.5	5.5
incl. Nenets autonomous area	.	.	.	.
Vologda region	1099.4	117.5	23.2	25.1
Kaliningrad region	373.7	960.6	13.2	23.8
Leningrad region	2066.7	793.9	48.7	13.7
City of St. Petersburg	1789.1	3802.9	157.7	233.4
Murmansk region	534.5	113.5	5.0	7.4
Novgorod region	287.8	106.6	10.5	6.9
Pskov region	108.7	162.4	5.7	3.4
Southern Federal District	**3311.7**	**1270.1**	**549.5**	**625.6**
Republic of Adygeya	95.2	21.3	0.4	0.7
Republic of Daghestan	74.4	5.1	18.0	13.3
Republic of Ingushetia	82.9	3.7	0.5	0.5
Chechen Republic	81.7	.	.	.
Kabardian-Balkar Republic	3.2	3.3	1.4	2.1
Republic of Kalmykia	114.4	38.6	12.4	23.3
Karachaev-Cherkess Republic	0.6	6.5	3.8	2.0
Republic of North Ossetia-Alania	63.5	47.8	4.6	20.2
Krasnodar territory	912.6	558.0	79.0	69.2
Stavropol territory	270.1	91.6	22.1	20.8
Astrakhan region	353.8	32.3	95.8	15.9
Volgograd region	612.8	199.8	122.9	72.3
Rostov region	646.7	262.1	188.7	385.1

(Table 6 continued)

Table 6 (continued)

Volga Federal District	**13091.1**	**1884.5**	**1673.5**	**998.4**
Republic of Bashkortostan	1891.3	222.2	335.5	40.1
Republic of Mariy El	28.1	10.6	4.9	3.3
Republic of Mordovia	19.2	24.9	12.5	3.9
Republic of Tatarstan	2476.2	269.0	350.6	77.8
Udmurt Republic	627.2	49.7	30.8	43.4
Chuvash Republic	59.1	60.6	12.3	9.0
Kirov region	222.0	30.8	20.5	7.2
Nizhny Novgorod region	802.7	310.3	251.6	86.8
Orenburg region	1270.7	40.4	107.1	418.7
Penza region	34.3	45.7	76.5	6.8
Perm region	1894.5	181.2	122.4	74.4
incl. Komi-Permyatsky autonomous area	.	.	.	.
Samara region	3331.8	475.5	268.7	180.2
Saratov region	357.2	127.0	45.9	34.9
Ulyanovsk region	76.8	36.6	34.2	11.8
Ural Federal District	**18025.9**	**1498.6**	**1874.6**	**821.4**
Kurgan region	38.2	18.8	75.0	31.4
Sverdlovsk region	2611.9	478.1	300.9	269.4
Tyumen region	13926.2	766.7	1226.9	63.5
incl. Khanty-Mansi autonomous area	.	.	.	.
incl. Yamalo-Nenets autonomous area	.	.	.	.
Chelyabinsk region	1449.5	234.9	271.8	457.1
Siberian Federal District	**9323.7**	**1591.6**	**1210.8**	**943.2**
Republic of Altai	28.1	129.2	13.9	8.9
Republic of Buryatia	139.7	21.0	2.1	9.2
Republic of Tyva	14.4	9.6	.	0.2
Republic of Khakassia	353.9	51.9	6.9	117.7
Altai territory	60.6	58.2	214.3	85.8
Krasnoyarsk territory	2755.5	378.2	104.0	232.3
incl. Taimyr autonomous area	.	.	.	.
incl. Evenki autonomous area	.	.	.	.
Irkutsk region	2668.3	333.4	41.8	101.0
incl. Ust-Ordyn Buryat aut.area	.	.	.	.
Kemerovo region	1888.3	67.9	214.5	113.1
Novosibirsk region	170.5	164.8	331.8	162.0
Omsk region	564.7	58.6	245.0	105.2
Tomsk region	596.2	59.2	34.7	4.1
Chita region	83.5	259.8	1.9	3.6
incl. Aginski Buryat autonomous area	.	.	.	.
Far Eastern Federal District	**5379.4**	**913.3**	**19.5**	**29.1**
Republic of Sakha (Yakutia)	1282.8	29.9	15.5	1.9
Primorsky territory	1145.0	452.1	1.1	14.0
Khabarovsk territory	2350.2	138.9	1.9	7.0
Amur region	96.4	20.0	0.1	1.6
Kamchatka region	155.4	46.4	.	0.4
incl. Koryak autonomous area	.	.	.	.
Magadan region	2.8	55.3	.	0.1
Sakhalin region	330.3	164.9	0.9	3.8
Jewish autonomous region	16.7	3.6	.	0.4
Chukchi autonomous area	0.1	2.2	.	.

Source: Goskomstat.

Table 7

Investment potential and investment risk in 2002, by region

Investment potential			Investment risk		
Rank	Region	% of Russian total	Rank	Region	% of Russian average
1	City of Moscow	18.29	1	Novgorod region	73.9
2	City of St. Petersburg	5.66	2	City of Moscow	74.1
3	Moscow region	4.65	3	Moscow region	78.5
4	Khanty-Mansi autonomous area	2.68	4	Yaroslavl region	78.5
5	Sverdlovsk region	2.59	5	Belgorod region	80.7
6	Samara region	2.26	6	Orel region	82.6
7	Krasnoyarsk territory	2.21	7	Nenets autonomous area	84.8
8	Nizhny Novgorod region	2.15	8	City of St. Petersburg	85.2
9	Republic of Tatarstan	2.05	9	Republic of Tatarstan	85.7
10	Krasnodar territory	2.04	10	Leningrad region	88.7
11	Chelyabinsk region	2.00	11	Vologda region	88.9
12	Perm region	1.96	12	Vladimir region	89.2
13	Rostov region	1.96	13	Tver region	90.1
14	Kemerovo region	1.90	14	Krasnodar territory	90.5
15	Republic of Bashkortostan	1.76	15	Nizhny Novgorod region	90.9
16	Irkutsk region	1.63	16	Chuvash Republic	91.5
17	Yamalo-Nenets aut. area	1.42	17	Republic of Bashkortostan	91.5
18	Republic of Sakha (Yakutia)	1.42	18	Rostov region	91.9
19	Novosibirsk region	1.36	19	Pskov region	92.1
20	Primorsky territory	1.26	20	Kaluga region	92.4
21	Saratov region	1.22	21	Kaliningrad region	92.5
22	Leningrad region	1.18	22	Lipetsk region	92.9
23	Khabarovsk territory	1.16	23	Saratov region	93.7
24	Belgorod region	1.10	24	Stavropol territory	93.9
25	Volgograd region	1.09	25	Smolensk region	94.5
26	Voronezh region	1.07	26	Kirov region	94.8
27	Altai territory	1.04	27	Republic of Mordovia	95.5
28	Tula region	0.99	28	Samara region	96.0
29	Orenburg region	0.95	29	Ryasan region	97.4
30	Murmansk region	0.92	30	Volgograd region	97.4
31	Stavropol territory	0.91	31	Republic of Karelia	97.4
32	Kaliningrad region	0.84	32	Kostroma region	97.5
33	Omsk region	0.83	33	Ivanovo region	97.6
34	Yaroslavl region	0.79	34	Tomsk region	98.3
35	Vladimir region	0.79	35	Republic of Altai	98.4
36	Kursk region	0.79	36	Voronezh region	99.2
37	Republic of Komi	0.77	37	Murmansk region	99.7
38	Udmurt Republic	0.74	38	Perm region	99.8
39	Tyumen region	0.72	39	Republic of Adygeya	100.3
40	Tomsk region	0.72	40	Ulyanovsk region	100.3
41	Lipetsk region	0.71	41	Udmurt Republic	100.6
42	Kaluga region	0.71	42	Penza region	101.4
43	Vologda region	0.70	43	Astrakhan region	101.7
44	Tver region	0.70	44	Arkhangelsk region	102.9
45	Arkhangelsk region	0.70	45	Kursk region	103.1
46	Ulyanovsk region	0.69	46	Kabardian-Balkar Republic	103.4

(Table 7 continued)

Table 7 (continued)

47	Chuvash Republic	0.65	47	Orenburg region	104.8
48	Penza region	0.64	48	Republic of North Ossetia-Alania	105.1
49	Chita region	0.64	49	Altai territory	105.5
50	Amur region	0.63	50	Tambov region	106.2
51	Ryasan region	0.63	51	Omsk region	109.7
52	Smolensk region	0.62	52	Sverdlovsk region	110.0
53	Bryansk region	0.61	53	Irkutsk region	110.0
54	Republic of Daghestan	0.58	54	Novosibirsk region	112.3
55	Tambov region	0.56	55	Sakhalin region	112.3
56	Astrakhan region	0.55	56	Khabarovsk territory	112.5
57	Orel region	0.55	57	Republic of Kalmykia	112.5
58	Republic of Buryatia	0.55	58	Kemerovo region	112.7
59	Kirov region	0.52	59	Republic of Khakassia	115.6
60	Republic of Mordovia	0.51	60	Republic of Mariy El	115.7
61	Republic of North Ossetia-Alania	0.50	61	Tula region	115.8
62	Republic of Karelia	0.49	62	Khanty-Mansi autonomous area	119.3
63	Novgorod region	0.48	63	Republic of Buryatia	120.2
64	Pskov region	0.46	64	Kurgan region	120.3
65	Sakhalin region	0.44	65	Amur region	120.5
66	Ivanovo region	0.44	66	Tyumen region	121.0
67	Kabardian-Balkar Republic	0.42	67	Republic of Komi	121.1
68	Kurgan region	0.41	68	Chita region	121.9
69	Kostroma region	0.37	69	Magadan region	123.8
70	Magadan region	0.36	70	Primorsky territory	124.7
71	Republic of Mariy El	0.36	71	Krasnoyarsk territory	124.9
72	Republic of Khakassia	0.31	72	Komi-Permyatsky aut. area	125.6
73	Republic of Adygeya	0.29	73	Bryansk region	126.2
74	Chukchi autonomous area	0.29	74	Republic of Sakha (Yakutia)	126.3
75	Kamchatka region	0.26	75	Chelyabinsk region	137.9
76	Republic of Ingushetia	0.25	76	Jewish autonomous region	140.1
77	Karachaev-Cherkess Republic	0.25	77	Ust-Ordyn Buryat aut. area	142.4
78	Taimyr autonomous area	0.22	78	Evenki autonomous area	143.2
79	Republic of Kalmykia	0.20	79	Aginski Buryat autonomous area	146.1
80	Jewish autonomous region	0.17	80	Republic of Daghestan	152.5
81	Republic of Tyva	0.15	81	Kamchatka region	161.8
82	Republic of Altai	0.15	82	Republic of Tyva	164.4
83	Ust-Ordyn Buryat aut. area	0.08	83	Yamalo-Nenets aut. area	168.9
84	Evenki autonomous area	0.08	84	Karachaev-Cherkess Republic	169.2
85	Nenets autonomous area	0.07	85	Chukchi autonomous area	178.1
86	Komi-Permyatsky aut. area	0.06	86	Taimyr autonomous area	192.9
87	Aginski Buryat autonomous area	0.06	87	Republic of Ingushetia	208.1
88	Koryak autonomous area	0.06	88	Koryak autonomous area	237.5
89	Chechen Republic	0.03	89	Chechen Republic	1336.4

Source: RA Ekspert.

Table 8

Top ten Russian regions in terms of FDI inflows in 2002

Region	FDI inflow in 2002 USD mn	FDI inflow in 2002 % of Russian total
City of Moscow	1508	37.7
Sakhalin region	680	17.0
Moscow region	589	14.7
Yamalo-Nenets autonomous area	134	3.3
Leningrad region	115	2.9
Sverdlovsk region	100	2.5
Samara region	98	2.4
Krasnodar territory	90	2.3
City of St. Petersburg	84	2.1
Nenets autonomous area	81	2.0
Russia total	*4002*	*100*

Source: Goskomstat, Institute for the Economy in Transition, and own calculations.

Table 9

Selected indicators of the banking sector

	01.07. 1998	01.01. 1999	01.01. 2000	01.01. 2001	01.01. 2002	01.01. 2003	01.04. 2003
Assets							
Assets, RUB bn	766.1	1046.6	1586.4	2362.5	3159.7	4145.3	4514.6
Rouble assets, RUB bn	558.2	.	.	1373.3	1963.8	2646.3	2939.0
Foreign currency assets, RUB bn	207.9	.	.	989.2	1195.9	1499.0	1575.6
Assets, % of GDP	.	39.8	32.9	32.3	35.0	38.2	39.3
Loans to domestic non-fin. enterpr.[1], RUB bn	199.7	300.3	445.2	758.3	1176.8	1591.4	1702.5
In roubles, RUB bn	117.7	99.6	244.3	503.2	810.1	1044.2	1107.1
In foreign currency, RUB bn	82.0	200.7	200.9	255.1	366.7	547.2	595.4
Loans to domestic non-fin. enterpr.[1], % of GDP	.	11.4	9.2	10.4	13.0	14.6	14.8
Loans to domestic non-fin. enterpr.[1], % of assets	26.1	28.7	28.1	32.1	37.2	38.4	37.7
Bank loans in fixed capital investment[2], RUB bn	.	15.2	24.2	29.5	48.7	65.1	.
% of fixed capital investment	.	3.7	3.6	2.5	3.0	3.9	.
Loans to domestic households, RUB bn	18.2	20.1	27.6	43.8	93.3	141.1	157.2
In roubles, RUB bn	12.4	10.6	15.9	34.2	77.9	115.8	128.4
In foreign currency, RUB bn	5.8	9.5	11.7	9.6	15.4	25.3	28.8
Loans to domestic households, % of GDP	.	0.8	0.6	0.6	1.0	1.3	1.4
Loans to domestic households, % of assets	2.4	1.9	1.7	1.9	3.0	3.4	3.5
Securities in banks' portfolio, RUB bn	246	271.3	325.7	473.2	562.0	779.9	980.4
% of GDP	.	10.3	6.8	6.5	6.2	7.2	8.5
% of assets	32.1	25.9	20.5	20.0	17.8	18.8	21.7
Liabilities							
Capitalization, RUB bn	116.3	76.5	168.2	286.4	453.9	581.3	677.0
% of GDP	.	2.9	3.5	3.9	5.0	5.4	5.9
% of assets	15.2	7.3	10.6	12.1	14.4	14.0	15.0
Household deposits, RUB bn	193.5	201.3	300.5	445.7	677.9	1029.6	1140.3
In roubles, RUB bn	155.8	141.0	202.8	297.7	434.7	633.0	714.7
In foreign currency, RUB bn	37.7	60.3	97.7	148.0	243.2	396.6	425.6
% of GDP	.	7.7	6.2	6.1	7.5	9.5	9.9
% of assets	25.3	19.2	18.9	18.9	21.5	24.8	25.3
% of money incomes of households	.	11.6	10.8	12.2	13.7	15.4	.
Balances of enterpr. & organizations[3], RUB bn	147	281.4	468.4	722.1	902.6	1091.4	1169.6
In roubles, RUB bn	91.4	.	.	423.5	579.7	716.4	764.5
In foreign currency, RUB bn	55.6	.	.	298.6	322.9	375.0	405.1
% of GDP	.	10.7	9.7	9.9	10.0	10.0	10.2
% of assets	19.2	26.9	29.5	30.6	28.6	26.3	25.9

Notes: 1) Including overdue loans. - 2) Without small businesses. - 3) Includes enterprise deposits, balances on corresponding accounts, and government funds.

Source: Central Bank of Russia, own calculations.

Table 10

Indicators of real growth of the banking sector[1], index, 1 July 1998 = 100

	01/07/1998	01/01/2001	01/01/2002	01/01/2003	01/04/2003
Assets	100	90.1	106.4	125.2	132.5
Capitalization	100	84.6	113.1	125.8	139.3
Loans to non-financial enterprises, incl. foreign	100	109.4	146.9	174.7	181.0
Household deposits	100	69.7	91.0	122.4	131.9
Balances of enterprises and organizations[2]	100	143.8	159.5	172.5	179.0

Notes: 1) Deflated with consumer price index. - 2) Includes enterprise deposits, balances on corresponding accounts, and government funds.

Source: Central Bank of Russia.

Table 11

Credit organizations and their branches, as of 1 April 2003, by federal district

Federal District	Number of registered credit organizations	Number of branches of credit organizations registered in the district	Number of branches of credit organizations registered in other districts
Central	744	268	461
incl. Moscow and Moscow region	669	215	86
Northwestern	88	74	306
Southern	141	170	305
Volga	157	188	488
Ural	77	203	217
Siberian	82	55	363
Far Eastern	46	64	142
Russia total	*1335*	*1022*	*2282*

Source: Central Bank of Russia.

Table 12

Concentration in the banking sector

	01/07/1998	01/01/2001	01/01/2002	01/01/2003	01/04/2003
Assets, as % of total assets of the banking sector					
5 biggest banks	41.0	41.2	42.8	44.2	45.2
next 15 banks	21.6	22.7	19.9	18.4	18.1
next 30 banks	13.6	11.8	11.8	10.9	10.6
next 150 banks	13.5	13.7	14.4	15.0	14.9
next 800 banks	9.6	10.3	10.7	11.2	10.9
remaining banks	0.7	0.3	0.3	0.3	0.3
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

Note: Banks are ranged by the size of assets

Source: Central Bank of Russia.

Table 13

The 50 biggest Russian banks, as of 1 April 2003.

Rank in assets	Bank	Location	Assets RUB th	Capitalization[1)] RUB th	Rank in equity
1	Sberbank	Moscow	1 222 865 216	130 331 866	1
2	Vneshtorgbank	Moscow	226 428 978	62 502 244	2
3	Gazprombank	Moscow	191 304 156	26 389 577	4
4	Alfabank	Moscow	172 125 115	22 827 980	5
5	Mezhdunarodnyi Promy shlennyi Bank	Moscow	127 595 785	28 594 514	3
6	Bank of Moscow	Moscow	105 833 640	10 705 182	6
7	MDM Bank	Moscow	92 060 627	8 191 224	10
8	Mezhdunarodnyi Moskovskiy Bank	Moscow	77 721 219	4 117 368	19
9	Rosbank	Moscow	75 265 001	10 210 088	8
10	Promstroybank	St. Petersburg	55 838 280	4 408 985	17
11	Citibank	Moscow	52 846 873	7 564 623	11
12	Raiffeisenbank Austria	Moscow	51 479 094	3 116 428	27
13	Uralsib	Ufa	49 046 261	9 333 055	9
14	Menatep St. Petersburg	St. Petersburg	42 600 117	3 443 685	22
15	Petrokommerz	Moscow	33 237 362	6 958 982	12
16	Investment Bank Trust	Moscow	32 610 533	6 158 922	14
17	Surgutneftegazbank	Surgut	28 893 855	1 434 242	67
18	Nomos-Bank	Moscow	27 140 364	4 228 142	18
19	Zenit	Moscow	25 552 592	3 073 182	28
20	Gutabank	Moscow	25 293 143	2 882 798	32
21	Nikoil	Moscow	24 777 011	6 223 696	13
22	Promsvyazbank	Moscow	22 811 969	2 718 388	35
23	Globeks	Moscow	21 013 996	10 349 253	7
24	Evrofinans	Moscow	20 649 556	3 305 946	24
25	Moskovskiy Bank Rekonstruktsii i Razvitiya	Moscow	19 996 595	2 745 573	34
26	Transkreditbank	Moscow	19 169 833	2 600 570	36
27	Ak Bars	Kazan'	18 665 591	3 230 883	25
28	Natsionalnyi Reservnyi Bank	Moscow	17 887 130	4 883 947	16
29	Commerzbank (Eurasia)	Moscow	17 876 061	744 934	130
30	Vozrozhdenie	Moscow	17 736 558	1 462 330	66
31	Impeksbank	Moscow	16 364 849	2 998 914	29
32	Avtobank	Moscow	15 903 600	1 807 654	50
33	BIN-Bank	Moscow	15 517 086	3 382 151	23
34	ING (Eurasia)	Moscow	15 207 415	1 950 161	45
35	Sobinbank	Moscow	15 178 672	3 904 525	21
36	ABN AMRO	Moscow	14 549 434	1 891 871	47
37	Khanty-Mansiyskiy Bank	Khanty-Mansiysk	14 003 616	2 879 341	33
38	Zapsibkombank	Salekhard	13 467 263	1 325 978	70
39	Deutsche Bank	Moscow	13 293 662	2 896 512	31
40	Moskovskiy Industrial'nyi Bank	Moscow	12 975 049	2 050 661	42
41	Mezhdunarodnyi Bank of St. Petersburg	St. Petersburg	12 348 119	1 059 114	95
42	Baltiyskiy Bank	St. Petersburg	10 774 411	804 480	119
43	Ingosstrakh-Soyuz	Moscow	10 762 978	1 268 302	76
44	Avangard	Moscow	10 350 799	2 040 347	44
45	MDM Bank St. Petersburg	St. Petersburg	9 956 844	724 082	134
46	Kreditnyi Agroprombank	Lytkarino	9 897 145	1 007 322	103
47	Rossel'khozbank	Moscow	9 872 586	3 974 994	20
48	Credit Suisse First Boston	Moscow	9 710 866	2 388 712	38
49	Probiznesbank	Moscow	9 654 217	1 060 939	94
50	Sudostroitel'nyi Bank	Moscow	9 543 340	1 716 353	54

Note: 1) Without subordinated lending.

Source: RA Ekspert.

Table 14

Banks with 100% foreign capital, as of 1 April 2003.

Nr.	Name	Location	Year of registration	Statutory capital, RUB th.
1	Deutsche Bank	Moscow	1998	1237450
2	Raiffeisenbank Austria	Moscow	1996	1004000
3	Citibank	Moscow	1993	1000000
4	HSBC[1) 2)]	Moscow	1996	746550
5	Dresdner Bank	St. Petersburg	1993	727320
6	ABN AMRO	Moscow	1993	677505
7	Standart Bank[1)]	Moscow	2002	650000
8	BNP Paribas[1)]	Moscow	2002	500000
9	Yapy Credit Bank Moscow	Moscow	1993	478272
10	Credit Suisse First Boston	Moscow	1993	460000
11	Guarantee Bank Moscow	Moscow	1995	441150
12	Westdeutsche Landesbank Vostok	Moscow	1995	400000
13	Bank Nateksis[1)]	Moscow	2002	379080
14	Bank Melli Iran[1)]	Moscow	2002	349560
15	Commerzbank (Eurasia)	Moscow	1998	305600
16	Bank of Crediting Small Business	Moscow	1992	286668
17	International Bank of Azerbaidzhan - Moscow[1)]	Moscow	2002	270200
18	Crédit Lyonnais	St. Petersburg	1991	240000
19	Delta Credit	Moscow	1999	237000
20	Société Generale Vostok	Moscow	1993	222350
21	Michinoku Bank (Moscow)	Moscow	1999	183000
22	Finansbank (Moscow)	Moscow	1997	158760
23	Home Credit & Finance Bank	Moscow	1990	100000
24	Asia-Invest Bank	Moscow	1996	72167
25	Investitsionnyi Bank of Kuban[1)]	Krasnodar	1999	66000
26	Iktisat Bank (Moscow)[1)]	Moscow	1998	53995
27	Bank of China (Elos)	Moscow	1993	41000
28	ING (Eurasia)	Moscow	1993	34905
29	JP Morgan Int.	Moscow	1993	15315

Notes: 1) Has no licence to deal with physical persons. - 2) Has a licence to deal with precious stones.
Source: Central Bank of Russia.

Table 15

Credit organizations with the participation of foreign capital, by region, as of 1 April 2003

	Registered	Having a license					
		total	of them with foreign capital, % of statutory capital				
			100	50-100	20-50	1-20	below 1
Russian Federation	**157**	**128**	**29**	**9**	**14**	**36**	**40**
Northwestern Federal District	**14**	**13**	**2**			**4**	**7**
City of St. Petersburg	9	8	2			1	5
Novgorod region	1	1					1
Pskov region	1	1					1
Republic of Karelia	1	1				1	
Vologda region	1	1				1	
Kaliningrad region	1	1				1	
Central Federal District	**111**	**90**	**26**	**9**	**12**	**27**	**16**
Kaluga region	1	1				1	
City of Moscow	108	87	26	9	12	26	14
Tver region	1	1					1
Yaroslavl region	1	1					1
Volga Federal District	**12**	**8**			**1**	**2**	**5**
Republic of Tatarstan	2						
Samara region	3	2				1	1
Nizhny Novgorod region	2	2			1		1
Udmurt Republic	2	2				1	1
Orenburg region	2	2					2
Perm region	1						
Southern Federal District	**3**	**3**	**1**		**1**		**1**
Republic of Daghestan	1	1			1		
Krasnodar territory	1	1	1				
Astrakhan region	1	1					1
Ural Federal District	**8**	**7**				**2**	**5**
Kurgan region	1	1					1
Chelyabinsk region	1	1				1	
Tyumen region	6	5				1	4
Siberian Federal District	**4**	**3**				**1**	**2**
Altai territory	1	1					1
Kemerovo region	1	1				1	
Irkutsk region	2	1					1
Far Eastern Federal District	**5**	**4**					**4**
Primorsky territory	3	2					2
Kamchatka region	1	1					1
Magadan region	1	1					1

Source: Central Bank of Russia.

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