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**RUSSIAN TRANSITION IN THE EARLY 21<sup>ST</sup> CENTURY**

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## Foreword and Abstract

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring of 2003 in order to co-ordinate research into Russia. NORDI's mission is to conduct research into Russia and issues related to Russia's relations with the EU with the aim of providing up-to-date information on different fields of technology and economics. NORDI's core research areas are Russian business and economy, energy and environment, the forest cluster, the ICT sector, as well as logistics and transport infrastructure.

This report describes some economic features of the transitional Russia in the early years of the 21st century. In the period of the cold war, the Soviet Union was a superpower with a huge military machine. Converting this armament industry into civilian use has not been an easy task – structure and development of the Russian industry has shown radical changes in the transitional period. After the economic crisis of 1998, living-standard has recovered rather fast, which is visible in the household expenditure structure. These issues are described in the Chapter 2. In transitional economies current account deficits are as a rule, while in Russia has experienced considerable CA annual surpluses thanks to her resource base. This topic is analysed in Chapter 3. The mirror image of CA surpluses has been Russia's role as net capital exporter – investment quota in Russia is still very modest considering the development stage of the country. In every successful economy, investment is a key factor in long-term economic growth. Russian features in this respect is described in Chapter 4. This report ends with conclusive remarks of the current economic trends (Chapter and Chapter 6).

## Esipuhe ja Tiivistelmä

Pohjoisen ulottuvuuden tutkimuskeskus (NORDI) on Lappeenrannan teknillisen yliopiston (LTY) erillisyksikkö, joka perustettiin keväällä 2003 koordinoimaan ja harjoittamaan tekniikan ja talouden yhdistävää Venäjä-tutkimusta. Tähänastisten tutkimusten aiheita ovat olleet mm. EU:n ja Venäjän väliset taloussuhteet, liiketoimintaympäristön kehitys, energia- ja ympäristö, metsäklusteri, ICT sekä logistiikka ja liikenne.

Tässä tutkimuksessa käsitellään Venäjän talouden kehitystä uudella vuosituhanella. Kylmän sodan aikaan Neuvostoliitto oli suurvalta, jonka asema perustui sotilasmahtiin. Sotateollisuuden konversio palvelemaan nykytarpeita ei ole ollut helppo tehtävä. Vuoden 1998 talouskriisin jälkeen elintaso on toipunut verraten nopeasti, mikä on nähtävissä tarkastellessa kotitalouksien kulutusrakenteita, joita käsitellään tarkemmin luvussa 2. Siirtymätalouksissa vaihtotaseen vajeet ovat yleisiä, mutta luonnonrikkauksiensa ansiosta Venäjän vaihtotaseet ovat olleet huomattavan ylijäämäisiä, mitä pohditaan luvussa 3. Vaihtotaseen ylijäämien heijatusvaikutus on ollut Venäjän rooli pääomien nettoviejänä – Venäjän investointikertymä on edelleen erittäin vaatimaton suhteutettuna maan kehitysvaiheeseen. Jokaisessa menestyksekkäässä taloudessa investoinnit ovat pitkän aikavälin taloudellisen menestyksen avaintekijä. Venäjän erityispiirteitä tähän liittyen on kuvattu luvussa 4. Raportti päättyy talouden nykytilanteen analyysiin (luvat 5 ja 6).

Lappeenranta, December 2005

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## 1. Introduction

In the early period of Russian transition, the economy declined rapidly, while price liberalisation caused a rapid inflation. In the second half of the 1990s this largest former Soviet republic seemed to reach a relative stability in her market-oriented economy, which was supposed to start a new period of growth in the post-communist Russia. January 1st, 1998 a new semi-fixed exchange rate system was launched. This system, in which the central rate was RUB 6,2 = USD 1 with fluctuation boundaries of  $\pm 15\%$  (around the central rate), collapsed in August of the same year. Rouble (RUB) depreciated strongly (Tiusanen, 2003a).

In the aftermath of the 1998 crisis, Russia experienced a remarkable recovery. In the turn of the century, world market prices of oil experienced a clear hike. This event, together with a new more realistic RUB exchange rate, started an economic boom in Russia. Obviously, it is an extremely interesting question whether economic growth in Russia in the 21st century is sustainable.

In every successful economy, investment is a key factor in long-term economic growth. If a society is living from hand to mouth consuming everything produced, development cannot take place. Thus, economic dynamism calls for savings, which can be invested. Saving is supposed to equal investment ( $S = I$ ). An individual can save money without investing him - or her. There are financial intermediaries (banks), which take in savings and lend money for potential investors.

In the present-day global economy, capital is extremely mobile. Theoretically it is possible that a society has no saving in the local economy and borrows money for her investment needs from the international financial market. Money can move internationally also in the so-called risk capital form. A Japanese company with surplus funds can buy a rival in Malaysia, or part of it. In this case, Japan is exporting and Malaysia importing capital.

In the communist system of central planning, the key point was capital formation. The state extracted forced savings from the local population and invested in massive scale in heavy industry. It was assumed that high investment quota (the share of investment of local gross domestic product (GDP), would guarantee everlasting (maximal) economic growth. The quality of investment goods (technology) was disregarded.

Communist central planning did not allocate capital on the basis of free price system, which in a market economy guides capital to purposes with high profit expectations. Misallocation of capital in massive scale took place in the centralized system. The famous Hungarian economist, Janos Kornai, called the Soviet type society "the economy of shortage." Sub-optimal allocation of resources caused permanent shortages in consumer goods supplies.

Social scientists, who watched the development of the Soviet and East European economy professionally in the communist era, realized that maximal economic growth based on extensive use of resources was not identical with optimal economic growth creating concrete welfare.

Misallocation of resources and waste involved in central planning is now a topic of economic history dealing with the 20th century Europe. This short research report is not covering this topic. The aim here is to describe some basic features of the post-Soviet Russia in the early years of the 21st century.

## **2. Some general aspects of the post-Soviet era**

### **2.1 The Commonwealth of Independent States (CIS)**

The former Soviet Union had 15 republics with an overall population of 289 million, about half of which lived in the Russian Federation. In the second half of the 1980s, there were several reform schemes to decentralize the Soviet economy.

In this context, individual republics were supposed to achieve more independence in the economic decision-making. This reform launched by the last Soviet leader, Mikhail Gorbachov, never reached a coherent form. This caused confusion in the old administrative system, as well as rapid erosion of the actual welfare. A systemic change became necessary.

This revolutionary change took place rather peacefully. However, in August 1991, there were some critical moments, when an entity called the State Committee for the State of Emergency had taken power after taking President Gorbachov into captivity. This attempt to rescue the communist system and to maintain the Soviet Union intact failed.

The actual dissolution of the Soviet Union took place on December 8th, 1991 by the Minsk Agreement on the Commonwealth of Independent States signed by the heads of state of the Russian Federation (RF), Belarus and Ukraine. In the following two years, all former Soviet republics except the Baltic States (Estonia, Latvia, Lithuania) signed the CIS treaty.

The CIS with 12 member states has a rather loose framework. The main body of the CIS is the Council of the Heads of State, which convenes no less than twice a year. The Executive Committee organizes the activities of the CIS with its seat in Minsk (Belarus). It is said that the CIS serves as a forum for discussion concerning post-Soviet affairs. The CIS is actually neither a customs union, nor a free-trade area. In the mid-1990s, Russia, Belarus, Kazakhstan, and the Kyrgyz Republic formed a customs union, which was joined by Tajikistan some years later. These five CIS countries signed a treaty on a Eurasian Economic Community, which supplements the customs union. This constellation, not covering all CIS-countries, entered into force in 2001.

Immediately after the collapse of the Soviet Union, the three Baltic States (Estonia, Latvia, and Lithuania), which were annexed by the Soviet Union during the WWII, declared that they would not participate in any post-Soviet constellation. Thus, the CIS is not identical with the Former Soviet Union (FSU), because the Baltic States are former Soviet republics without being members of the CIS. The Baltic States became EU-members together with East-central European ones (Poland, the Czech Republic, Slovakia, Slovenia and Hungary) in May 1st, 2004.

**Table 1. Basic data (2003)**

	Population (m)	GDP per capita <sup>1</sup>	GDP per capita <sup>2</sup>
<i>East-Central Europe</i>	65,9	12.760	6.640
<i>Balkans</i>	54,6	6.650	2.610
<i>Baltics</i>	7,2	11.410	5.270
<i>CIS</i>	280,1	6.750	2.050
Russia	144,7	8.300	3.000
Ukraine	47,5	5.550	1.040
Belarus	9,9	9.630	1.760
Moldova	4,3	2.870	460
Armenia	3,0	4.980	930
Azerbaijan	8,3	4.010	860
Georgia	4,3	4.110	910
Kazakhstan	15,0	8.150	1.990
Kyrgyz Republic	5,0	3.120	380
Tajikistan	6,5	1.580	240
Turkmenistan	6,0	6.420	2.630
Uzbekistan	25,7	2.580	340
<i>Transition Economies total</i>	407,8	7.790	2.920

<sup>1</sup> USD at purchasing power parity<sup>2</sup> USD at market exchange rate

Source: The Economist Intelligence Unit.

The Russian Federation inherited about half of the Soviet population and about three quarters of her territory. This Russian part of the former Union contains the big bulk of the most valuable resources, including oil and gas.

As Table 1 shows above, about three quarters of the population in the post-communist countries (transitional economies, or TEs) live in the CIS. More than half of this population belongs to the Russian Federation.

There are very considerable differentials in the living standard in the group of TEs. It is customary to compare living standard internationally by taking GDP figures per capita in target countries calculated in US dollars or euros. These figures are normally biased because official exchange rates do not necessarily reflect different price levels correctly. Emerging markets, like TEs, have low prices. Therefore, in living standard comparisons it is advisable to adjust GDP figures with purchasing power parity (PPP). These corrected figures (GDP at purchasing power parity) give more realistic picture of real living standard level in comparison to the original figures.

In the light of the GDP per capita figures at PPP (in US dollars), the living standard in those TEs, which became EU-members in 2004, is about two times higher than in the CIS states. In addition, Table 1 shows that there are very remarkable differences in living standard within the CIS.

Russians earn over five times more than citizens of Tajikistan, the poorest state within the CIS. Belorussians are the highest earners in the CIS sphere. Kazakhstan is not far away from the Russian standard. Kazakhstan

with about 15 million inhabitants is rich on oil, and thus, has a higher GDP per capita, PPP adjusted, than Ukraine. Moldova is the poorest CIS-country in Europe: her living standard is only about one quarter of the level achieved in the Baltic States. The difference is striking.

It is often pointed out that the Russian Federation subsidizes certain deliveries, especially gas and probably also oil, to other CIS-countries. There are no details available on this issue. However, it is evident that there is no grand scheme to even out living standard differentials in the post-Soviet economic space. Economic activity levels show an extremely uneven development within the CIS in the above table.

## **2.2 Demographic trends**

In the post-war period, the population of the Soviet Union increased rather rapidly. In the late 1950s, the total population of the USSR was 209 million, in 1970s about 242 million and in 1990s almost 289 million. The equivalent figures in the Russian Federation were 118 million, 130 million and 148 million.

The first post-Soviet census was taken in the early period of the 21st century, and its results were published in the autumn 2002. According to the latest census, the population of Russian is 145,3 million, or about 2 million below the previous one carried out in 1989.

This decline in the population would have been even more dramatic had it not been for clear net immigration in the early years of the transition, when many Russians left other parts of the former Union, in order to resettle in the Russian Federation. In the 1990s, the birth rate per 1.000 was about 8, while the death rate per 1.000 was about 15. In the transitional period, the male life expectancy has been below 60 years, which is an exceptionally low figure in international comparison.

Quite obviously, the early period of Russian transition with declining economy and high uncertainty concerning employment and regular pay have caused enormous stress, which is visible in the demographic trend. According to the Vienna Institute for International Economic Studies (WIIW), the population of Russia decreased from 148,5 million in 1990 to 145,2 million in 2000, and to 143,5 million on 2003.

It can be assumed that the high death rates are closely linked with the deteriorating healthcare system and insufficient social safety net. In the Soviet period, a rapid degradation of the environment took place. Reappearance of some epidemic diseases has taken place. According to estimates, some 25–30% of the population live below the official minimum subsistence level. The average pension in 2003 was RUB 1.650 (about 50 euros), not enough to provide the minimal living standard. Low birth rates and high infant mortality rates are obviously linked with rather poor housing conditions.

These negative demographic trends can only be reversed by rapid economic growth, which started to appear in the turn of the century. This topic will be dealt with in detail in the following.

Economic growth is a necessary but not a sufficient precondition for improving overall welfare in the post-Soviet Russia. In the transitional circumstances, income distribution has become extremely uneven in Russia. There are winners and losers in the present-day market system after the communist experiment.

It is evident that more responsibility must be given to individuals. Private healthcare insurance schemes and old-age pension policies are emerging in Russian transition. These schemes take time to be properly established. Individual mortgages for housing are urgently needed. Also arrangements in this field take time. In the meantime, the overall physical condition of the housing stock deteriorates rapidly.

If present demographic trends continue over the next decades, there will be about 110 million inhabitants in Russia in 2050. This scenario will not materialize, if a sustainable economic growth path will be found. Economic growth is in the middle of the present decade directly linked with high energy prices on the world market. This “oil boom” must gain strength from other sectors of the economy.

### **2.3 Demand structure trends**

In the Soviet period, there was a general tendency to overinvest. Normal feasibility studies were not made in investment planning. The central administration favoured high investment in order to advance overall economic growth. Maximal growth, however, was not necessarily equal with optimal growth from the point of view of consumer satisfaction.

It is a well-known fact that the former Soviet Union was a military superpower with huge stockpiles of military hardware. The military-industrial complex swallowed enormous amounts of financial and also scientific resources. Naturally, this sector was part of the public sector demand. It is assumed that Soviet-time budgets never gave a real picture of the burden the military sector imposed on the national economy. Private consumption naturally suffered because of the high share of defence spending of overall demand. High level of investment together with the high state procurement of military hardware kept the concrete living standard in the form of private consumption on a continuously low level in the Soviet period.

**Table 2. Gross Domestic Product (GDP) by expenditure (% of total) at current prices**

	1999	2000	2001	2002	2003
Private consumption	53,5	46,2	49,6	51,4	50,5
% change year on year at constant prices	(- 2,9)	(7,1)	(9,9)	(8,7)	(7,2)
Government consumption	14,6	15,1	16,4	17,7	16,9
% change year on year at constant prices	(3,1)	(2,1)	(- 0,8)	(2,6)	(2,2)
Gross fixed investment	14,4	16,9	18,9	17,9	18,2
% change year on year at constant prices	(6,3)	(18,1)	(10,3)	(3,0)	(12,9)
Export of goods and services	43,2	44,1	36,9	35,1	34,6
% change year on year at constant prices	(11,3)	(9,5)	(4,2)	(9,9)	(11,7)
Imports of goods and services	26,2	24,0	24,4	24,6	23,3
% change year on year at constant prices	(- 17,1)	(32,4)	(19,8)	(14,5)	(16,5)

Source: Goskomstat.

In the turn of the century, private consumption was about half of GDP calculated at current prices. The highest figure in the above table can be found in 1999 (53,5%), which is the first year after the RUB devaluation crisis of 1998 (Tiusanen, 2003a). In 1999, the private consumption decreased about 3% calculated in real terms (constant prices). In 2000, the share of private consumption of GDP went down to 46,2%, but increased in real terms rather strongly, by over 7%. This growth accelerated to almost 10% in 2001. Also in 2002–2003, the private consumption enhanced strongly in real terms (by 8,7% in 2002 and by 7,2% in 2003). In 2002–2003 this part of overall demand exceeded the 50% mark.

The share of government consumption of Russian GDP is relatively modest, about 17%. This position shows a moderately increasing trend in 1999–2003. Government consumption has increased in real terms roughly 2% in annual average in the period under review here. In this context it is useful to bear in mind that the Russian economy in transition deviates strongly from Scandinavian welfare states, in which the public sector plays a very decisive role by reallocating funds to so called “free services”. In actual fact these services (or government consumption) are not free at all, but paid by taxpayers.

Gross fixed investment had a very modest GDP share in 1999, only 14,4%. This part of overall demand shows a strongly increasing trend: in 2003, the equivalent figure was already over 18%. Investment activity calculated in real terms shows everywhere and almost always strong fluctuations. The above table confirms this fact. The strong devaluation of RUB in 1998 created excellent preconditions for investment in local economy. Many local products, for example, in food and beverage branch became competitive in price, and thus, import-substituting activities have a strong incentive to extend capacities. Investment in fixed assets increased in the first post-crisis year (1999) by 6,3% in real terms, while the same growth rate in 2000 was about three times higher (18,1%). Deceleration of growth took place in 2001 (to still strong 10,3%) and in 2002 (to 3,0%). In 2003, a strong acceleration of investment growth can be observed to no less than 12,9%. Even if the share of investment shows a strong increase in the time span under review, the final investment quota figure in the above table (18,2% in 2003) is still very moderate. Taking the development level of Russia with a GDP per capita (PPP adjusted) of about one third of the West European level, the investment

quota ought to be brought up somewhere to 25–30%. The capital stock of Russia is in a rather bad shape. The housing stock, the big bulk of which is built in the post-war period, badly needs face lifting. About 2 million housing units are not in adequate condition. Water pipe and sewing systems urgently need renovation. Also a big part of industrial buildings ought to be modernized. Transport infrastructure is not able to cope with higher challenges coming from the rather rapid overall economic growth.

The machine park of Russia is in average some 35 years old. Thus, not only technological level of machines and equipment is badly outdated, but also there is a danger that many rundown machines will fall apart physically. Only one third of gross fixed investment is in recent years used for machines and equipment.

Export of goods and services had a very high share of GDP in 1999 and 2000, 43,2% and 44,1%, respectively. This share shows a clearly decreasing trend to less than 35% in 2003. Export has increased in real terms by an annual average rate of about ten percent in 1999–2000 and 2002–2003. In 2001 the equivalent growth rate was 4,2%. The share of import of GDP is considerably more modest than that of export. This share has moderately declined from 26,2% in 1999 to 23,3% in 2003. Imports decreased in real terms very strongly (-17,1%) in 1999, which is natural in a year after a substantial devaluation of the local currency. A clear turnaround took place in 2000: import increased over 30%. Also in 2001–2003, the import growth figures in real terms were high, about 15–20% a year. Russia is one of the few emerging markets, which has the tendency to earn surpluses in her balance of payments on current account (CA). There is one basic reason for this phenomenon: Russia has an extremely rich resource base and earns plenty of export income by selling primary products. Therefore, export income has the tendency to exceed import expenditure. Other TEs struggle to keep their CA in relative equilibrium.

**Table 3. Current account in Russia**

	1999	2000	2001	2002	2003
EUR billion	23,1	50,6	37,9	30,8	31,8
% of GDP	12,6	18,0	11,1	8,4	8,3

Source: WIIW.

In the first year of the Table 3, in 1999 the Russian CA was in surplus equivalent of 12,6% of local GDP. In this post-devaluation year, import was very modest. In 2000, oil price on the world market picked up considerably causing a 60% increase in Russian export value. The CA surplus thus achieved an extremely high value of 18% of GDP. The equivalent share in 2001 was still clearly over 11%, while in 2002–2003 the result was slightly more moderate but still in both years over 8%.

This in actual fact means that Russia could import a supplementary amount of goods and services in total value of about EUR 30 billion a year without borrowing any money from abroad (or without using other methods of capital import).

In economics, there is a term called “current account constraint”. It means that emerging markets often buy more than they sell in global trade. Deficits thus emerging in the CA cannot be eternally financed. Thus, it may become necessary to cool down overall demand in order to limit the expansion of import. Expressed in other words, CA deficit creates an obstacle to economic growth under certain circumstances. In this case, it is often said that the economy in question is “overheated”. As pointed out in the Table 3, there is no CA constraint in the Russian economy in the early years of the 21st century. The situation is much more favourable in this sense than in other TEs.

In the Soviet period, industry was the symbol of progress. Agriculture and service sector had a secondary importance only.

**Table 4. Gross value added (% of total)**

	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Industry	28,0	28,0	25,0	24,0
Construction	5,5	5,9	6,7	6,6
Agriculture and forestry	6,6	5,8	5,8	5,2
Transport and telecom	8,5	8,0	8,3	9,0
Trade	20,8	21,2	20,0	20,6
Other sectors	20,5	20,5	23,4	25,1

Source: WIIW.

In 1990, the share of industry in value added creation was over 35%, while it presently is about one quarter. “Other sectors”, including financial services, have a higher weight in gross value added than industry. Trade takes about one fifth of the overall “cake” of value added. Russia in transition is thus on her way to a “post-industrial service society”.

**Table 5. Employment by sector in thousands (% of total in brackets)**

	1999	2000	2001	2002
Industry	14.297	14.543	14.692	14.534
(% of total)	(22,4)	(22,6)	(22,7)	(22,2)
Agriculture & forestry	8.738	8.609	8.200	7.947
(% of total)	(13,7)	(13,4)	(12,7)	(12,2)
Construction	5.083	5.002	5.015	4.982
(% of total)	(7,9)	(7,8)	(7,7)	(7,6)
Transport & communications	4.919	5.011	5.015	5.019
(% of total)	(7,7)	(7,8)	(7,7)	(7,7)
Trade & catering	9.320	9.421	9.997	10.837
(% of total)	(14,6)	(14,6)	(15,4)	(16,6)
Health, education, arts & science	12.769	12.719	11.548	12.859
(% of total)	(20,0)	(19,8)	(17,8)	(19,7)
Administration & finance	3.602	3.667	3.667	3.781
(% of total)	(5,6)	(5,7)	(5,7)	(5,8)
Other	5.235	5.355	6.576	5.400
(% of total)	(8,2)	(8,3)	(10,2)	(8,3)
<b>Total</b>	<b>63.963</b>	<b>64.327</b>	<b>64.710</b>	<b>65.359</b>

Source: Goskomstat.

In the employment scene, no revolutionary changes have been under way lately. Industry is the most important employer giving permanently work for over 22% of the total employable labour force. Health, education, arts and science are on the second place employing about one fifth of the total. Trade and catering are a bit behind with slightly increasing share. Agriculture plus forestry still give work for plenty of people (over 12% of total), much more in relative terms than in mature Western market economies.

## 2.4 Development trends within industry

In the Soviet era, industry was favoured as a symbol of progress. Agriculture and services were regarded as inferior branches, and thus, neglected.

There was a certain ideologically coloured division of industry into two categories: “Group A” of industry produced “input goods” (steel, machinery, etc.); “Group B” produced consumer goods often called “light industry”. Soviet-time central planning permanently underlined the importance of the “Group A” in industrial development. Thus, consumer demand never played a decisive role in Soviet industrial development.

In the early period of Russian transition, industrial production decreased rapidly. When the year of the systemic change is marked with hundred (1991 = 100), in the late 1990s the index of industrial production was only slightly over half of its original value. Thus, the drop was really remarkable. In the turn of the century, a very clear recovery started to take shape in the industrial production.

**Table 6. Industrial production (1991 = 100)**

	1999	2000	2001	2002	2003	Growth % (1999–2003)
Electricity	73,9	75,6	76,9	76,4	77,1	4,3
Fuels	70,6	74,0	78,5	84,0	91,8	30,0
Ferrous metallurgy	65,5	75,8	75,6	77,9	84,8	29,5
Non-ferrous metallurgy	64,6	74,4	78,1	82,8	87,9	36,1
Engineering & metalworking	42,8	51,4	55,1	56,2	61,5	43,7
Chemicals & petrochemicals	54,0	61,1	65,0	65,7	68,5	26,9
Timber, pulp & paper	43,7	49,5	50,8	51,8	52,6	20,4
Construction materials	33,0	37,3	39,4	40,6	43,2	30,9
Light industry	14,1	17,1	17,9	17,4	17,0	20,6
Food industry	53,0	60,7	65,8	70,4	74,0	39,6
<b>Total</b>	<b>55,2</b>	<b>61,8</b>	<b>64,8</b>	<b>67,4</b>	<b>72,1</b>	<b>30,6</b>

Source: Goskomstat.

One of the most important background factors in the increasing trend of the Russian industrial production is the rouble depreciation in 1998. The new, weaker exchange rate gave incentive to invest in export-oriented branches, and more importantly, in import substituting production facilities. The rouble crisis of 1998 was a clear blessing for the Russian industrial production.

As shown in Table 6, the overall industrial production in Russia grew by over 30% between 1999 and 2003. However, the index number in 2003 was only 72,1, which means that the total industrial production in that year was still about 28% below the starting point (1991 = 100).

The most dynamic development has taken place in the industrial branch of engineering and metalworking. This important sphere shows a growth rate of almost 44% between 1999–2003. However, this industrial branch is still very far away from the original level: the difference between 1991 and 2003 is almost 40%. The second most dynamic industrial branch in Table 6 is food processing, which shows a growth of about 40% between 1999 and 2003. This industrial sector is about one quarter smaller than in 1991. Non-ferrous metallurgy shows the third most dynamic development trend in the Table 6 with 36,1% growth since 1999. This branch is only about 12% below the level of 1991. Construction materials production has increased by about 31% from 1999 level. In this branch the index figure in 2003 is only 43,2, which means that this sector is still very far from the 1991 level. Fuels production shows with 30% a similar growth as construction materials branch in 1999–2003. In this vital sector, the index number is 91,8, which means that the recovery has taken the production level very close to the basis year (1991). Ferrous metallurgy has grown approximately as fast as the fuels sector (about 30% since 1999). This branch is still about 15% below the 1991 level. Chemicals and petrochemicals branch shows a below average growth of 26,9% (1999–2003). This sector produced about two-thirds of its 1991 level in 2003. Light industry is a very special case in the Table 6: this branch collapsed almost altogether with communism. Production in 1999 was about 86% lower than in 1991. Even if light industry production grew by 20,6% (1999–2003), the index figure in 2003 was only 17, which means that the output was 83% smaller than in 1991. It can be assumed that the light industry

(textile, clothing, footwear etc.) has been confronted with especially savage competition by imports in the transitional period. Cheap and fashionable alternatives cannot be created in a short period of time (in one decade). The Russian wood processing industry (timber, pulp and paper) has shown similar, rather modest growth of over 20%, as the light industry in the period under review (1999–2003). This industrial branch produced in the early years of the 21st century some 50% a year less than in 1991. Thus, the slump has not been quite as deep as in the light industry, which produces less than one fifth of her 1991 output level. The growth of electricity production has been very modest, only 4,3% between 1999 and 2003. In this branch the original output collapse was rather modest, about one quarter only (1991–1999). The production in 2003 was about 23% below the basis year (1991).

**Table 7. National energy statistics (million tons)**

	1999	2000	2001	2002	2003	Growth % (1999–2003)
Oil & gas condensate	305	323	348	380	421	38,0
Natural gas (bn cubic metres)	586	584	581	595	581	-0,9
Coal	250	258	269	253	275	10,0

Source: Goskomstat.

Oil and natural gas are the most important export products of Russia. Oil industry produces gas condensate as a by-product. In the 1980s, the Soviet Union produced in her best production years about 600 million tons of oil. Not the entire amount was extracted in the Russian Federation's territory.

In the early years of post-Soviet time, the Russian oil production was about 300 million tons per year. In the turn of the century, oil production has recovered rather quickly: the growth between 1999 and 2003 was 38%. In the same period, there was a modest decrease in the natural gas production (-0,9%). Coal production has grown about 10% (1999–2003). Dynamism in oil production, as well as favourable price development in oil exports has been the backbone of Russian economic recovery. The difference in dynamism of oil sector and of natural gas output is striking: the former grew by almost 40%, while the latter had a slight decrease in the period under review (1999–2003). These two vitally important production branches have decisively different institutional frameworks.

In the 1990s, the big bulk of assets linked with oil production were privatised. In this context, a rather small group of extremely wealthy persons was created. Media started to use the term "oligarchs", when private sector owners-managers were discussed. These oligarchs became owners of basic industries including oil extraction. One oil company, Rosneft, remained in state ownership. The oil pipeline system, Transneft, also remained state's property. Quite obviously, private oil firms started to compete on the market using investment as a tool to gain market power. The oil company "Yukos" seemed to gain the leading position in this race between oil giants in the early years of the 21st century. Yukos's top managers and dominant

owners, Platon Lebedev and Mikhail Khodorkovsky, were arrested in 2003. In this event, which created uncertainty in the overall business environment, the main accusation is tax evasion. In the spring 2004, these two owners of Yukos got long prison sentences and the ownership structure of the company was rearranged.

In the natural gas business, the dominant player is the state-controlled giant Gazprom, which also controls the Russian gas pipeline system. This huge company with a 51% state share has a virtual monopoly in gas market. Oil companies can sell gas extracted as a by-product of oil, but the main gas wells are under Gazprom's control. In 1991, gas output peaked at 643 billion cubic metres. The equivalent figure in 2003 was only 581 billion. This poor performance has several reasons. In the Russian internal market, gas prices for households are heavily subsidised. Obviously, Russia is also somewhat subsidizing gas bills of some of her CIS neighbours (Ukraine, Belarus). Thus, Gazprom, which exports gas in huge quantity to Western Europe, especially to Germany, cannot maximize her profits in normal market manner. Therefore, Gazprom has not invested heavily in the transitional period: gas production comes mainly from the Soviet –era gas fields in Siberia, which are close to exhaustion. Several new gas wells have been discovered in the meantime, but the exploitation of them would require large sums of investment funds. Without substantial new investment in the gas sector, no turnaround of the sluggish output trend can be expected.

The World Bank has carried out a study on Russian economic structure (EBRD, 2004). In this study, the largest Russian firms are surveyed. On the basis of this survey, the Bank estimates that the 23 largest private owners (oligarchs) controlled about 16% of employment and 35% of sales (in the entire industry). In addition, the study estimates that the federal government is permanently a major player in the industry with an 8% share in employment and 20% of industrial sales. The biggest firms of Russia are listed in the Appendix 1.

The World Bank study shows that the Russian SME-sector outperforms oligarch firms in terms of labour productivity and profitability. However, the large firms with oligarch owners are more effective than state-owned companies. The study lists some recommendations: improvement of regulatory framework that protects property rights and enhances competition; the establishment of anti-monopoly rules with agencies strong enough to implement the rules; improvement of the financial infrastructure to ensure SME-sector's access to capital; privatisation of those assets still in state ownership; reduction of the adverse impact of local administrations on competition.

In the 1990s, Poland was the first TE overcoming the severe post-communist slump. Also Hungary experienced an early recovery. According to the World Bank, in these two TEs a link between emergence of new enterprises and overall economic growth can be observed in the previous decade, during which the Russian economy contracted strongly. The Bank argues that one of the main reasons of the prolonged recession in Russia in the 1990s was missing dynamism in the start-up sector: small and medium-sized

enterprises (SMEs) have been slow in coming in post-Soviet Russia. Similarly, the OECD (2002) in a survey of the Russian economy concluded that “the small business sector can be viewed as a barometer for measuring progress in creating an overall healthy and competitive business climate, the most important prerequisite to sustainable economic growth. Small companies tend to grow faster than larger (either state-owned or privatised) ones, they have a greater propensity to invest, they are more profitable and create more employment. In transition economies they also boast higher levels of productivity than large companies, which in turn implies that transferring capital and labour from large enterprises to smaller companies would be accompanied by an accelerative economic growth.

Russia has never had a strong capitalist tradition of entrepreneurship. Its strongest period of new business development was during the last half of the 19th century (Zhuplev et al., 1998). In the Soviet era, government encouraged development of large industrial companies, and small companies did not play any significant role in that time. Progressive concentration and centralization of capital and labor resources to large-scale enterprises were the norm—regulation of the economy was dominated by the paradigm “large is beautiful” (Radaev, 2001).

Anders Åslund (2002) has analyzed the small business development in the aftermath of communism as follows. Marxism-Leninism had fostered the idea of the whole country as one big company, and gigantomania was a hallmark of communism, especially in the Soviet Union. Many Soviet citizens could not imagine that small enterprises could grow big or that small enterprises could be relevant for economic growth. As communism ended, in the CIS countries it was generally argued that small enterprises could not manage without support of the state though subsidies, subsidized credits, and tax exemptions. The fundamental problem was that state officials argued that small entrepreneurs could not do anything without “help” from bureaucrats, who would request personal “commissions”. State committees and funds for the support of small business were set up in several countries, but they tended to allocate the small financial resources the state gave them to people close to themselves and not necessarily to small enterprises. These institutions were breeding grounds for corruption. The same was true of discretionary tax exemptions, which were paid for. Rather than stimulating private enterprise with economic freedom, the government suffocated them with regulation and extortion under the pretext that they needed financial support. (Åslund, 2002)

In the mid-1980s there were fewer than 100.000 small companies in Russia. Small business and business managers have thus relatively short operational history, and the role of small business is still rather modest. In 2003, small business contributed some 12% of Russian GDP. The number of small firms in Russia grew quickly from 267.000 in 1991 to 865.000 in 1993. However, after this stage the number of small business units has stagnated and even declined. Kontorovich (1999) has listed likely causes for this stagnation: 1) increased tax and regulatory burdens; 2) barriers to entry raised by the authorities; 3) the use of new businesses to plunder state-owned firms; and 4) the consequences of the banking crises in 1998.

In the end of 2003 there were 230.400 enterprises operating in Finland, which means that there are 45 enterprises per 1.000 inhabitants. However, the enterprise density in Finland is lower than in many Western countries (Hyrsky & Lipponen, 2004). The respective figure for Russia was some 890.000 small enterprises, or 6 companies per 1.000 inhabitants. However, this amount should be interpreted with caution. Firstly, in Russia small enterprises are classified as those with less than 100 employees, while the World Bank definition includes companies with less than 50 employees. But, in Russia this number (890.000) calculates only small companies that are registered as legal entities but not those set up as sole proprietorships. There are over 4 million sole proprietorships, many of which are set up for tax reasons only. Secondly, a large share of the companies that are registered are likely to be out of business soon. Finally, it is estimated that up to half of all small enterprises operate in the grey economy. Thus, the OECD estimates that SMEs in Russia employ more than 20% of the workforce—or roughly twice as much as according to official statistics.

Astrakhan and Chepurenko (2003) list several characteristics of Russian SMEs. Firstly, most of the companies are not specialised in certain products or technologies but change their field of activities often due to the instability of different product markets and changing profitability of different sectors. Secondly, SME owner-managers are interested in flexible multifunctional personnel rather than in professionals. Thirdly, every entrepreneur sooner or later changes his/her field, which makes their professional know-how insufficient.

The sectoral distribution of small enterprises has changed little since 1995. The non-manufacturing sector is attractive for small enterprises, which may be explained by the fact that the service sector requires less investment than the production sector. Out of 890.000 enterprises in 2003, some 47% operated in the field of retail trade and catering.

**Table 8. Sectoral distribution of Russian small business**

Sector	Number of small business units		% of total
	2001	2003	
Trade and catering	388.100	416.700	46,7
Industry	125.100	118.700	13,3
Construction	121.900	116.800	13,1
General commercial activity	34.700	39.500	4,4
Material supplies	15.900	27.400	3,1
Real estate operations	14.200	23.600	2,6
Science and scientific research	28.500	22.100	2,5
Transport	18.800	21.800	2,4
Healthcare and social services	17.400	19.900	2,2
Agriculture	13.400	17.800	2,0
<i>10 largest sectors total</i>	<i>778.000</i>	<i>824.300</i>	<i>92,5</i>
<i>Total</i>	<i>843.000</i>	<i>890.900</i>	<i>100,0</i>

Source: Goskomstat.

In general, new private start-up companies tend to be concentrated in the fastest growing sectors. It is not surprising that almost half of Russian SMEs operate in retail, which was severely underdeveloped during communism having thus huge potential for growth. The same applies for construction.

There is plenty of evidence that SME-sector prospers the business environment. Just like all the enterprises, small companies need finance, secure property rights, low and stable taxes and a light regulatory framework. Financial markets in TEs are underdeveloped, and thus, receiving outside funding is a potential impediment in SME-sector. Russian SMEs complain about the lack of bank finance, but at the same moment less than half have actually tried to apply for a loan and prefer funding from informal sources, such as family members or friends. The role of regulation and bureaucracy as constraint for SMEs is not easy to be measured. However, some international comparisons can be made. In the turn of the century in Russia setting up a business involved some 20 different licenses and permits and took an average of almost two months, while in the US such procedure took 4 permits and less than one week. However, Russian figures are not exceptionally bad in this context – for example in Poland the procedure was not any quicker. In monetary terms the setting-up procedure was even more costly in Poland than in Russia. However, in Russia licenses and permissions are checked regularly – according to some sources in the case of retail business in Moscow the frequency in the turn of the century was every third day (some 120 times during a year). Health, safety and fire inspectors tend to be frequent customers of these business units. Even though Putin's administration is aiming to reduce the regulatory burden on businesses (for example, trying to make it easier to set up new businesses), it is evident that in a country with both long tradition of powerful bureaucrats (many of whom are severely underpaid) the implementation of regulation will take long time.

It has been often underlined that personal relationships are essential in Russia. Informal structures cause transaction costs hampering the SME development.

Quite obviously, there are some enterprise-level impediments in the Russian SME-sector. These might include management deficiencies, lack of skills and insufficient planning. Surveys made in the turn of the century point out that time horizons of Russian entrepreneurs hardly was longer than 3–6 months. Even though in Russia (alike in many other countries) managers do not usually implement on practice the theoretical knowledge, some 16% of the interviewees mentioned some concrete planning tools (etc. SWOT and PEST analysis) to be utilized in their work. Modern planning tools, like SWOT and PEST analyses are not widely known in the Russian SME-sector.

It can be assumed that the SME-sector in Russia benefits from post-crisis economic growth: new opportunities for entrepreneurial people will emerge. Managers will be learning by doing. Financial markets will develop amid increasing prosperity alleviating SME-sector's shortage of capital. Business environment in Russia is definitely better in the first years of the 21st century than in the early years of post-communism.

## **2.5 Some features of consumer sector**

In the period of cold war, it was extremely difficult to compare actual living standard in different economic systems. In market economies, the traditional measure of aggregate economic activity is called either GDP (gross domestic product) or GNP (gross national product). In Soviet-type economies the equivalent measure was called NMP (net material product). These measures were not identical, and thus, comparisons between East and West were difficult. Statistics dealing with transitional period show, that output decline took place in every post-communist country in the early years of transition. This decline was extremely serious in Russia and Ukraine. Large drops in economic activity normally reflect deterioration of living standard.

In transitional circumstances of post-Soviet Russia, certain details in this context must be taken into consideration. The analysis is complicated by the pre-transition situation, which included an overproduction of industrial goods, a prevalence of worthless output, the non-existence of some claimed production, and waste of output that was produced. In the cold war period, it was customary to estimate that Soviet defence spending was about 15–20% of GDP. In the post-Soviet era, many specialists (including some Russian ones) put the defence share of Soviet GNP at 25%, or even as high as 35–40%. Since investment quota in the USSR was estimated to be about 30–35% (of GDP), there was a modest share of private consumption in the Soviet economy.

Thus, it can be stated that falling output figures alone are not sign of collapsing living standard: private consumption did not decrease as rapidly as overall production. The price liberalization cut queuing for goods, which was excessive in the Soviet period, quite substantially. Obviously, it is not possible to discuss

all details of measures in the Soviet and in the post-Soviet period. It suffices to say here that overall economic activity decreased substantially in the early period of Russian transition, but consumption decreased underproportionally; in other words, living conditions did not necessarily deteriorate as rapidly as economic aggregates declined in the 1990's in Russia. In 2003, the PPP adjusted GDP per capita in Russia was about 8.000 euros, in comparison to about 24.000 euros in EU (15 countries). Thus, the living standard in 2003 was about one third of the West European level.

In economic reviews it is normally assumed that in low income countries propensity to save is rather low. There is not necessarily empirical evidence for this assumption: the USA with high income level is permanently a low savings rate country, while China with rather low income level has a high propensity to save. Low-income households normally spend a high proportion of their disposable income on food and beverage. The share of this group of consumption has a tendency to decrease with increasing household income. Russia's consumption trends are described below by considering some general trends in the turn of the century.

**Table 9. Russia's Household Spending Structure (%)**

	1998	1999	2000	2001	2002
Goods and services	77,7	78,4	75,4	74,4	72,8
Mandatory payments	6,1	6,7	7,8	8,9	9,3
Savings	2,5	5,3	7,6	9,0	10,5
Hard currency purchase	12,0	7,8	6,4	5,7	5,6
Cash on hands	1,7	1,8	2,8	2,0	1,8

Source: Goskomstat.

Average household budget in transitional Russia has some peculiar features. The big bulk of money (about three quarters) is spent to buy goods and services, while less than 10% are used to settle compulsory payments. This odd structure of household expenditure is linked with a very special set-up of the Russian housing market.

In the early period of transition, about 60% of Russian housing stock was privatised. The remaining 40% was removed from state ownership to municipality property. In both cases, in rented flats from local authorities and in privately owned housing units, fixed costs, including heating and electricity bills, are very low. At the same time, maintenance of the housing stock is obviously suboptimal. According a recent study by ECE (Economic Committee of Europe) the housing stock in Russia is rapidly deteriorating. Especially, high buildings constructed in the post-war decades need fundamental repairing. However, rents paid to municipalities and payments collected by flat-owners do not necessarily cover the estimated costs to save the big bulk of capital involved in housing stock. Thus, a decay of flats takes place. Compulsory payments ought to be radically increased, in order to maintain the vast capital invested in Russian housing.

The share of mandatory payments shows an increasing trend; while in the Table 9 the percentage of buying goods and services has a declining tendency in the household expenditure since 1998. It can be assumed that some new compulsory bills, like car insurance and health care insurance payments have caused the increasing trend in the “fixed costs” of Russian families.

Savings show a rapidly increasing relative figure in the average Russian family budget from 2,5% in 1998 to 10,5% in 2002. At the same time, the share of hard currency purchase in household budget decreased from 12% to 5,6%. Obviously, this position can be interpreted as an alternative way of saving; in the pre-crisis (1998), it was popular to buy hard currency to avoid economic losses of eventual rouble devaluation. In the post-crisis years, this form of saving has lost importance. Saving in various forms, including maintaining cash-holdings make up some 15–18% of family budget. There seems to be a clearly increasing willingness to keep household savings in local currency. The overall share of saving in family budget is continuously rather high.

It was pointed out earlier that the Russian economy recovered very rapidly in the early years of the 21st century. This recovery has affected the structure of personal consumption very strongly.

**Table 9. Russia's Household Expenditure (%)**

	1998	1999	2000	2001	2002
Food (incl. alcoholic drinks)	55,9	56,2	51,9	50,8	46,3
Food (excl. alcoholic drinks)	51,3	52,0	47,6	45,9	41,7
Catering (out of home eating)	2,0	1,7	1,8	2,5	2,4
Alcoholic drinks	2,6	2,5	2,5	2,4	2,2
Non-food Spending	30,2	30,8	34,3	34,4	36,2
Clothing and Footwear	12,9	13,5	15,5	13,4	13,3
Consumer durables	2,8	2,6	3,2	3,2	3,4
Automobiles	2,3	3,1	2,8	3,6	4,6
Construction Materials	1,1	0,9	1,0	1,4	1,5
Fuel	1,0	1,3	1,5	1,3	1,6
Furniture	4,2	3,8	4,5	5,2	5,7
Services	13,9	13,0	13,8	14,8	17,5
Housing	5,2	4,7	4,6	5,2	6,2
Repair Services	1,8	1,7	1,8	1,6	2,2
Education	1,0	1,5	1,2	1,4	1,7
Leisure & health	1,1	0,9	1,6	1,0	1,2
Public Transportation Expenses	2,6	2,4	2,6	2,5	2,7
Communication	1,2	1,1	1,2	1,2	1,5
Other Services	1,0	0,7	0,8	1,9	2,0

Source: Goskomstat.

The structure of private consumption has changed rather radically since 1998. Food and beverage took about 56% of the average consumer basket in 1998–1999. The equivalent figure in 2002 was with 46,3% almost ten percentage points lower. The weight of the non-food product purchases increased at the same time from about 30% in 1998 to over 36% in 2002. The service part of the average consumer basket has grown by some 3,5 percentage points between 1998 and 2002.

No revolutionary changes can be observed in the non-food part of the consumer basket. Cars show an increasing tendency, but have an under 5% marking in overall basket. Housing costs have increased somewhat in the service sector, but with a 6,2% share of overall consumption this sphere is continuously only a tiny part of household expenditure.

It is often pointed out that open-air markets in Russia still play a very important role in foodstuffs trade. This part of retailing is not necessarily covered in official statistics. At the same time, there is a rather high level of “self-sufficiency” in the sphere of foodstuffs: a multitude of Russian families have a small plot, where they grow potatoes and vegetables. It is customary to pick wild berries and mushrooms. These activities remain unrecorded by statisticians.

According to Renaissance Capital, an investment bank, Russia’s total household borrowing was a mere USD 4,5 billion, or USD 31,2 per capita in 2002. Large loans (to buy cars, houses, flats, etc.) only comprise 20% of the total. Consumer credits are mainly taken to buy furniture, consumer electronics and household appliances. Consumer credits bear high nominal interest rates. The same source estimates that some 12–15% of the Russian population belongs to “middle class” with a rather comfortable life. In absolute figures this means that about 17–22 million people have “middle class” status in terms of living standard. It is obvious that one of the most decisive structural problems Russian economy is facing in the next couple of decades can be found in the housing market. In the transitional period, many new rich persons have been able to build new housing units with every possible luxury. At the same time, mortgage system is in its infancy making the improvement of housing stock a long-term problem. Essentially more funds must be channelled into the accommodation market to enable the construction of new flats and to repair the old ones. In all TEs, mortgage systems have been created. It can be assumed that considerable structural changes will take place in family budgets during next decades: housing costs are likely to take an increasing share of overall spending of the population.

In the meantime, retail sales have grown rapidly in TEs, and thus, many large international retailers have invested in post-communist countries. Competition in retail sector seems to be permanently increasing. Retailing in four TEs listed in the Table 10 was a USD 300 billion business in 2003. Almost half of this sum originates from Russia.

**Table 10. Retail sales (2003)**

	USD (billion)	USD per capita
Czech Republic	30,5	3.047
Hungary	21,6	2.158
Poland	103,3	2.718
Russia	145,4	1.009

Source: EIU.

Czech Republic has the highest per capita figure in retail service: the Czechs spend in average over USD 3.000 a year in retail shops. Poland is with USD 2.700 not far away from the Czech figure, while Hungary with about USD 2160 average retail purchases per head is clearly behind those two countries in Central Eastern Europe. Russian equivalent result is with about USD 1.000 only one third of the Czech figures.

One of the reasons in the described differences is obviously linked with income distribution. According to the World Bank (World Development Report 2005), the share of population living with less than USD 2 a day is 23,8% in Russia, 7,3% in Hungary, less than 2% in Czech Republic, and less than 2% in Poland. The highest 20% of population in terms of income or consumption receive 51,3% of total in Russia; equivalent figure in Poland is 42,5%, in Hungary 37,5% and in Czech Republic 35,9%. On the basis of these figures, it can be concluded that income distribution in Russia is more uneven, than in other TEs of the Table 10. This might partially explain differences in retail sales described above.

## **1 External economy**

The post-Soviet Russia has a tendency to earn current account surpluses. This tendency was clearly strengthened by the strong depreciation of rouble in 1998. This currency crisis reduced imports considerably.

**Table 11. Main composition of trade (USD million)**

	1999	2003	Growth 1999-2003
<b>Exports fob</b>			
Oil, fuel and gas	32.700	70.190	114,6
Metals	19.000	17.432	-8,3
Machinery and equipment	8.000	10.763	34,3
Chemicals	6.200	8.426	35,9
Total exports incl. others	75.551	135.930	79,9
<b>Imports cif</b>			
Machinery and equipment	10.000	19.447	94,4
Food and agricultural products	8.100	11.158	37,8
Chemicals	4.900	9.103	85,8
Metals	2.200	3.614	64,3
Total imports incl. others	39.536	75.437	90,8

Source: Customs Committee.

**Table 12. Export and Import Structure of Russia (2003)**

Principal exports	% of total	Principal imports	% of total
Oil, fuel & gas	51,6	Machinery & transport equipment	25,8
Metals	12,8	Food, beverages & agricultural products	14,8
Machinery & transport equipment	7,9	Chemicals	12,1
Chemicals	6,2	Metals	4,8
Main destinations of exports	% of total	Main of origins of imports	% of total
Germany	7,7	Germany	10,7
Netherlands	6,5	Belarus	6,5
Italy	6,3	Ukraine	5,9
China	6,2	China	4,4
Ukraine	5,6	Kazakhstan	3,9
		US	3,9

Source: EIU.

In the aftermath of the 1998 crisis, a rapid recovery of export took place, because the world market price of oil increased substantially in 2000 giving a boost to Russian export earnings. Between 1999 and 2003, total exports expanded about 80%. In the same period, the group of energy bearers (oil, fuel and gas) in export statistics more than doubled in value (with a 115% growth).

In the period under review (1999–2003) metal exports decreased by over 8% in spite of the devaluation advantage. Both machinery and equipment and chemicals exports expanded by roughly one third in the same time span. The position of oil, fuel and gas permanently dominate the export trade in Russia with on over 50% share of total. Metals come second with 13% in 2003. Machinery and equipment has a rather modest share of 8% only. The equivalent figure of chemicals is over 6%.

Total imports in Russia increased in 1999–2003 even more rapidly than exports, by 91%. The most rapid growth is visible in the group of machines and equipment, which counts for about one quarter of the import business. This position includes cars, which have been in high demand in the early 21st century Russia. Foodstuffs are the second most important import position with roughly 15% of total. In the post-devaluation period, this import group shows with an almost 40% growth rather high dynamism, which, however, is clearly lower than the total import increase. Chemicals import growth has been almost as vigorous as the total import increase.

Germany is continuously the main trading partner of Russia, in both import and export statistics. Germany buys permanently huge quantities of Russian gas and sells traditionally machines and presently also big quantities of cars to Russia. Netherlands is on the second place in the Russian export statistics. In this context it is important to note that Russia sells a big part of her export oil in Amsterdam spot market. The final destiny of that oil cannot be figured out of foreign trade statistics of Russia. About 15% of Russian exports in 2003 went to other CIS countries, which provide about one quarter of Russian imports, mainly in the foodstuffs category. China has in recent years become an increasingly important trading partner for Russia. In the mid 1990's China became a net importer of energy, and thus, looking for co-operation with Russia in the energy sector. China's economic boom has also affected metals trade between these two countries.

In 2003, Russia's balance of trade showed a healthy surplus of over USD 60 billion. This positive balance in merchandise trade is a core element in the current account surplus: trade in services in Russia is in the red.

The export structure of the Russian emerging market is based on commodities trade, which always in the global market is full of uncertainties. Price fluctuations may be strong and difficult to predict. However, in the early 21st century there are several signs in the world market of energy bearers indicating that a high price level will prevail. There seems to be permanently high demand (i.e. because of increasing import need by China), while supply faces factors of uncertainty, especially in the Middle East. Thus, strong price drops of oil, oil products and gas are unlikely. Products of metallurgy are sensitive items in the global market. It is not unusual to have dumping accusations in the steel market. Thus, the second most important export category of Russia (metals) has not necessarily as good medium term prospects, as energy bearers' business.

The enlarged EU of 25 countries is far the most important trading partner of Russia counting more than half of the country's exports and imports. It is highly likely that the EU–Russian economic links will intensify further in the foreseeable future.

The State Committee of Statistics (Goskomstat) in Russia gives some FDI figures, which are normally lower than FDI estimates in the West. In any case Goskomstat is an interesting source of information concerning FDI. In the early period of the 21st century Russia was divided in seven “macro regions”. The capital city,

Moscow, is situated in the Central macro region, which is the most populous part of the country with over one quarter of citizens living in it. Far East macro region has only 6,7 million inhabitants counting for less than 5% of the overall population.

**Table 13. Main Economic Indicators of the Federal Districts 2002**

Federal District	Population (million)	Population (% of Russia)	GDP share (%)	Unemployment rate	Cumulative FDI stock 1997–2002 (million USD)	% of total FDI
Central	38,0	26,4	34,1	5,4	13,1	52
Northwest	14,0	9,7	9,9	6,3	2,5	10
Southern	21,8	15,1	7,9	12,0	3,0	12
Volga	31,1	21,6	17,2	7,7	1,4	5
Urals	12,4	8,6	15,0	8,2	1,4	6
Siberia	20,1	13,9	10,9	10,1	0,8	3
Far East	6,7	4,6	5,1	8,6	3,0	12
Russia	144,1	100,0	100,0	8,0	25,4	100

Source: Goskomstat.

The central region with Moscow in it, is over proportionally represented in GDP figures: about one quarter of the population creates more than one third of the economy. Employment situation is better than elsewhere in Russia: the average unemployment rate in the country as a whole is 8%, while the equivalent figure in the central region is only 5,4%.

St. Petersburg, “the second capital city”, is in Northwest macro-region, which counts a bit less than 10% of the total population. This percentage reflects almost exactly the regional contribution to GDP. Unemployment rate is somewhat higher than in Central region (6,3%), but below the national average.

The southern macro-region with huge farming areas has about 22 million inhabitants, or about 15% of the Russian population. This region contributes relatively modestly, with about 8% only, to Russian GDP. Unemployment rate is with 12% clearly over the national average.

Volga is the second most populous macro region after the Central one: 21,6% of people live in Volga area with an underproportional share of 17,2% in GDP creation. However, Volga region has an unemployment rate (7,7%) below the national average.

Urals macro-region has a huge concentration of mineral wealth. It counts for 8,6% of total population, but creates 15% of Russian GDP.

The huge landmass of Siberia inhabits some 20 million people, or 13,9% of Russian population. The GDP share is with 10,9 percentage points relatively modest.

Far East macro-region has only 6,7 million inhabitants, or 4,6% of Russian population. This region creates 5,1% of the national GDP, which is almost directly in line with the share of population.

Table 13 shows that central region has been far superior in attracting FDI: more than half (52%) of FDI (between 1997 and 2002) are located in the most populous region of Russia. Southern region and Far East are well represented in the FDI competition, both with a rather high percentage of 12% of total. In the Southern territory, with connection to Black Sea in Krasnodar territory gives a special attraction to foreign investors interested in transportation linked business. In the Far East territory the main FDI attraction seems to be the island of Sakhalin: it has plenty of oil wells, which were not exploited fully in the Soviet era. In the transitional period, this important branch of “black gold” is developed with substantial foreign contributions.

In the FDI statistics, Northwestern region with St. Petersburg in it, has rather low share of 10% only. This percentage corresponds roughly to the share of that region in population and GDP creation. St. Petersburg’s location in the Western frontier of Russia has not been able to catapult that major city high up in the FDI scale.

Top ten locations of FDI (in absolute figures) in Table 14 are not chosen on the basis of macro-regions.

**Table 14. Regions with largest cumulative FDI inflow (1997–2002)**

Rank	Region	Federal District	Accumulated FDI 1997–2002 (million USD)
1	Moscow city	Central	9.845
2	Sakhalin oblast	Far East	2.504
3	Krasnodar krai	Southern	2.399
4	Moscow oblast	Central	2.206
5	St. Petersburg	Northwest	1.026
6	Leningradskaya oblast	Northwest	961
7	Samara oblast	Volga	605
8	Novosibirsk oblast	Siberia	582
9	Sverdlovskaya oblast	Ural	541
10	Jamalo-Nenetsk ao.	Ural	350

Moscow city is not only a service centre with company headquarters, but also an important industrial location: it is in clear lead in the FDI statistics. The surrounding area, Moscow oblast, has also been very attractive for foreign investors. The second metropolitan area, St. Petersburg and Leningrad oblast, are far behind Moscow with her surrounding. The tenth FDI location at the bottom of the list (Jamalo-Nenetsk) is an area with important oil and gas wells.

According to Goskomstat, 19% of Russian inward FDI stock originates from Cyprus, while the USA is with 16% on the second place and Great Britain together with Netherlands on the third place with an 11% stake each. Germany is next with one tenth of the FDI stock.

These rather surprising results have a certain background. Cyprus is one of the favourite locations of Russian flight capital, which is partially repatriated by FDI method. Netherlands has for several decades been a favoured destination of non-European investment within EU: there are logistic and tax reasons for that capital movement. Thus, many foreign investors in TEs are non-European (especially American) companies with European headquarters in Netherlands. Many of these international companies invest in TEs via their Dutch daughters.

Thus, statistics covering FDI activities may have some biases. It can be assumed that companies investing in Russia or Ukraine from Cyprus have a special history. Switzerland and Virgin Islands are included in the list of foreign direct investors in Russia with 3% of FDI capital each. Also in these cases it can be assumed that part of that investment funding is originally from TE-region.

These figures describing FDI flows from various countries to Russia allow the assumption that roughly one quarter of the Russian inward FDI stock is repatriated Russian flight capital. It is self-evident that no exact calculations in this context can be made.

### **3. Investment issues**

#### **3.1 Investment and development**

In the era of industrial revolution, investment was the most important factor of economic growth. About 200 years ago, land and labour were easily available, while capital as a factor of production was scarce. Accumulation of capital became a key factor of economic progress.

It is evident that a society, which consumes everything it produces, cannot make progress. In a dynamic economy, a part of GDP must be saved to make investment possible. The core of industrial revolution and modern welfare is in productive investment financed by equivalent savings.

The classical socialist system of central planning developed a specific type of economic growth, in which forced industrialisation, rush and haste were underlined. The original, often repeated promise of communism rested on a belief that it could catch up with the developed countries quite fast by virtue of central planning system's superiority. It was decided centrally that investment activity would be kept permanently (without business cycles) on a high level. In this economic model it was assumed that adding factors of production (advancing capital accumulation and moving labour from agriculture to manufacturing) would necessarily enhance welfare. The communist strategy of economic development with maximal investment activity was

called “the extensive way of economic growth”. In this model, enterprises regarded capital assets to be a free gift from above and led them to apply for more. In this system, there was no self-imposed limit in the enterprise sector to the demand for investment resources. Productive firms did not take genuine risks in the sphere of investment: they knew in beforehand that the state would bail them out in every case of overinvestment

Already in the 1960s and 1970s it became clear that the extensive growth model based on maximal investment started facing resource bottlenecks. Thus, a new term came up in the communist economics called “the intensive method of economic growth”. This expression refers to factor-productivity growth (instead of adding factors of production). Centrally planned economies started to look for new methods to allocate the resources more rationally and to advance new technologies. An era of economic reform started in centrally planned economies with the aim to replace the extensive growth model with the intensive (productivity-based) one. It is a historical fact that this period of economic reform failed in the European communist part. Thus, a systemic change became inevitable: centrally planned economies with one-party rule collapsed one after the other. The period of transition started in the turn of the 1980s and 1990s. It is impossible to cover economic reform discussions and experiments in the communist part of Europe here. It suffices to say that the traditional system of communism with state-owned assets was unable to cope with challenges of a post-industrial information society based on maximal growth of efficiency and productivity. The experiment of strict central planning made it clear that capital accumulation as such is not the decisive factor in welfare. Rational capital allocation and quality of final products cannot be optimally secured by central planning and by omitting actual demand on the market.

In every modern society, there is a new factor of production: human capital, which cannot be defined in exact terms. General welfare depends in the post-industrial society on the ability to combine factors of production (land, labour, physical capital, and human capital) in an optimal manner. Highest possible productivity level presupposes that resource allocation is as rational as possible. In this context not the quantity of physical capital, but its quality (technology) has become more and more decisive. The quality of physical capital (technology development) can only advance by involvement of human capital. Thus, the latter must be taken into consideration in the allocation of resources in a modern society. The original communist dream to create highest possible well-being by accumulating capital and producing with it a maximal gross output in physical units without considering quality, technology and innovation is definitely over.

In transitional economies, resources are mainly allocated on the basis of market signals. Thus, economic growth and improvement of market supplies have taken place in the post-communist period. Evidence of this fact has been given in several NORDI publications (<http://www.lut.fi/nordi/publications/index.html>).

### 3.2 Investment trends in transitional Russia

In the communist countries, the investment quota (investment as a percentage of GDP) was permanently on a high level of some 30%. High investment quota combined with extremely low profitability of investment was naturally detrimental from the point of view of consumption. In the early period of Russian transition, gross fixed capital formation (investment) decreased rapidly. At the same time, the investment quota dropped from 24% in 1990 to less than 15% in 1999.

In the 1990s, capital flight from the transitional Russia took place obviously in a massive scale. It meant that capital formation (savings) took place, but Russian physical and juridical persons were reluctant to take investment risks in the local economy. Capital flight in the world economy is not an invention of post-communism. There has been a tendency in emerging markets for capital to escape from places, in which inflation is high and inflationary expectations permanent. Savings seek stability, because instability with high inflation rates may erode the real value of accumulated money. Investment calculations are difficult in circumstances, in which price increases are tens, or even hundreds of percent a year. Capital flight was thus favoured and local investment avoided in the Russian economy of 1990s. This same effect was not necessarily visible in all transitional economies (TEs).

Inflation was a very serious problem in the early period of Russian transition. In that period, there was a second issue of importance from the point of view of capital flight: the external value of rouble (the exchange rate) appreciated rapidly in real terms (Tiusanen, 2003a). The appreciation of the real rouble exchange rate in the 1990s meant that the Russian inflation rate was continuously much higher than the nominal depreciation of the rouble exchange rate (ER). Thus, the ER of RUB experienced a strong revaluation in real terms before the crisis of 1998. Obviously, it became very attractive to exchange roubles into Western currencies in the pre-crisis (1998) period, because the rouble ER was grossly “overvalued”.

Investment dynamism in transitional economies of Central Eastern Europe has been much higher than in Russia. There are essential differences in this respect within the TE-group of countries.

**Table 15. Gross fixed capital formation (1990 = 100)**

	2002
Poland	197,6
Slovenia	186,6
Hungary	157,6
Czech Republic	132,3
Romania	123,2
Bulgaria	108,9
Slovak Republic	101,9
Russia	29,2

Source: WIIW.

Country-wise differences in the Table 15 are striking. Investment in physical capital has almost doubled in Poland during the transitional period. Slovenia is not far away from the Polish achievement. In Russia, investment has decreased by some 70% since 1990.

An essential turnaround of the investment trend took place in the late 1990s and in the early 21st century. It can be assumed that the most important background factor in this context was the rouble crisis of 1998, after which the ER of Russian monetary unit started floating according to demand and supply of the market.

**Table 16. Gross fixed capital formation in Russia**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Real change (%) against preceding year	-10,0	-18,0	-5,0	-12,0	5,3	17,7	8,7	2,6	12,5

Source: WIIW.

There was a rapid decline in real investment figures in Russia from 1995 to 1998. In 1996, the real investment figure decreased no less than 18% against the previous year. In the year of the rouble crisis (1998), the equivalent figure was 12%.

After the very strong depreciation of the RUB exchange rate in 1998, the annual inflation rate jumped from 28% in 1998 to 86% in 1999 (consumer prices). This phenomenon – acceleration of inflation – is rather normal in the aftermath of devaluation. Even if the price hikes in 1999 were considerable, the positive trend in investment (in real terms) took place: gross fixed capital formation increased by over 5% in 1999. The declining trend of investment in Russian transition came to an end in the last year of 1990s. In 2000, real investment growth accelerated to almost 18%.

It can be assumed that the post-crisis (1998) ER in Russia has been a blessing for the local economy. In the pre-crisis situation, it was rather convenient to import consumer goods (including foodstuffs) in massive scale, because the rouble ER was clearly “overvalued”. The 1998 devaluation made investment in import

substituting branches suddenly attractive. Many price sensitive import items were replaced by local alternatives. The world market price of oil roughly doubled in 2000, which brought a windfall profit to Russian oil extracting branch. The value of Russian overall export jumped by 60% in 2000. The favourable price development in the oil branch caused an investment boom by “oligarch firms” in Russia (especially in oil production). These two special factors (the ER factor and oil price factor) have changed the investment scene fundamentally in Russian economy in the turn of the century. Entirely new dynamism can be observed in the Russian economic scene in the early years of the 21st century.

However, the investment quota of Russia is still with about 20% relatively modest. A long-term and strong investment boom is needed in Russia in order to bring the country in ultimate prosperity. In Russia, the purchasing power parity adjusted GDP per capita is about one third of the West European level (of 15 EU-countries before the Eastern enlargement). Catching up with the affluent part of the old continent takes several decades and presupposes a lengthy period of strong investment boom in Russia.

### **3.3 Foreign direct investment in Russia**

Foreign direct investment (FDI) has played an extremely important role in the development of transitional economies (TEs). The distribution of FDI in the post-communist world has been very uneven. In relative terms, the Czech Republic and Estonia have been able to attract more FDIs than other TEs (Tiusanen et al., 2004b).

In this context, it is necessary to bear in mind that FDI is only one part of international capital movement. Thus, FDI balance (outward versus inward FDI) does not reflect overall capital export and import scene. In the most TEs, FDI inflow has been much larger than outflow, which means that TEs have had clear net capital import in the framework of FDI activity. In this respect, Russia is an exception: in transitional period, Russia has had rather substantial FDI inflow and outflow.

There is a magnitude of FDI statistics available. Figures given on this topic, FDI concerning TEs, are not necessarily comparable: there are differences in statistical methods. UNCTAD (United Nations Conference on Trade and Development) in Geneva publishes yearly a detailed FDI study called World Investment Report, which is .

**Table 17. FDI inward and outward stocks in selected TEs (2003, USD billion)**

	Inward	Outward	Balance
Russia	52,5	51,8	0,7
Poland	52,1	1,8	50,3
Czech Republic	41,0	1,7	39,3
Hungary	42,9	3,9	39,0

Source: UNCTAD (2004).

In the Table 17, three countries of Central Eastern Europe (CEE) are included as comparison with Russia. Poland, the Czech Republic and Hungary are the three most important national economies in CEE now belonging to the EU.

Russia and Poland have almost an identical inward FDI stock (2003) of over USD 52 billion. The population of Russia is almost four times bigger than that of Poland. Thus, in relative terms Poland has been much more successful in attracting FDIs than Russia. The Czech Republic and Hungary, both with a population of about 10 million, have attracted an inward FDI stock of over USD 40 billion each. In relative terms that is substantially more than in Poland with a population of about 39 million. In Russia, the outward FDI stock is almost as big as the inward FDI stock: in the framework of FDI, Russia has a net capital import of only USD 0,7 billion. In the Polish case, the outward FDI stock is very modest, USD 1,8 billion only. Thus, Poland has in FDI bookkeeping a net import of capital of over USD 50 billion. Like Poland, the Czech Republic has hardly invested in the outside world in the form of FDI: the net inflow of capital in FDI sphere is close to USD 40 billion. Hungary's outward FDI stock is somewhat bigger with USD3,9 billion: net capital import in FDI sphere is almost USD 40 billion (like in Czech Republic).

One method to estimate the relative importance of FDI stock in different economies is to take that stock as a percentage of local GDP.

**Table 18. Inward and outward FDI stocks as % of local GDP (2003)**

	Inward	Outward
Russia	12,1	11,9
Poland	24,9	0,9
Czech Republic	48,0	2,0
Hungary	51,8	4,7

Source: UNCTAD (2004).

In Russia, two percentage figures are only about 12% of local GDP, which means that the influence of FDI in the Russian economy is very modest. At the same time, it can be maintained that the relative figure of the outward FDI stock is relatively high; the emerging economy of Russia has invested rather much outside her territory in the form of FDI.

In Poland, the inward FDI stock is about one quarter of local GDP, which is more than double of the Russian equivalent figure. In Czech Republic and Hungary, the inward FDI stock is close to 50% of GDP. Thus, the importance of this sphere is about twice as high as in Poland in those two CEEs mentioned in the Table 18. In Poland, the relative importance of outward FDI stock (as a percentage of GDP) is very modest, less than one. The equivalent figure in the Czech Republic is about two and in Hungary less than five.

These two tables based on UNCTAD figures show clearly that Russia is a special case within the TE-group of countries: so far, Russia has been a rather unattractive country from the point of view of foreign direct investors; Russian companies show a rather high propensity to invest outside of their own home base. Three other TEs in the Table 17 and Table 18 show a tendency to import capital in the FDI frame in a clear manner reflected in net figures of FDI stocks.

World Investment Report 2004 by UNCTAD explains the outside FDI drive of Russia with the following remarks: Outward FDI by Russian firms is motivated partly by a desire to gain a foothold in the enlarged EU, and partly by a desire to control their value chains globally. As part of the latter's strategy, Russian companies continue to focus a large part of their outward FDI in other member countries of the Commonwealth of Independent States (CIS). In 2002–2003, four of the ten top destinations of outward FDI projects from the Russian Federations were other CIS member countries.

In 2002–2003, the majority of the leading Russian outward investing firms (8 of the 15) – in terms of new projects set up abroad – were engaged in natural-resource-based activities. In the energy industry, in particular, Russian companies started to diversify their production base and access foreign markets by acquiring companies and establishing foreign affiliates. Gazprom began a large long-term pipeline joint venture linking the Russian Federation with Germany; and LUKOIL initiated a USD 3 billion Greenfield project in gas exploration in Kazakhstan. Ukraine is the second most important former Soviet republic with almost 50 million inhabitants. Russian extensive investment in the Ukrainian market is not surprising.

**Table 19. The top 10 destinations of FDI projects from the Russian Federation 2002–2003**

Country	Share (%)
Ukraine (CIS)	13,9
Belarus (CIS)	4,8
China	4,3
Germany	4,3
Uzbekistan (CIS)	4,3
Kazakhstan (CIS)	3,9
Latvia	3,5
Romania	3,5
Egypt	3,0
Vietnam	3,0
Top 10 destinations	48,5

Source: UNCTAD (2004).

The relative importance of Ukraine as a destination of Russian outward FDI is clear in the Table 19, in which the second largest CIS-country has a share of almost 14%. Obviously, official statistics underestimate the Russian influence in the Ukrainian FDI scene. Many Russian and also Ukrainian companies actively use offshore companies in Cyprus, the British Virgin Island, Switzerland and some other countries to repatriate their capital flight to the CIS-region. Russian influence in Ukraine's economy is rather strong (Tiusanen et al., 2004a). According to UNCTAD, foreign banks have penetrated not only the business segment, but also retail markets in the most TEs via FDI. In this respect, Russia is a special case: foreign banks have very modest influence in Russia.

**Table 20. Foreign affiliates dominating banking assets in TEs (2001)**

Country	Share (%)	Country	Share (%)
Estonia	99	Latvia	65
Czech Republic	90	Macedonia	51
Croatia	89	Romania	47
Hungary	89	Albania	46
Slovakia	86	Moldova	37
Lithuania	78	Belarus	26
Bulgaria	75	Slovenia	21
Bosnia and Herzegovina	73	Ukraine	11
Poland	69	Russian Federation	9

Source: UNCTAD (2004).

Foreign capital owns virtually all banking assets in Estonia. The same can be said in the Czech, Croatian and Hungarian cases. In eleven TEs, foreigners possess more than half of the banking assets.

In the Table 20, Russia is at the bottom of the list with only 9% (thus, foreigners own less than one tenth of Russian banking assets). Ukraine is close to Russia with only an 11% marking. In the early period of Russian

transition, thousands of banks came into being. The currency crisis of 1998 bankrupted several thousands of them, but about 1,300 banks survived. Many of them have a very thin capital base.

Russia's banking sector is continuously dominated by one unit, namely Sberbank, which in the Soviet era had a virtual monopoly in retail sector: the former Soviet savings bank – still state-owned – manages about 70–80% of all retail deposits. The Soviet-era foreign trade bank (Vneshtorgbank) is still in business and doing well in the public sector ownership. Foreign ownership in the Russian banking sector is legally limited to maximum of 12% of total sectoral capital. Some foreign banks serve their clients in the two major cities, but foreign capital invested in financial institutions is below the legally set limit.

### **3.4 Some aspects of the investment climate**

There is plenty of evidence that in the 1990s no common path to successful transition was found in TEs. As pointed out earlier, Poland experienced a strong investment boom in the early period of her transition (Tiusanen, 2003b). Three former Soviet republics in the Baltic region also experienced positive economic development rather early in the transitional period (Tiusanen, 2003c). In Russia, local and foreign potential investors were very reluctant to take risks. Thus, investment in real terms declined rapidly in the “pre-crisis period”, before the collapse of the rouble ER in 1998. Thus, it was obvious that the investment climate was not optimal in the Russian case.

A better investment climate for everyone is the title of the World Development Report 2005 by the World Bank. The authors of this report have summarized their message in the following manner: The investment climate is central to growth and poverty reduction. Improving the opportunities and incentives for firms of all types to invest productively, create jobs and expand should be a top priority for governments. It is not just about increasing the volume of investment but also spurring productivity improvements that are the keys to sustainable growth.

- The goal is to create a better investment climate for everyone. A good investment climate benefits society as a whole, not just firms. And it embraces all firms, not just large or politically connected firms.
- Expanding opportunities for young people is a pressing concern for developing countries, where 53 percent of people live on less than USD 2 a day, youths have more than double the average unemployment rate, and populations are growing rapidly.

Reducing unjustified costs is critical, but policy-related risks and barriers to competition also need to be tackled. All the following three matter for firms and thus for growth and poverty reduction:

- Costs associated with weak contract enforcement, inadequate infrastructure, crime, corruption, and regulation can amount to over 25 percent of sales – or more than three times what firms typically pay in taxes
- Firms in developing countries rate policy uncertainty as their top concern. This and other sources of policy-related risk – such as insecure property rights, macroeconomic instability, and arbitrary regulation – chill incentives to invest. Improving policy predictability can increase the likelihood of new investment by over 30 percent.
- Barriers to competition benefit some firms but deny opportunities and increase costs to other firms and to consumers. They also weaken incentives for protected firms to innovate and improve their productivity. Increasing competitive pressure can increase the probability of firm innovation by more than 50 percent.

Progress requires more than changes to formal policies. Over 90 percent of firms claim gaps between formal rules and what happens in practice, and the informal economy accounts for more than half of output in many developing countries. Creating a better investment climate requires governments to bridge these gaps and to tackle deeper sources of policy failure that undermine a sound investment climate. This requires efforts such as:

- To restrain corruption and other forms of rent seeking that increase costs and distort policies;
- To build policy credibility to give firms the confidence to invest;
- To foster the public trust required to enable and sustain policy improvements; and
- To ensure policy responses are drafted to fit local conditions.

Investment climate improvements are a process, not an event. Government policies and behaviours influencing the investment climate cover a wide field. But everything does not have to be fixed at once, and perfection on even a single policy dimensions is not required. Significant progress can be made by addressing important constraints facing firms in a way that gives them the confidence to invest—and by sustaining a process of ongoing improvements.

- Because constraints differ widely across and even within countries, priorities need to be assessed in each case. Reform processes benefit from effective public communication and other measure to build consensus and maintain momentum.

The World Bank admits in her 2005 report that it is difficult to measure all aspects of the investment climate. Thus, that institution has together with client governments and others developed new measures of the investment climate. The Investment Climate surveys conducted in 2002–2003 measure specific constraints facing firms and relate them to measures of firm performance, growth and investment. The Report gives statistical results of these surveys made in emerging markets, including several TEs.

Some details of this World Bank survey study concerning TEs are brought up below: given results naturally reflect the opinion of local decision-makers interviewed in the framework of the mentioned study. Poland, the Czech Republic and Hungary are included here to enable a comparison between four TEs.

**Table 21. Policy uncertainty and corruption in selected TEs**

	Policy uncertainty		Corruption		
	Major constraint	Unpredictable Interpretation of regulations	Major constraint	Report bribes are paid	Average bribe (%) of sales
Russia	31,5	75,1	13,7	78,0	2,3
Poland	59,1	68,0	27,6	52,4	3,1
Czech Republic	20,2	56,0	12,5	55,5	2,9
Hungary	21,1	42,7	8,8	60,4	2,4

Source: EBRD.

The first point in the Table 21 deals with policy uncertainty with two separate points. In Russia, 31,5% of the respondents says that policy uncertainty is a major constraint in doing business. The equivalent figure in Poland is with 59,1% almost twice as high as in Russia. The Czech Republic has in this context the lowest figure in the Table 21 (20,2%), together with Hungary (21,1%).

In Russia, three quarters of the respondents have the opinion that regulations are interpreted in no predictable manner, which refers to high confusion and policy uncertainty. Also Poland has a high figure of 68% in this context. Unclear regulations and their interpretation seem to be a general problem in the business environment in TEs: over half of Czech (56%) and over 40% (42,7%) of Hungarian respondents complain the unpredictability of regulations' interpretation.

In the poll concerning corruption, only 13,7% of Russian respondents regards corruption as a major constraint for doing business. However, 78% of them report that bribes are paid: average bribe as % of sales is assessed to be 2,3%. In Poland, the poll results are essentially different: over one quarter (27,6%) of respondents say that corruption is a major obstacle of doing business, while over half of them (52,4%) maintain that bribes are paid. The average bribe of sales value is estimated with 3,1% higher than in Russia. In the Czech poll, the first figure is with 12,5% relatively modest. The equivalent percentage in Hungary is with 8,8 even lower. Thus, in these two countries rather rather few respondents regard corruption as a major constraint to business. However, 55,5% of Czechs and 60,4% of Hungarians polled report that bribes are paid. The average bribe of sales is 2,9% in Czech Republic and 2,4% of sales in Hungary.

This part of the World Bank poll is rather interesting: in above selection of four TEs, Russia, Czech Republic and Hungary (and Poland in lesser extend) regard corruption, so to speak, as a manageable problem (not as a major constraint of doing business). At the same time, over half of respondents (in Russia, even over three

quarters) admit paying bribes, which range from 2,3% to 3,1% of sales. Bribes are occasionally called “unofficial taxes”.

**Table 22. Courts and crime in selected TEs**

	Courts		Crime		
	Major constraint	Lack confidence courts uphold property rights	Major constraint	Report losses from crime	Average loss from crime (%) of sales
Russia	9,5	65,3	12,4	36,4	2,9
Poland	27,0	46,2	24,9	31,6	2,8
Czech Republic	11,1	47,1	14,3	33,6	3,1
Hungary	4,5	40,3	4,9	33,6	1,1

Source: EBRD.

The World Bank survey also deals with courts as an important component of investment climate. In Russia, almost 10% of respondents regard courts as a major constraint in business. The equivalent figure in Poland is with 27% essentially higher. The Czechs polled give a rather similar response as Russian (about 11% regard courts as a major obstacle). Hungarians deviate from those three clearly: the equivalent figure is only 4,5%. In Russia, there seems to be high skepticism concerning stability of private property rights: almost two thirds (65,3%) of Russian respondents lack confidence that courts have interest in upholding property rights. The equivalent figures in Poland (46,2%), Czech Republic (47,1%) and in Hungary (40,3%) are essentially lower. Altogether, these figures are exceptionally interesting. It can be stated that a big bulk of business people in TEs, especially in Russia, has the feeling that courts do not honour private property. This fear is essentially lower in Hungary than in Russia. In Poland and in Czech Republic almost half of respondents think that local courts do not appreciate private property rights.

Crime is a topic causing permanently concern in emerging markets. In the Table 22, it is indicated that about one quarter of Polish businesses interviewed regard crime as a major constraint of success. The equivalent figure in Russia is about half of the Polish one (12,4%). In Hungary, only about 5% of respondents consider crime as a major obstacle of doing business. In the neighbouring Czech Republic, the same figure is about 3 times higher than in Hungary. About one third of respondents in our sample of four TEs report losses of crime. Russia has a slightly higher figure (36,4%) than Czech Republic and Hungary (both 33,6%), and Poland (31,6%). In Russia, Poland and Czech Republic, it is assessed that average loss from crime is about 3% of sales, while equivalent loss in Hungary is only 1,1%.

Taxes and labour markets play an essential role in investment decisions. It is often said that high taxes and labour market inflexibilities are impediments of investment. Modest taxes and labour market flexibilities are supposed to be an essential part of incentives in FDI activity in TEs. These two issues, taxes and labour, are included in the EBRD survey.

**Table 23. Taxes and labour in selected TEs**

	Taxes		Labour	
	Tax rates as major constraint	Tax administration as major constraint	Skills as major constraint	Labour regulation as major constraint
Russia	24,6	31,8	9,9	3,3
Poland	64,7	41,0	12,2	25,2
Czech Republic	25,6	19,8	9,1	3,5
Hungary	30,2	13,7	12,5	7,3

Source: EBRD.

In the survey results under review here, there are considerable differences between TEs in assessing local tax regimes. In Poland, about 65% of respondents regard tax rates as a major constraint in doing business, while the equivalent figure in Russia and also in Czech republic is about 25%, and about 30% in Hungary. In addition, Polish respondents show high dissatisfaction with the tax administrations: over 40% of them regard the handling of taxes as a major hindrance in doing business. The equivalent figure in Hungary is only 14%. About 20% of the Czech and 32% of Russian respondents are unhappy about administrating the tax system.

Labour market situation in TE-region has been dealt with in several previous NORDI publications (<http://www.lut.fi/nordi/publications/index.html>), which show that Poland has an unusually high unemployment rate of around 20%. The EBRD poll shows that business circles in Poland are unhappy with labour regulations: over one quarter of respondents regards this point as a major impediment of success. Only a bit over 3% of respondents in Russia and Czech Republic agree with that statement. The equivalent figure in Hungary is about 7%. Lack of skill is a major constraint in the opinion of about 12% of respondents in Poland and Hungary, while Russia and Czech Republic score in this issue less than 10%.

This incomplete summary of the World Bank study on investment climate in emerging markets contains some interesting details. In all four TEs scrutinized here, corruption and crime are regarded as a serious problem in doing business: these two spheres suck together off an estimated 5–6% of total sales value in TE-business community. This “unofficial tax” burden is rather high. In this context, it is worth to notice that the World Bank study of surveys is qualitative and not quantitative in its nature: the figures commented above reflect opinions. There is no clear evidence that the overall tax burden in Poland (in the business sector) is higher than in other TEs included in the above comparison. However, the Polish respondents have the feeling that high taxes are a major impediment of doing business.

One of the best-known qualitative indices is called Corruption Perception Index published every year by a non-profit organisation Transparency International. This index measures regularly one of the most important aspects of investment climate in various countries. It is compiled by interviewing several thousands of people involved in international business. The respondents are asked to assess corruption in more than 100

countries. The scale is between 10 and 0 points: an entirely honest country gets the maximum of 10 points, while entirely dishonest (with maximal corruption) country scores zero points. This CPI (Corruption Perception Index) has been published annually for more than ten years. Scandinavian countries regularly score very high figures in the CPI of Transparency International. TEs are not in the upper part of the scale. In the latest assessment (2004), the best-scoring TEs (Estonia, Slovenia) are on the 31st place, both with 6,0 points of ten possible. Romania and Russia normally receive modest results.

**Table 24. Corruption Perceptions Index (2004)**

Country rank	Country	CPI Score 2004
1	Finland	9,7
2	New Zealand	9,6
3	Denmark Iceland	9,5
5	Singapore	9,3
6	Sweden	9,2
7	Switzerland	9,1
8	Norway	8,9
9	Australia	8,8
10	Netherlands	8,7
31	Estonia Slovenia	6,0
42	Hungary	4,8
44	Lithuania	4,6
51	Czech Republic	4,2
54	Bulgaria	4,1
55	Latvia Slovakia	4,0
67	Croatia Poland	3,5
74	Belarus	3,3
77	Turkey	3,2
87	Romania	2,9
90	Russia	2,8

Source: Transparency International.

CPI-scores and country ranks show hardly any annual fluctuations. This means that the administrative environment in the global economy hardly experiences any revolutionary changes. There are no methods available in emerging markets to root out corruption quickly. International investors are normally familiar with the problem when they make their investment decisions.

Public sector finances naturally form an important ingredient of the investment climate in every country. Central government budget deficits in the pre-crisis (1998) Russia had the tendency to be extensive. Thus, the state was an eager borrower on the capital market. In the crisis period, the state defaulted her internal debt, while the external part of it was rescheduled. Thus, it became necessary to create more discipline in the fiscal policy.

**Table 25. Central government budget balance**

	1997	1998	1999	2000	2001	2002	2003
Budget balance (%) of GDP	-4,0	-5,6	-1,1	1,4	3,0	1,4	2,0

In the turn of the century, an essential shift took place in the Russian state bookkeeping. In the year of the rouble crisis (1998), the deficit in federal budget was no less than 5,6% of GDP. This deficit decelerated to 1,1% (of GDP) in 1999. In 2000 the oil price hike affected Russian economy positively. The state budget showed a surplus of 1,4% of GDP, which accelerated to 3,0% in 2001. In the two following years, there were surpluses in the budget.

Obviously, this essential improvement of the budget balancing has several background factors. Undoubtedly, one of the major factors in this context is profound tax reform. In the 1990s, Russia's tax system was burdensome and complex impeding investment. Thus, tax evasion in large scale took place making budget balancing impossible.

When in the turn of the century Mr. Vladimir Putin replaced Mr. Boris Yeltsin as the President of Russia, tax reforms started taking place. The complicated progressive income-tax system was dismantled and replaced by a flat personal income tax of only 13%. In addition, the replacement of various social levies with a simplified, regressive social tax took place. The maximum corporate profit tax was reduced from 35% to 24%. Turnover taxes were abolished and the standard rate of value-added tax was cut from 20% to 18%. Oil sector taxation was essentially reformed: in this important sector, export levies were introduced. It is of utmost importance that the same tax reform includes improved provisions for the deductibility of regular expenses incurring in doing business in Russia. Obviously, tax reforms, which have simplified the system essentially, must be implemented. This process has not been without problems. However, tax evasion has clearly decreased via the reform described earlier.

It is important to note that in the framework of the fiscal reform, Russia resumed full foreign debt servicing (according to rescheduled debt scheme) in 2000, the year of the first budget surplus. This honouring of the external financial obligations re-established Russia's international creditworthiness. An interesting novelty in the Russian fiscal policy is the creation of a stabilisation fund in 2003. In this arrangement, part of the windfall profit of high oil price is yearly diverted into a special fund not to be used for current state expenditure. The fiscal policy aim of this special fund is to use this money put aside to even out business cycles: if in the future economic growth decelerates (as a consequence of lower oil price), extra money from the "oil fund" can be used to revive demand.

The Economist Intelligence Unit (EIU) every year conducts a survey of 500 global investors with the aim to assess the attractiveness of various countries and regions from the FDI point of view. The results of the latest survey are published in World Investment Prospects 2004.

**Table 26. Criteria attracting FDI to different countries**

	China	Russia	New EU entrants
New consumer markets	49	5	15
Low-cost labour	50	3	12
Access to highly skilled labour force	6	3	10
Research and development activities	11	4	6

Source: EIU.

In the Table 26, only parts of the global economy are included: China as well as the new EU-members (8 TEs as a group) are compared with Russia as potential locations of FDI. Several criteria are included. China is highly appreciated in two accounts: 49% of respondents regards China as the best location to conquer new consumer markets; 50% of potential investors feel that China provides the best environment as a low-cost labour location. The equivalent figures in Russian case are 5% and 3%, while 15% of the respondents regard EU's new members as the best location to get new consumer markets, and 12% of them think that EU's newcomers have the most cost-effective labour.

Access to highly skilled labour has become more and more important ingredient in the FDI allocation. In the Table 26, some 6% of the polled decision-makers assess that China is the best location to choose, while the equivalent figure in Russia is only 3%. EU's TEs score 10% in this context beating both China and Russia.

Research and development oriented FDIs are naturally qualitatively the best ones. It is probably a bit surprising that China receives the best score of the three alternatives in the table: in the opinion of 11% of interviewed, China is the most attractive location from the R&D point of view. In this point, the equivalent figure in the region of EU entrants is 6% and in Russia 4%. The fresh EIU survey shows clearly that there is a lot of "China enthusiasm" in the global economy. China is the best emerging region for market-seeking investors. At the same time, China is permanently regarded as a cheap labour location suitable for sourcing investors. It is interesting to observe that China is assessed as a better location than Russia and CEE-countries in research and development sphere.

As shown earlier, investment activity in Russia decreased rapidly in the early period of transition. A new, growing trend started in the aftermath of the rouble crisis of 1998. Inflation and inflationary expectations are more moderate than before. The economy has grown rapidly in the early years of the new century. Those facts influence the propensity to invest essentially. Furthermore, it was pointed out earlier that FDI stock in Russia is relatively modest. In some TEs, like in the Czech Republic and Estonia, the FDI stock per capita

(2003) was about EUR 4.000, while the equivalent figure in Russia was less than one tenth of that. In the context of FDI statistics concerning Russia some clarifying points are needed. In 2003, one of the biggest oil companies in the world, British Petroleum (BP) signed a joint venture deal with Tyumen Oil of Russia (TNK). This USD 7 billion deal was in media classified as the biggest FDI in Russia so far. This interpretation is not accurate, because this BP–TNK deal is an offshore transaction: both TNK and the TNK–BP joint venture are registered in the British Virgin Islands. Thus, the foreign share of that company is not part of FDI-inflow in Russia.

Aggregate FDI stock figures in Russia hide the fact that an essential part of FDI inflow is not necessarily “foreign capital”, but actually repatriated Russian flight capital, a big part of which originates in Cyprus and other offshore centres in banking. In the FDI statistics, it is impossible to separate “genuine” foreign capital from Russian flight capital flowing back to Russia.

In the summer 2004, it was announced in international financial press that the American oil company, Conoco, invested USD 2 billion in Russia. This big sum of money is not a FDI, but a typical example of portfolio equity investment. In this deal, the foreign investor bought LUKOIL shares for the mentioned sum without gaining management control in that Russian oil company.

A dominant share of Russian FDI stock has gone into food and retail sector. Other sectors have not been able to attract FDI extensively. Therefore, FDI inflows in Russia have so far brought fewer benefits in terms of technology transfers than in many other European TEs. Thus, it can be concluded that the inward FDI activity in transitional Russia has been of rather modest in quantitative, as well as in qualitative terms. Inward FDI stock roughly equals outward investment stock.

In the early years of the 21st century, there have been essential improvements in the Russian investment climate. One of them is the “realistic” exchange rate of RUB (in the post-crisis) era. Thus, it is realistic to assume that FDI development in the present decade will be more exciting than in the 1990s.

### **3.5 Current account, savings and investment**

The current account (CA) balance is the balance of trade in goods and services plus net rents, interest, profits and dividends (also called RIPDs) and current transfer payments. The category of RIPD reflects past capital flows: net capital export generates net capital income in future periods. Transfer payments include foreign workers’ remittances to their home countries (e.g. Mexicans working in the USA, who are sending money back home), and government payments of foreign aid.

The current account can also be defined as the difference between a nation's saving and its domestic investment. Any CA imbalance is precisely matched by an imbalance between domestic saving and investment ( $CA = S - I$ ). Certain countries have higher saving than investment; in that case, the country exports its surplus capital. This is reflected in CA: in that case, the country has an export surplus. Any deficit on the current account must be matched by an equivalent financial inflow on the capital side of the account. Countries with CA surplus thus export capital, while countries with CA deficit import capital.

In traditional economic texts it is often assumed that rich countries have high propensity to save, while investment opportunities in mature economies are limited. Thus, there is rather widespread perception that Western industrialized countries are exporters of capital (surplus savings flow out). Simultaneously, it is generally assumed that emerging markets have a low propensity to save, while they offer plenty of investment opportunities. The common perception is that underdeveloped countries cannot save enough to finance all local investment, and thus, must rely on capital import (use part of savings from the rest of the world, or RoW).

These theories are hopelessly outdated. The USA, a big and very affluent country has for several decades been the leading capital importer, while China with rather modest living standard has become an important capital exporter. Thus, there seems to be structural deficit in US current account and structural surplus in China's CA. In the latter, savings rate is about 40%. In the US-economy, savings rate is clearly below the 20% mark. Savings rate is the share of saving of local GDP comprising savings of individuals (households), enterprises, and public sector. Thus, savings rate reflects the overall propensity to save of a national economy.

It is not the aim of this study to discuss issues linked with current accounts, savings and investments in the global economy extensively. It suffices to say here that certain countries have capital inflow and other capital outflow, which means that there is CA deficits and CA surpluses. As pointed out earlier, Russia has in the turn of the century had a tendency to have rather substantial CA surpluses, which in our definition means that Russia is financing with her surplus savings the outside world.

The World Bank (World Development Report 2005) gives figures of GDP components in different countries in 2003. One position in EBRD's data is called "external balance of goods and services, % of GDP". This can be taken as a proxy for CA. The highest relative surplus in the World Bank table (in CA) is in Singapore with 33% of GDP. Oil exporting countries, like Norway (17%), Saudi-Arabia (18%), Kuwait (9%), Algeria (14%) and Venezuela (12%) have all CA surpluses. Oil and gas exporters have thus a tendency to earn rather high CA surpluses. Singapore is a special case: this mini-state with modest natural resources but high savings exports plenty of capital in relative terms.

In the EBRD table, countries are divided in groups. Low-income group has a minus sign (CA deficits taken together): -3% of GDP. The group of “middle income” has an equivalent figure of 2% (CA surplus). Sub-category “upper middle income” scores four percent surplus in the same table. “High income” group has a zero balance: the aggregate CA of the rich part of the world is in equilibrium. In these results it is not surprising that low-income countries as a group show a CA deficit, and thus, import capital to finance the gap. What is amazing is the fact that “middle income” group of countries produce a CA surplus, while the wealthy part of the globe has a zero result. In the EBRD report under review, Russia scores a CA surplus of 11% of her GDP, which in the same table is marked with USD 433,5 billion. Thus, the monetary value of Russian CA surplus in 2003 was USD 47,7 billion. The Russian investment quota (gross capital formation as percent of GDP) is in EBRD calculation 20% in 2003, or USD 86,7 billion. At the same time, Russia used the mentioned sum of USD 47,7 billion to finance RoW.

In the World Bank classification, Russia is a “lower middle income” country, in which over one tenth of her GDP flows out to finance other countries’ CA deficits. In the same category is also Algeria, which exports energy bearers and achieves high CA surplus. Saudi-Arabia and Venezuela are oil-exporting countries with considerable CA surpluses getting the classification of the EBRD called “upper middle income” countries. Two CA surplus countries mentioned above, Norway and Kuwait are in the group of high-income national economies (both with high oil export income). It is not the aim of this study to discuss the details of the World Bank method of dividing countries in different groups on the basis of income. It is essential to state here that countries with substantial export of energy bearing raw materials have a tendency to earn high CA surpluses (in relative terms, as percentage of GDP). Only Norway and Kuwait can be without any doubt classified as high living-standard countries with high petrol-dollar export income.

Russia could theoretically use her capital export to build up her own economy. Investment quota could be increased from about 20% to about 30% by balancing her current account. This option presupposes that Russian investment climate improves.

In the early years of the 21st century the investment quota of China has been about 40%, or roughly double the Russian equivalent. For the previous ten years, China has been a net importer of energy. However, China has had yearly CA surpluses, which have been more modest than those in Russia (in relative terms).

#### 4. Current economic trends

Statistics are used in economic texts in massive scale. Discussion on globalization has become fashionable lately. In this discussion it is frequently pointed out that global development has become more and more uneven: the gap in living-standard between rich countries and poor ones is said to widen. It is customary to compare living-standard in various parts of the globe by calculating GDP figures per capita converted into US-dollars. Presently, using euro as the common denominator does the same. In both cases, official exchange rates are used. It is not the aim of this study to compare living-standard globally. A modest attempt is made here to compare the development level of Russia in European framework.

It is common for economists to envisage a simplified world in which all countries produce the same good. In the global market arbitrage – actions of firms who ship goods from places where they are cheap to places where they are expensive – forces the price of that good to be equal in every corner of the world. This elimination of price differentials is occasionally referred to as the “Law of One Price”. In this simplified world with perfect market, exchange rates reflect reality perfectly well. The economic model assumes that a hamburger looks, tastes and costs just the same everywhere.

The Law of One Price is seriously biased, being designed for a simple world of homogeneous products, with competitive prices undistorted by multinational companies and governmental regulations, and with no significant capital flows unrelated to trade in commodities. In real world movements of capital, whether in the form of long-term investment, or volatile speculative flows responding to interest rate differentials and stock exchange fluctuations, influence exchange rate alignments. Thus, there is a multitude of factors, which may push exchange rate alignments away from purchasing power parity (PPP). The theory, which assumes that exchange rates tend to give different currencies equal purchasing power over goods and services, is not in line with real life.

It is a well-known fact that not all goods and services are traded internationally in a similar manner. In practice, services are traded less than goods. In addition, it is generally assumed that international productivity differences are less pronounced in service branches than in production industries. A professor, lawyer or doctor in an emerging market will deliver something closer to the level of service in a rich country than a worker in manufacturing or catering. However, this is not necessarily reflected in the relative pay: service sector wages in low-income countries are held down by the low wages prevailing in the industries producing traded goods. As a result, relative GDP per capita in emerging markets may be clearly understated when measuring living-standard by using official exchange rates (ER).

Therefore, it has become clear that GDP figures per capita calculated in euros or dollars cannot provide an exact yardstick in international living-standard comparisons. For tourists it is clear that EUR 100 can buy more goods and services in a transitional economy than in euro-area. If this is the case, it can be maintained that local currencies are undervalued at current exchange rates in transitional economies. Thus, GDP figures are made more accurate if euros are converted into transitional economies' money via exchange rates calculated on a purchasing power parity basis – that is, exchange rates need to be adjusted so that an identical sample of basic goods and services costs the same in one country as in other. If a fast-food meal costs EUR 5 in Helsinki and EUR 2,50 in Budapest then the forint (Hungarian currency) is undervalued: Hungarian GDP figures as measured in euros must be readjusted accordingly.

This correction is easily done in one-item world of Big Mac meals. The product is available in over 30.000 restaurants in the world prepared with the same recipe in every single one of them. “The consumer basket” is identical in every case of the sample.

Creating an ideal consumer basket reflecting real life in various national economies is hard work. Housing costs take a big part of every household budget in West-European big cities. In Bangladesh, about 90% of people live in their own houses, while the equivalent figure in Germany is about 35%. Obviously, housing costs in these two countries differ hugely. These differences can hardly be taken into consideration in an optimal way in international living-standard comparisons

In economics, quality is extremely difficult to measure. It is simply impossible to construct an average consumer basket, in which all items are identical in quality (homogeneous) in every corner of the world. Quality always affects the price. Thus, no fully comparable consumer basket for PPP adjustment can be made to serve international economics.

In principle PPPs can be defined for every good and service, as well as an average PPP for the economy as a whole. It is impossible to discuss possible shortcomings of PPP calculations here. Research reports of NORDI rely permanently on data provided by WIIW (Vienna Institute for International Economic Studies). PPP adjusted GDP figures below are taken from that source.

It is obvious that transitional economies have more imperfect markets than mature economies of the West. Thus, in TEs there are many price biases. For example, office space rents are in Moscow more or less on the same level as in Paris or London. This is surprising, because the Russian rouble is clearly undervalued in average PPP adjustment. Obviously, this distortion comes from the office space market: demand has exploded in the transitional period's Moscow, while supply of suitable offices has not been able to cope with the changing market.

In international living-standard comparisons there are many pitfalls. Many poor people in emerging markets may not be in close contact with the official monetary economy. These people may neither sell the product of their work, nor buy many goods or services. The bulk of their consumption might be provided by them or bartered for in unrecorded trade, as subsistence farmers do. Many participants in the informal sector may be more integrated into the modern market economy but will rarely disclose their income or output. There are studies made in post-Soviet Russia, which estimate that the unofficial economy is in the range of 30–35% of GDP. Obviously, no official assessment of the magnitude of the unofficial economy can be made.

In sum, it is impossible to provide any exact figures of the Russian living-standard. However, it can be maintained that the rude GDP per capita figures calculated in euros grossly underestimate the development level of Russia. PPP-adjusted figures may have distortions, but they provide a more realistic picture than the original GDP figures (on official exchange rate).

**Table 29. Living standard indicators (2004)**

<b>GDP (billion euro)</b>	<b>GDP per capita at official exchange rate (euro)</b>	<b>GDP per capita (PPP-adjusted)</b>	<b>ERDI</b>	<b>Nominal gross monthly wage (euro)</b>	<b>Real wage (nominal wage multiplied by ERDI)</b>
468,6	3.258	8.270	2,54	191	484

Source: WIIW.

Russia's GDP calculated in euro at the official exchange rate (RUB 35,81 = 1 euro in 2004) is rather modest, EUR 468,6 billion. This figure tells very little about relative price levels in Russian and euro-area.

Per capita GDP in Russia calculated at purchasing power parity (PPP) was EUR 8.270 in 2004 according to WIIW's data. This adjusted figure is 2,54 times higher than the original figure, which means that the exchange rate deviation index (ERDI) in Russia is 2,54. The value of ERDI here indicates that prices in average are 2,54 times higher in the euro-area than the official rouble-euro exchange rate presupposes. In other words, it can be stated that the rouble exchange rate deviates rather strongly from reality (real differences in prices are not reflected in the official exchange rate between rouble and euro). Russia's GDP in 2004 was EUR 1.190 billion PPP corrected (EUR 468,6 billion times 2,54). Thus, "real" GDP in Russia is over one trillion euro (over EUR 1.000 billion).

Per capita GDP at PPP was EUR 24.251 in the "old" EU-countries (15) in 2004. Thus, Russia's living-standard is about one third of the West-European level. GDP per capita at PPP is EUR 22.288 in the present-day EU (of 25 countries). Russia's figure is 37% of the average EU-living-standard. Average gross monthly wage was EUR 191 in Russia in 2004, while the equivalent figure in Finland was about EUR 2.200. When the Russian figure is multiplied by ERDI (2,54), the average "real" Russian gross monthly wage is EUR 484.

This ERDI correction actually means that the relatively low price level in Russia must be taken into consideration when income comparisons are made internationally.

Development of Russian current account was commented earlier. It was maintained that high CA surpluses reflect net capital export under circumstances, in which investment rate is relatively modest. It is evident that exchange rates always and everywhere affect CA situation.

Russian GDP calculations show that rouble is clearly undervalued, which favours exports and makes imports expensive. Undervaluation of a currency is called “exchange rate protectionism”. Imports per capita are very low.

In transitional economies of Eastern Europe, ERDI figures show a downward trend overtime, which means that undervaluation of currencies in these TEs gets more moderate. This is understandable because the international competitiveness improves in TEs via FDIs, which enhance local export capabilities and create import-substituting products. Therefore, CA management has become easier (heavy undervaluation of local currency is no more in need). It is said that ERDI becomes smaller in emerging markets via development. ERDI increased substantially amid the rouble depreciation crisis (1998), which is natural. In the aftermath of the crisis export, especially of oil, increased rapidly. Rouble ER has appreciated in the early years of the 21st century in real terms. However, Russian ERDI value is still on a rather high level. After the rouble depreciation floating exchange rate regime has been applied. Exchange rates, like any prices, can be left to let the markets decide what the right level should be. Monetary authorities (Central Banks) may wish to limit any excessive swings in their currency’s price (ER) by entering the currency market. They thus attempt to manage (or control) the floating price at an acceptable level.

There is very little knowledge in how far the Russian Central Bank is “managing” the rouble rate, in other words, in how far it is playing around with interventions. Obviously, the Central Bank is in a position to manipulate the rouble rate. In the autumn 1998, the Central Bank made the attempt to defend the officially set limit of 15% depreciation (against the set central rate), but failed because it ran out of dollars (currency reserve was meager). So it could not buy enough roubles (for dollars) to hinder an over 15% devaluation. At the end of 2004, the currency reserve of the Russian Central Bank was USD 120 billion, six times higher than in the 1998 crisis period. The Central Bank could easily revalue rouble if it considers that it is too low (too much undervalued) by manipulating the market through interventions. One option open is to establish fixed exchange regime. In this case the Central Bank (RCB) fixes rouble ER (for example against dollar) within strictly defined limits (e.g.  $\pm 2\%$  movement around the beg). Naturally, the fixing can also be done against a basket of currencies (e.g. containing US dollar and euro).

Exchange rate regimes always contain a multitude of background issues. The aim here is not to recommend fixed ER policy in Russia. An attempt is made here to point out that Russia in her economic policy-making is not forced by any internal or external factor or factors to run undervalued currency, which is obviously linked with her CA surpluses. CA deficits may be difficult to eliminate in certain circumstances, but eliminating CA surpluses can be achieved relatively easily. Theoretically every CA surplus country can dismantle the disequilibria in her external balance by revaluing her currency. However, appreciation of ER is a disincentive to invest in the local economy.

The global energy market was full of uncertainties in 2004. Therefore, the world market price of oil was on an unusually high level, which was good news for all oil-exporting countries, including Russia. Export growth accelerated from 6% in 2003 to almost 23% in 2004. GDP growth exceeded 7% a year in both 2003 and 2004. Consumption growth accelerated clearly in real terms in 2004, while investment growth decelerated slightly. However, gross capital formation in real terms had still an impressive increase in 2004 by almost 11% against the previous year.

**Table 30. Russian economic indicators**

	Real growth against previous year (%)			
	2003	2004	2005*	2006*
GDP	7,3	7,1	5,0	5,5
Consumption	7,5	11,3	9,0	8,0
Investment	12,8	10,8	8,0	8,0
Average monthly wage	11,0	10,8	..	..
Consumer prices	13,6	11,0	11,0	10,0
Export	6,0	22,6	2,0	3,0
Import	4,4	13,4	10,0	10,0

Source: WIIW. (\*Forecast)

The oil boom has clearly affected income development positively: average gross monthly wage increased in 2003–2004 about 11% a year in real terms, which supports dynamism in private consumption. Inflation decelerated somewhat in 2004, but was with 11% still rather high in international comparison. Amid economic growth, inflation rate is likely to remain in double-digit figures also in the next couple of years. General government budget has shown surpluses every year since 2000. In the state bookkeeping, there was an unusually high surplus in 2004 equivalent of 6% of GDP. Public sector expenditure decreased strongly in 2004. Savings in social costs seem to be a clear aim of the state, which has caused very visible protests by the population in the winter 2004–2005.

Russia's current account reached once more a high surplus in 2004 of some EUR 47 billion, which is about 10% of GDP in comparison to 8,2% one year earlier. The main component of this surplus comes from visible trade, in which export exceeded import by over EUR 70 billion. As pointed out earlier, Russia has been a net exporter of capital for several years, which is rather surprising when the Russian development stage is taken

into consideration. In this context it was pointed out that current account surplus is a mirror image of net capital export. CA surplus increased from EUR 31 billion in 2003 to EUR 47 billion in 2004. It is possible to calculate the cumulative CA surplus of Russia in the first five years of the 21st century (2000–2004) in euro-based figures: it is almost EUR 200 billion (EUR 197,5 billion). Russian gross fixed capital formation (investment) calculated in euros was 83,8 billion in 2004. In 2003 it was 69,7 billion, and 65,3 billion in 2002. In these three years (2002–2004) the total investment value was thus EUR 218,8 billion, which is somewhat higher than the cumulative CA surplus in the five-year period 2000–2004.

Therefore, it can be concluded that Russia's net capital export in the first five years of the 21st century was almost as high as the total investment in local fixed capital in the three-year period 2002–2004. This comparison illustrates that Russia is an important net capital exporter (in relative terms) in the global economy.

## **5. Some conclusions**

The Russian Federation is a the largest transitional economy with some 144 million inhabitants covering a huge territory with plentiful natural resources. Thus, the country has good preconditions of economic success in the transitional period.

It is a well-known fact that in the period of the cold war, the Soviet Union was a superpower with a huge military machine. Obviously, this military might was built up via extensive forced savings. It is highly likely that no researcher will ever find out what was the real burden of the military-industrial complex in the economy of the former Soviet Union. However, it is clear that converting this armament industry into civilian use in the biggest republic of the former Union was not an easy task. Therefore, it is understandable that the early period of Russian transition was more difficult than in countries of the former Eastern bloc. A long and deep recession in the 1990s was inevitable.

An extremely deep slump took place in the Russian investment sphere during the first years of post-Soviet power. In this respect, the situation in the largest former Eastern bloc country, Poland, was dissimilar: in the first post-communist decade, investment in Poland roughly doubled in real terms, while there was a decline of investment in Russia of about 70%. The difference between these two countries in investment trends is striking. Amid the investment slump, the investment quota in Russia was roughly halved from 30% to 15% in the 1990s.

It is often assumed that rich persons and wealthy nations have a high propensity to save. This is not necessarily in line with reality. China has a high savings rate, while the USA has a very low one. The latter is a net importer of capital, while the former is a net exporter of capital. In transitional Russia, saving rates have been relatively high. Even if the general living-standard in Russia is rather modest, household sector has continuously savings (when average household budgets are considered). In the Russian household savings there is one oddity: part of the savings is converted into “hard currency”. Obviously, there is a fear in Russia that rouble denominated savings may lose value more easily than savings in dollar and/or euro form.

It can be stated that current account (CA) deficits are a rule in transitional economies, while surpluses in CA are exceptional. In this respect, Russia is a clear exception: in the turn of the century, Russia had considerable CA surpluses annually. In the five-year calculation (2000–2004), the total CA surplus was about EUR 200 billion. These surpluses are naturally closely linked with Russian resource base: it is self-sufficient in many goods and has exportable surpluses in the most important energy-bearers. In the first years of the 21st century, global oil market has brought windfall profits to Russia. The booming oil market is an essential background factor in the Russian economic revival and in the CA surplus figures. In her external economy, Russia has more revenue than expenditure, which is reflected in the CA surpluses. An annual surplus in CA, which lately in Russia has been about 10% of GDP, is the mirror image of net capital export. Thus, Russia with a relatively modest income level (in international comparison) contributes to finance the rest of the world (RoW). The investment quota in Russia is with 20% relatively modest considering the development stage of the country. Thus, the situation in Russia is paradoxical. There is a high need to invest in order to improve the local infrastructure, to expand and mend the housing stock, and to modernize industrial capacities. Thus, the aim of the economic policy-making ought to be balancing the current account: local (Russian) investment climate should be improved to advance long-term economic growth.

The semi-fixed exchange rate regime in Russia collapsed in August 1998. Amid this RUB crisis, the real exchange rate depreciated rather strongly which improved Russian investment climate considerably. Real investment started to grow. However, in the early years of the new century, the real exchange rate of rouble has recovered somewhat. In this context, it is occasionally pointed out that the Russian economy suffers of “Dutch illness”. This term originates from 1970s. In the period of the first oil crisis, natural gas was found off the Dutch shore. This energy bearer became an important export article with high price in Netherlands appreciating the local currency. It was maintained that this appreciation of the Dutch currency hampered “traditional” export via decreasing price competitiveness. Even since this term “Dutch disease” has been used in economic texts. It is, for example, often used in texts dealing with the Norwegian economy: Norway became an exceptionally rich country after North Sea oil discoveries. Norway earns regularly CA surpluses, has high price level and a “strong currency”. Thus, traditional industries in Norway have difficulties in price competitiveness. Obviously, monetary authorities must watch carefully the development of RUB real exchange rate and try to hinder Russia catching serious Dutch disease.

In the post-crisis Russia (after 1998), living-standard has recovered rather fast. This recovery is visible in the household expenditure structure. The share of food (incl. alcoholic beverages) has decreased continuously in the average consumer basket. However, this component of consumption still remains on a rather high level.

In the 1990s, the state budget of Russia had rather high deficits, which were financed by selling government bonds (treasury bills). In the year of RUB crisis (1998), the state defaulted her internal debt. Starting in 2000, the central government budget shows annual surpluses. This turnaround in the state's bookkeeping is remarkable. Obviously, it is not an easy task to balance the books in the public sector. In the winter 2004–2005 there were several very visible protests in Russia against cutting social expenditure in context of old age pensioners' welfare. In the fiscal policy-making social issues must be considered carefully in the near future, because street demonstrations cannot be excluded any more in the social policy matters.

The structure of the Russian industry shows really radical changes in the transitional period. When the year of the systemic change (1991) is marked with 100, the index of overall industrial production had a marking of only 55,2 in 1999, which indicates a decline of almost 50%. The recession in the industry in the 1990s did not hit all branches equally severely.

In the post-crisis period (after 1998), investment boom started in Russia. However, in 2004 investment quota (the share of investment of GDP) is still rather low with less than 20%. In the same year, CA surplus was 10% of GDP. Exchange rate deviation index (ERDI) has recently become more moderate (in euro-based calculations). However, Russian ERDI is with over 2,5 still relatively high. Thus, Russia exercises clear “exchange rate protectionism” via rouble undervaluation. This fact is an essential background factor in her CA surpluses, which in relative terms are exceptionally high. Local investment ought to be supported and capital export somehow discouraged.

It was pointed out earlier that large enterprises dominate the economic scene in Russian transition. The public sector still has an important stake in the business sphere. The small and medium size enterprise sector (SME) has started to emerge in the post-Soviet era and is the most efficient part of the Russian economy. However, this sphere has still a relative modest weight in the Russian economic scene. Obviously, development of the SME-sector will be one of the key factors in the future economic growth of Russia. Special attention ought to be paid to the availability of capital in the SME-group of firms.

To sum up, Russia's economy in the second half of the first decade in the 21st century faces interesting challenges. Income and private consumption have profited from the economic boom. Income distribution is rather uneven. Social safety net is not very tight. Market mechanism has created winners and losers. Long-term sustainability of economic growth depends on propensity to invest into local economy.

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**Appendix 1. The biggest companies in Russia in 2004**

2004 Rank	Company	Revenues mUSD	Profits mUSD	Market value mUSD	Industry
1	Gazprom	27.835	5.402	31.554	Oil and Gas
2	Lukoil	22.299	3.701	18.306	Oil and Gas
3	RAO UES	20.140	916	11.976	Energy
4	Russian Railways	19.392	1.283	n.a.	Transportation
5	Yukos	12.199	3.546	27.750	Oil and Gas
6	TNK-BP	12.079	2.811	7.529	Oil and Gas
7	Sberbank	6.739	473	5.133	Banks
8	Sibneft	6.717	2.278	10.559	Oil and Gas
9	Norilsk Nickel	5.196	861	13.514	Metals
10	Tatneft	4.940	536	1.678	Oil and Gas
11	Svyazinvest	4.522	94	3.304	Telecommunications
12	Avotvaz	4.261	96	795	Motor vehicles and parts
13	Sistema	3.760	387	n.a.	Financial-industrial groups
14	Rosneft	3.641	386	n.a.	Oil and Gas
15	Transneft	3.082	878	..	Transportation
16	Magnitogorsk Metallurgical Combine	3.047	630	..	Metals
17	Severstal	2.919	773	2.631	Metals
18	Novolipetsk Metallurgical Combine	2.468	657	2.078	Metals
19	Alrosa	2.038	216	..	Diamond production
20	Aeroflot	1.716	128	766	Transportation
21	Vimpelcom	1.336	234	n.a.	Telecommunications
22	Kamaz	1.147	0	283	Motor vehicles and parts
23	Vneshtorgbank	1.090	254	..	Banks
24	Nizhniy Tagil Iron&Steel Works	1.040	65	..	Metals
25	West Siberian Metal. Integrated plant	1.026	109	..	Metals
26	Wimm-Bill-Dann	939	21	n.a.	Food production
27	Megafon	815	99	n.a.	Telecommunications
28	Baltika Brewery	805	123	1.532	Beverages
29	Sun Interbrew	675	27	644	Beverages
30	Bank of Moscow	617	91	n.a.	Banks
31	Novatek	583	111	..	Oil and gas
32	OMZ	546	15	283	Machinery construction
33	Irkut	529	-8	350	Machinery construction
34	Alfa Group	489	1.991	..	Financial-industrial groups
35	Ikutskenergo	481	11	558	Energy
36	Amtel	383	12	..	Motor vehicles and parts
37	Novosibirskenergo	365	15	454	Energy
38	Transneftproduct	362	58	n.a.	Transportation
39	Power Machines	352	3	n.a.	Machinery construction
40	Acron	345	2	n.a.	Chemicals
41	MDM Financial Grou	325	110	n.a.	Banks
42	Rosbank	316	14	n.a.	Banks
43	Ural-Siberian Bank	285	17	n.a.	Banks
44	Zavolzhsy Motor Plant	229	25	n.a.	Machinery construction
45	International Moscow Bank	217	60	n.a.	Banks
46	Citibank (Russia)	187	92	..	Banks
47	Trust Investment Bank	170	42	n.a.	Banks
48	Concern Kalina	157	11	..	Household products
49	Novokuznetsk Metallurgical Combine	155	9	n.a.	Metals
50	Northgas	152	-3	1.225	Oil and gas

Source: Fortune (2005).