BUDGET AND INFLATION: CURRENT SITUATION AND PROSPECTS FOR 1999

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Budgetary outlook

General description.
In a remarkable contrast to previous years the 1999 budget law passed the various legislative hurdles with an unprecedented speed, and came in effect on 10 March. It foresees 1999 total federal revenues at 11.84% of GDP, with almost 10% of GDP arising from taxes, and federal expenditures at 14.38%. The planned budget deficit of 2.54% arises in spite of a 1.64% of GDP primary surplus, due to relatively large debt servicing costs.

The planned shifts in federal expenditures.
The budget plan for 1999 assumes a slight cut in expenditures of 0.76% of GDP with respect to the realised 1998 budget. Major differences between the 1999 budget draft and the 1998 enacted budget are in the following areas: after the GKO default and the large real depreciation of the rouble, there has been a large shift from expenditures on domestic debt payments towards those on foreign debt. Second, as a consequence of the erosion of the real value of social payments, a decrease in their share of GDP, as well as those of the transfers to regional bodies (that often are used for social purposes) can be observed. Finally, a significant relative increase in planned spending for security, law enforcement and international activity reflects Russian policymakers' ambitions to strengthen law and order (which investors will appreciate insofar as property rights are concerned) and to play a more important role in international affairs in 1999.

It should be stressed that the recent wage rise for state employees[1] (roughly a doubling, but varying for different groups) and the lump-sum R60 increase in pensions[2], intended to reverse partly the negative effect of inflation on real incomes, have already been fully taken into account in the 1999 budget and will thus not lead to any further expenditures.

Table 1 Federal expenditure targets for 1999 compared to actual 1998 figures, %GDP

Expenditure items	*Federal budget law plan 1999*	*Actual federal budget expenditures 1998*	*Change in expenditures*
International activity	1.05	0.3	0.75
Agriculture and fisheries	0.2	0.1	0.1
Judiciary	0.14	0.09	0.05
Basic research and science	0.29	0.19	0.1
Law enforcement and security	1.27	1.1	0.17
Defense	2.31	2.1	0.21
State administration	0.39	0.35	0.04
Environmental protection, meteorology and	0.07	0.08	-0.01

1 Governmental decree #311, March 19, 1999
2 Presidential decree "On the lump-sum compensation to pensioners", March 31, 1999

cartography			
Industry, energy and construction	0.3	0.4	-0.1
Transport, roads and computers	0.02	0.04	-0.02
Culture and art	0.07	0.04	0.03
Mass media	0.04	0.04	0
Education	0.52	0.45	0.07
Emergencies	0.19	0.2	-0.01
External debt servicing	2.5	1.55	0.95
Health and sport	0.2	0.22	-0.02
Disarmament	0.04	0.05	-0.01
Social policy	1	1.35	-0.35
Internal debt servicing	1.67	2.45	-0.78
Financial aid to the other levels of government	1	1.68	-0.68
Replenishment of state reserves	0	0.14	-0.14
Targeted budgetary fund expenditures total	1.11	0.76	0.35
of which:			
Federal road fund	0.7	0.6	0.1
Federal ecological fund	0	0	0
State crime-fighting fund	0.01	0.01	0
Fund for the development of the customs system	0.09	0.1	-0.01
Management, study, reservation, replenishment of water bio resources	0.1		0.1
Fund for the renewal of the raw materials stock		0.05	-0.05
Military reform fund	0.07		0.07
Replenishment of minerals fund	0.1		0.1
Total expenditures	**14.38**	**15.14**	**-0.76**

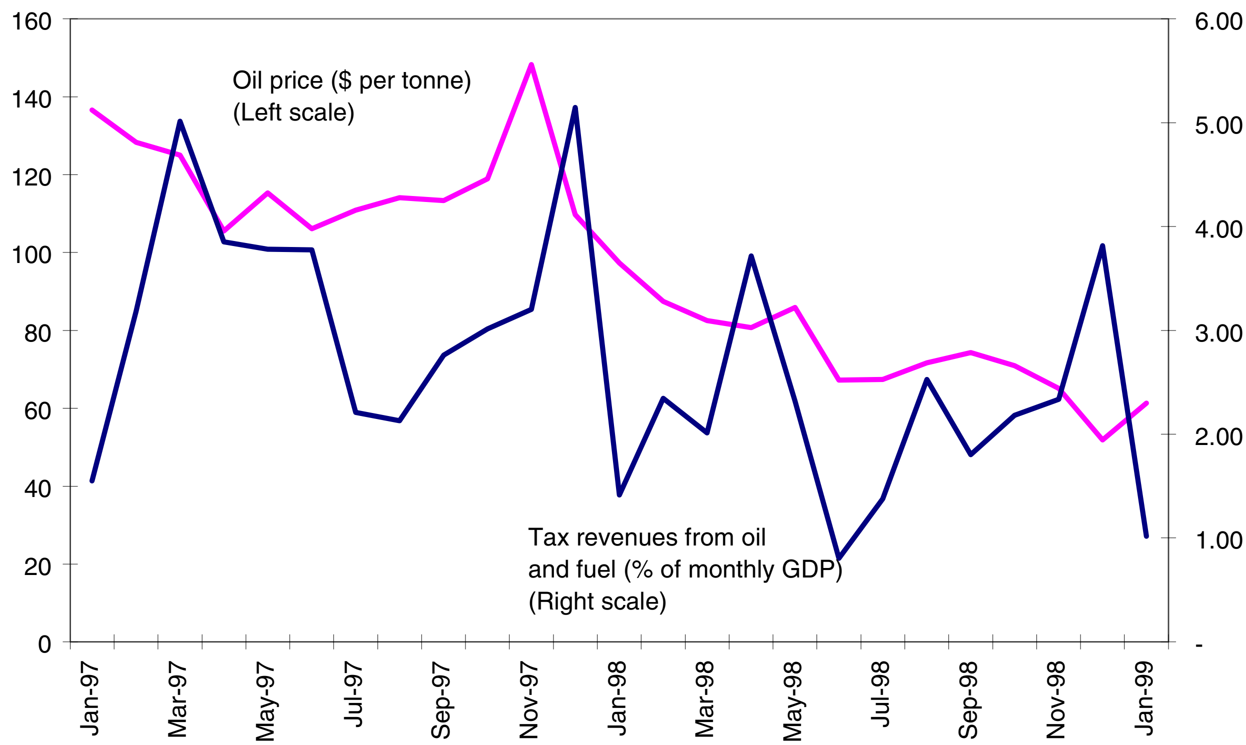
Source: Federal Law, Ministry of Finance, Goskomstat

The impact of the legal changes on federal revenues.

These tax changes as presented in the government package of 19 tax laws (see annex «Tax legislation») were taken into account in the calculation of the revenue side of the 1999 budget. However, of those laws the President has signed only six so far. In particular, the President has declined the draft law «On Amendments to the federal law 'On the Value Added Tax'». His refusal to sanction the VAT reduction from 20 to 15% from the July 1 will have an extremely beneficial impact on the budget revenue situation, at the same time removing one of the biggest obstacles to the conclusion of an IMF agreement. The budget law establishes the new sharing rule of the VAT that raises the stake of federal government from 75 to 85%. This is evidently only a redistributive measure towards the federal budget, but as regions now are allowed to levy a sales tax, the consolidated revenue will largely profit from this situation. Further major changes that have been approved are the decrease in the profit tax rate from 35 to 30%, of which the federal share decreased from 13 to 11 points. Though this measure in itself is highly desirable since it eases the burden on the production sector, it is doubtful whether this measure alone will lead to a very significant increase in tax compliance, as is assumed in the budget law. Thus, profit tax revenues may well turn out below the levels anticipated in the budget plan. Introduction of the federal income tax of 3% (on the expense of regional governments) will bring some additional revenues to the federal budget. Besides, one may expect a slight increase in tax compliance due to the increase in control.

The export tariff on oil introduced in February will equally bring some additional tax revenues to the federal budget. Since the tariff is determined by the export prices on oil for the previous month[3], one may expect that the tariff suspended on 24 March for 1 month will take effect again on 24 April, and lead to some revenue due to the increase in world oil prices in March. However, the total effect of the increase in world oil prices on the federal budget is unclear, as the total amount of taxes paid by these powerful enterprises is rather the result of a bargaining process with the central government.

Figure 1 oil prices and tax revenues from fuel industry



Source: STS, Goskomstat

Other changes in tax legislation (in particular, the introduction of the imputed income tax, gambling tax etc.) will only have a negligible positive effect on the federal budget. The fact that a part of government revenues is basically collected in or indexed to the dollar will lead to a relative increase of roughly 0.8% of GDP under the assumptions of a more realistic average exchange rate around 30R/$ (the budget is based on an exchange rate of 21.5R/$) and a drop in hard currency budget revenue compared to 1998 (see Annex for details)

3 If the oil price in the previous month is below 9.8$/b then the tariff is set at zero rate. If this price was in the interval between 9.8$/b and 12.3$/b then the tariff is set at the rate 2.5 Euro. If the price exceeded 12.3$/b then the tariff is set at the rate 5 Euro.

Table 2 Estimated effects of changes in tax legislation and real rouble depreciation on budget revenues

Tax	*Net effect on the federal budget*	*Net effect on the regional budgets*
Profit tax	-0.16	-0.28
Income tax	0.49	-0.50
VAT on Russian goods	0.32	-0.32
Export tariff on oil	0.09	0.00
Other taxes	0.17	0.00
The effect of the nominal ruble depreciation	0.78	0.00
Taxes on import	-0.13	0.00
Sales tax	0.00	0.40
Imputed income tax	0.01	0.20
Total effect	**1.57**	**-0.50**

Source: RECEP estimates

This estimation of a 1.57% of GDP increase in federal revenues due to the changes in tax law compares with an estimated 2.35% of GDP increase due to those measures in the official budget. Thus our estimates are roughly 0.8% of GDP lower, which might be a source of potential budget revenue shortfalls.

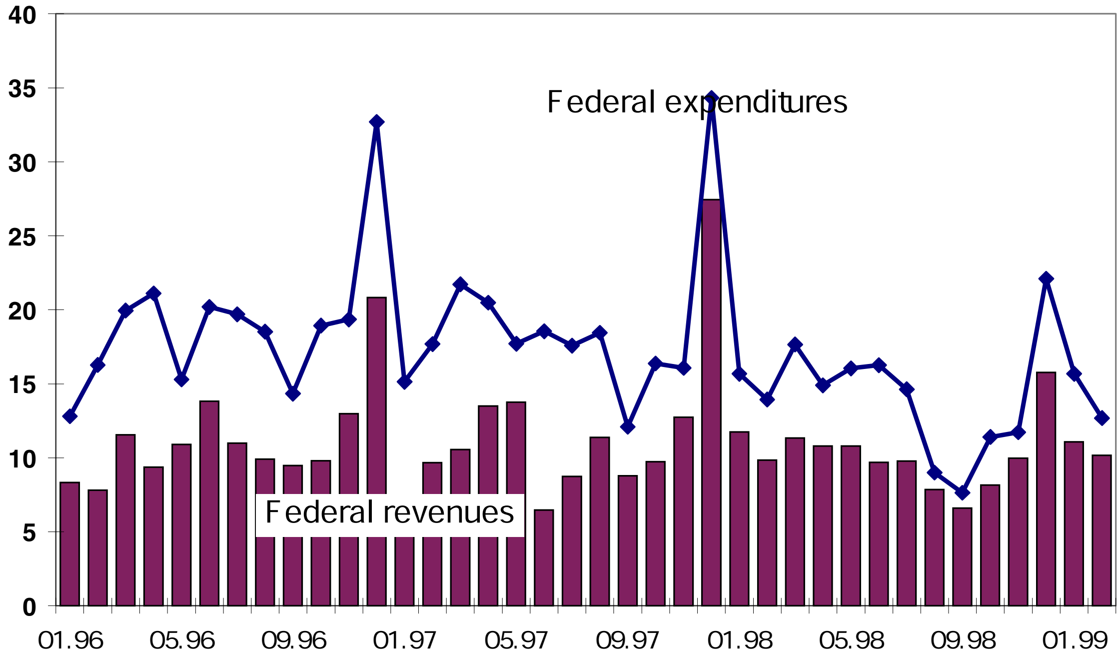
Regional revenues will obviously be negatively affected by changes that give a greater share of tax income to the federal budget. This will amount to mainly the above mentioned loss of a 3% share of income tax which goes now to the federal budget, the reduction of the regional profit tax rate from 22% to 19% and the introduction of the new VAT sharing scheme that decreases their share from 25% to 15% of the total tax income. These effects might be partly compensated by the introduction of the sales tax (note that this tax can be introduced without the abolishment of numerous local taxes, in contrast to the situation last year) and the imputed income tax. According to our estimates the total negative effect on the regional budgets for 1999 will be –0.5% of GDP.

The first two months of 1999

During the first two months of 1999 tax revenues to the federal budget constituted 10.7% of GDP, which is above the 10.3% collected in 1998.

We furthermore see that following the August crises expenditures as a percentage of GDP have decreased, while revenues as a percentage of GDP seem to have slightly risen. As so often this increase in budget discipline unfortunately comes only when there are basically no borrowing possibilities for the government any more.

Figure 2: Revenues and expenditures of the Federal budget in 1996-1999, % GDP.



Source: Ministry of Finance, Goskomstat

Table 3 Federal Budget Execution in 1999 %GDP.

	Jan-Feb, 1997	*Jan-Feb, 1998*	*Jan-Feb, 1999*
Total revenues to the Federal Budget, %GDP	9.70	10.30	10.70
Tax Revenues to the Federal Budget, %GDP	7.53	8.48	9.52
of which:			
Profit tax	0.77	0.89	0.79
VAT	4.24	4.24	4.24
Excises	0.87	1.92	2.58
Other taxes	1.64	1.43	1.90
of which:			
Taxes on foreign trade and foreign economic operations	0.82	1.14	1.58

Source: Ministry of Finance

From the above table we see that profit tax and VAT revenues have been relatively constant. The rise in total tax revenues is mainly explained by the increase in excise taxes and taxes on foreign trade, mainly due to their increased share as % of GDP after the large real depreciation. It is equally interesting to note that the share of tax revenue in the total revenue increased from 0.78 in the first two months of 1997 to 0.89 in 1999. Though the relatively good revenue collection in January and February might have been partly due to offsets during this period, it seems nevertheless that there is some room for slight optimism on the budget front.

Tax legislation

The legislative basis of the tax system should have been determined by the first part of Tax Code, which entered into force on 1 January 1999. The Tax Code was passed by the State Duma in the third reading on 16 July 1998. It was then approved by the Federal Council on 17 July 1998 and signed by the President on 31 July 1998. The document was published in "Rossijskaja gazeta" on 6 August 1998. Nevertheless, since 1 April 1999 an amendment to Tax Code (Federal Law N51-ФЗ, 30.03.99) has come into force, suspending the validity of Paragraph 1 of Article 5 of the Tax Code until 1 January 2000. Article 5 of the Tax Code set the constraints on the time lag between the approval of a tax law and its coming into force. Due to this amendment, new federal laws on regional sales tax and the tax on imputed income can come into force before 1 January 2000, legalizing the introduction of that tax.

The government submitted the package of 19 tax law drafts to the State Duma on 8 December 1998. The majority of the laws (eleven) were passed by the Duma in the second and third readings, and the Federal Council approved nine laws. The President signed the following laws:

-*On amendments to the Russian Federation Law* On the Enterprise Income Tax. The law assumes the reduction of the tax rate from 35% to 30%. In particular, the federal rate is to be reduced from 13% to 11% as of April 1. The law does not abolish the restriction on the exemption for profits invested in production.

- *On Amendments to the Federal Law* On the Personal Income Tax

The law includes the introduction of the federal income tax at the flat rate of 3% and the new progressive scale for the regional income tax. As of January 2000 the maximum rate will constitute 45% (3%+42%).

-*On Amendments to the Federal Law* On the Single Imputed Income Tax

The law expands the tax base for the imputed income tax. Not only small business enterprises, but also enterprises with up to 100 employees, providing transport services are to pay this tax.

On Amendments to Article 4 of the Federal Law On Payment for Water Facilities

Maximum tax rates are to be applied until regional officials specify particular tax rates.

-*On Amendments to Certain* Tax Laws of the Russian Federation

The law establishes equal rules for the tax on profit duties for foreign and domestic taxpayers.

-*On Amendments to the Article 5 of the Federal Law* On Closed Cities.

The law establishes certain restrictions on the existing exemptions for enterprises registered in the closed cities' tax inspections. They are to keep not less than 90% of their basic reserves and 70% of their turnover within the closed city.

The Federal law on the «Federal Budget for 1999» passed by Duma in the fourth (final) reading on February 4 was approved by the Federal council on February 17. The law was signed by the President on February 22, published officially on February 22 and came into effect on March 10 after the publication of all appendices. In particular, the law establishes the new sharing scheme of the VAT on Russian goods tax revenues: 85% to the federal budget and 15% to the regional budgets as of April 1.

Inflation Outlook for 1999

Not surprisingly, econometric analysis shows that the main factors affecting inflation in Russia are money supply growth, exchange rate dynamics and inflationary expectations. The more interesting phenomenon however is the large degree to which inflation is influenced by adaptive expectations. In other words, economic agents that experienced a certain level of price rises during recent months expect price rises to be of the same order of magnitude in the near future. This implies that even if the other major sources of inflation, namely a further devaluation of the exchange rate and money printing are eliminated, it will take some months before inflation comes down significantly. Still, this does not mean that money printing or exchange rate dynamics do not play crucial roles in keeping inflation at high rates. Econometric analysis shows that changes in the exchange rate affect inflation in the current as well as in subsequent months. In addition there is statistical evidence that money supply growth affects the inflation rate with a three months lag.

In our forecast we use actual data of several variables from January 1992 until March 1999. For the remainder of 1999 we assume three different political and economic scenarios and estimate their implications for inflation in 1999:

Scenario I (optimistic "official" scenario):

- The rouble depreciates by 2.5% per month;
- Monetary base growth of 1.3% per month, which corresponds to the R32.7 bn of CBR financing for the federal budget planned in the 1999 budget;

Scenario II (intermediate scenario):

- The rouble depreciates by 7.5% per month;
- Monetary base growth of 3.8% per month.

Such excessive (compared to Scenario I) growth of the money supply would result in total money printing of R82.7 bn which arises from:

1. R32.7 bn of the CBR financing of the federal budget planned in the 1999 budget;
2. Extra money printing of R50 bn to cover shortfalls from tax collection, extra expenditures (spending targets are hard to meet in election years) or inability to obtain some external financing.

Scenario III (pessimistic scenario - no external financing for the federal budget):

- The rouble depreciates by 14.5% per month;
- Monetary base growth of 10% per month.

Total money printing of Scenario III (about R300 bn) includes:

1. R32.7 bn roubles of CBR financing for the federal budget as projected in the 1999 budget draft;
2. Failing to reach an IMF agreement, Russia is unable to obtain most of the planned external financing and can only attract $1 bn US$ instead of the planned 7 billion. In order to fulfill the planned debt expenditures, Russia prints money to an amount of roughly $6 bn (about R270 bn at the average exchange rate of 45R/$).

The results of the inflation rate evaluation for scenarios I - III are presented in the table below. The table shows that even in the most optimistic Scenario I the predicted inflation rate is rather high: about 30% in the 1st half of 1999, and about 50% for the whole of the year. The implementation of the intermediate Scenario II would lead to an inflation rate of around 35% for the 1st half and 90% for the total of 1999. In the pessimistic Scenario III we see a major increase in inflation during the second half of the year. Inflation in the 1st half of the year would "only" be about 42%, but would amount to almost 180% for the total year.

Table 4 Evaluation of the Inflation Rate (%).

Time period	*Scenario I*	*Scenario II*	*Scenario III*
January-99	8.5	8.5	8.5
February-99	4.1	4.1	4.1
March-99	2.8	2.8	2.8
April-99	5.0	5.8	6.9
May-99	3.0	4.7	6.9
June-99	2.5	4.3	6.9
1st half 99	28.8	34.1	41.8
July-99	2.7	5.4	9.4
August-99	2.3	5.5	10.6
September-99	2.3	6.0	12.1
October-99	2.3	6.2	12.8
November-99	2.2	6.3	13.2
December-99	2.2	6.4	13.5
1999	**47.9**	**89.7**	**178.6**

Source: Recep estimates

ANNEX Effect of the exchange rate depreciation on budget revenues and expenditures

The unrealistic nature of an average exchange rate of $21.5, on which the 1999 budget is based, became obvious almost immediately. It has thus become important to understand how the budget is affected by a larger than planned exchange rate depreciation. Basically, there are two types of effects of exchange rate depreciation on the budget situation – the direct effect, simply that part of federal budget revenues (or expenditures) is collected (or has to be paid) in hard currency. The second effect, indirect, results from the influence of the exchange rate on a large range of macroeconomic indicators (among them inflation, exports and imports), which in turn affect budget revenues. These effects are hard to estimate in full, however. In addition, when estimating the direct effect, one should be aware that the indirect effects of an exchange rate depreciation influence the direct effects as well. For example the drop in the real exchange rate has led to a fall in imports, resulting in lower hard currency revenues from import taxes.

The direct effect of the exchange rate depreciation on budget revenues and expenditures
In 1998 about 10.8% of total federal budget revenue was collected in hard currency, or 1.2% of GDP. The tax and non-tax revenues collected in foreign currency were roughly 60% and 40% respectively. Foreign currency collection in non-tax revenue mostly resulted from occasional sales of precious metals and stones from state reserves. On the tax revenue side, most foreign currency contributions arose from customs tariffs, VAT on imports and excises.

The 1999 budget law assumes that budget revenues in hard currency remain at the 1998 level. This would result in a relative revenue increase of 0.82% of GDP, as even the official budget law exchange rate of 21.5R/$ signifies a major depreciation from last year's levels. Nevertheless, in January-February 1999 the federal budget revenue in foreign currency was 3.8 times lower than during the same period in 1998 (though there were not many sales of state valuables in these months). For the rest of 1999, it seems reasonable to assume the same ratio, and to assume that Russia sells state reserves for the same dollar revenue as last year. Doing so, we obtain hard currency revenue of $1 bn less than in 1998. Still, this lower hard currency revenue translates into an increased figure in relative terms, as it will be transformed into roubles at a much higher exchange rate than the officially assumed 21.5R/$. It seems rather conservative to assume that the average exchange rate in 1999 will be at 30R/$. The total effect of the exchange rate depreciation would thus be a relative revenue increase of 0.78% of GDP.

A depreciation of the exchange rate is not only beneficial for the budget, as it increases at the same time the relative cost of foreign debt service. Following the budget law, roughly $9.5 bn are earmarked for payments of principal and interest on foreign currency denominated Russian debt. As the total amount due in 1999 is about $17 bn, already this implies an almost complete restructuring of, or default on, all "Soviet debt". The budget law assumes $7 bn to be obtained by foreign financing, so the net payment would be in the order of $2.5 bn. Supposing that these payments are effected at an average exchange rate of 30R/$ instead of 21.5R/$ would increase expenditures by roughly 0.5% of GDP.

The indirect effect of the exchange rate depreciation on budget revenues and expenditures

In 1998 revenue from all import taxes was 2.4% of GDP, of which the largest parts came from VAT on imports (1.23%) and customs import tariffs (1.06% of GDP). In the 1999 budget, revenue from VAT on imports (under the assumption of reducing VAT from 20% to15%) is predicted at 1.49%, and from customs import tariffs at 1.5% of GDP. While both planned increases look optimistic, the latter is even more so since the projected rise would take place in spite of the abolition from March 1st on of the additional 3% import tariff, introduced in 1998 as part of the crisis prevention measures.

Revenues from import tariffs, VAT and excises on imports are reported in table X for the whole of 1998, as planned in the 1999 budget, and for the first two months of 1998 and 1999.

Table 5 Import tax revenues

	VAT on imports % of GDP	*Customs import tariffs % of GDP*	*Excises on imports % of GDP*	*Total taxes on import % of GDP*	*Imports % of GDP*	*Implicit import tariff rate % of imports*
1998	1.23	1.02	0.16	2.40	19.5	12.82
Planned 1999 *VAT at 15%*	1.49	1.51	0.13	3.13	n. a.	n. a.
Jan-Feb 1998	1.24	1.10	0.20	2.54	18.9	13.41
Jan-Feb 1999	1.35	1.11	0.05	2.51	26.03*	9.63

Source: Ministry of Finance, Federal Law on budget 1999, Recep estimates.

As can be seen from the above table, even with a reduction of VAT to 15%, the projected extra revenue for 1999 from all taxes on import is about 0.93% of GDP, in comparison to the 1998 realizations. Theoretically such an improvement (supposing the same scheme of tariffs and taxes) could be achieved via better tax compliance, exchange rate depreciation and/or increases in imports.

Before we discuss these channels more in detail, a quick look at the above table tells us that in spite of the decrease in import tariffs and the large drop in imports4, total import tax revenue (as % of GDP) for January-February 1999 was almost the same as during the corresponding period in 1998. This surprising feature results mainly from the fact that despite the significant absolute drop of imports, their share of GDP increased due to the rouble depreciation. Nevertheless, those revenues

4 Imports in January 1999 were only 51.3% of imports in January last year according to the methodology of balance of payments. There are no available data of imports for February 1999.

were still far below the targets of the 1999 budget, indicating that it will be extremely difficult to meet those revenue targets. A feature that might help in this respect is the postponement of the import VAT cut. Leaving import VAT at 20% would lead to an additional income of 0.5% of GDP, and would thus partly offset the shortfalls from overoptimistic budget revenue forecasts in the budget law.

Obviously, revenues from import taxes depend crucially on the volume of imports and their share in GDP, the latter being mostly affected by real exchange rate dynamics and changes in real GDP. Using our estimates of real import elasticities with respect to the real exchange rate and real GDP, we can estimate the effects of changes in exchange rate and real GDP on imports, and consequently on tax revenue.

If we assume a stable rouble in real terms for the rest of the year (that is depreciation roughly corresponding to inflation) and a real GDP drop in the order of 3-5% for 1999, we estimate imports to be 19% of GDP and total import tax revenue[5] at around 2.27% of GDP - almost no change compared to the 1998 figures. Assuming different scenarios for the development of the real exchange rate does not substantially alter these figures. If we assume a real depreciation of the rouble in the order of 20% (as did occur in 1998), we estimate 1999 imports to decline to 17.5% of GDP, and the amount of total import tax revenue to fall to about 2.2 % of GDP. In the case of a substantial appreciation of the rouble of 20% in real terms (which is not very likely given the low level of Russia's foreign currency reserves) imports would increase to 23.5% of GDP and revenues from import taxes would increase to 2.9% of GDP.

So we see that, even under fundamentally different economic environments, there is almost no way to achieve the planned 1999 target for import taxes. Under the - to our mind - most likely scenario of the rouble staying roughly constant in real terms, we would see a shortfall of revenue on total import taxes of about 1.2% of GDP. This would be partially offset by the non-reduction in import VAT that would generate an additional 0.5% of GDP in revenue.

To sum up our findings on the direct and indirect effects on the exchange rate of revenues: Under the assumption of an average nominal exchange rate of 30R/$ and a constant real exchange rate, we estimate a net shortfall of 0.4% of GDP. Nevertheless this would be offset by an additional 0.5% of GDP revenue from the unchanged import VAT. Expenditures would increase by roughly 0.5% of GDP. Thus the net total effect on the budget situation of an average exchange rate of 30R/% will be in the order of –0.5% of GDP. If the average exchange rate for 1999 would fall below 30R/$, this shortfall would become more significant.

5 assuming the same implicit import tariff rate

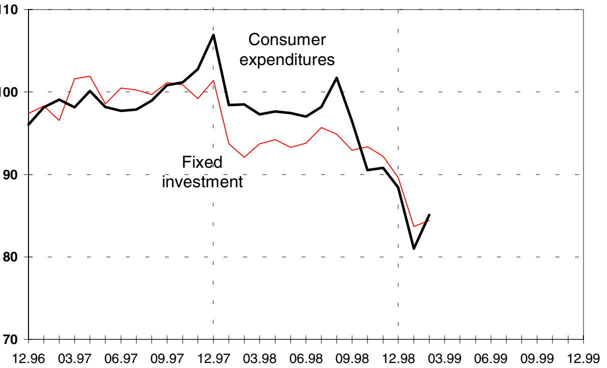
ECONOMIC UPDATE

Aggregate demand

In February seasonally adjusted real consumer expenditures on goods and services grew by about 5%, the first monthly increase since August 1998. Although consumer expenditures are still 15% lower than the average 1997 level this increase gives some grounds for cautious optimism. The turnaround in consumer demand was accompanied by mild growth in seasonally adjusted imports in December and January. Despite the fact that the rise in imports has a negative impact on the trade balance, it also indicates positive changes in the economy. In February a small growth of fixed investment was registered (+1% over the January level in seasonally adjusted terms).

At the same time, government demand continues to decline. In January it dropped by about 15% compared to its December 1998 level in seasonally adjusted real terms. This fall was caused by a new substantial rise in debt service expenditures, which amounted to about 40% of the federal budget outlays compared to 20% in November–December.

Components of aggregate demand (1997 = 100, seasonally adjusted)



Source: Goskomstat.

Output

Moderate positive changes in aggregate demand gave an impulse to growth in output. In February the seasonally adjusted index of gross output of ‘basic sectors’ grew by 0.8% compared to January. What is more important, growth was registered not only in industry, as in previous months, but also in construction (+1%), production of agricultural animal products (+0.5%), and retail trade (+5.5%).

Industrial production already exceeds the level of May–June 1998, and is only 2.5% lower than the average level of 1997. Still, the growth of industrial production is spread very unevenly across different sectors. In fact, this growth is supported not even by particular industries but by specific commodities. Until now it reflected the short-term adjustment of supply and demand to the new price structure, the latter being a result of the devaluation of the rouble. These short-term effects are coming to an end, and the further growth of output will depend more and more on changes in aggregate demand.

Gross output (1997 = 100, seasonally adjusted)*

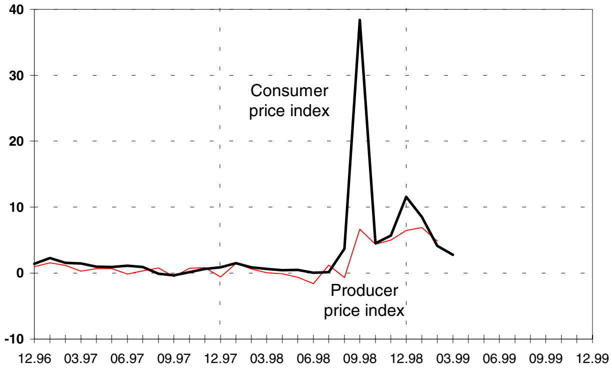
** Index of gross output of 5 basic sectors include industry, construction, agriculture, transportation and trade.*
Source: Goskomstat.

Prices

In the last two months inflation has been decelerating. In March CPI increased by 2.8%, compared to 4.1% in February and 8.5% in January. The composite producer price index grew in February by 4.9% compared to 6.9% in January. More significantly, in February prices for all the components of both CPI and PPI increased at a slower rate than in January. For example, price growth for consumer food decreased from 10.4% in January to 4.4% in February, and price growth for consumer non-food goods fell from 6.4% to 3.9%. PPI in industry in February increased by 5.5% compared to 6.8% in January, and prices for agricultural animal products grew by 9% compared to 15.9% in January.

It can be assumed that the mid-term effects of the devaluation of the rouble on price growth are gradually coming to an end. This means that unless a new devaluation occurs, rates of inflation in the near further will depend mostly on monetary factors, i.e. on the policy of monetary authorities.

Monthly growth of price indices, %*



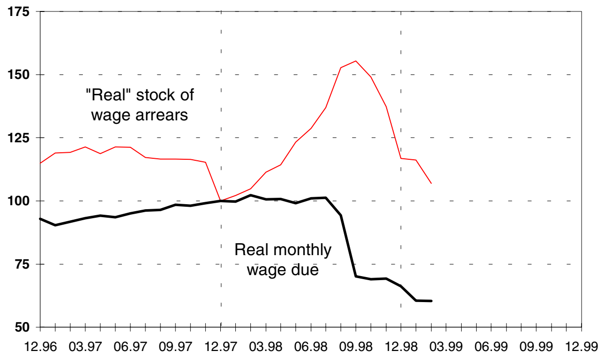
** Producer price index covers prices in industry, construction, production of agricultural animal products, and tariffs for freight transportation and communications.*
Source: Goskomstat.

Labour

According to various indirect estimates, the situation in the labour market is slightly improving. Registered vacancy ratio (number of job seekers per vacancy) in seasonally adjusted terms continues to fall. In February it was 4.3 compared to 7.2 in October 1998. The unemployment rate by VCIOM polls fell from 18.4% in November 1998 to 17.9% in January 1999.

The real monthly wage due in February, according to preliminary estimates, remained unchanged compared to the previous month (in seasonally adjusted terms). At the same time wage arrears decreased by R3.4 bn or 4.5%, mainly due to repayment of non-budgetaty arrears of enterprises. This means that actual real wages paid increased somewhat in February. And although their level still remains about 40% lower than a year ago, even such a small increase in real wages paid has contributed to a rise in consumer demand.

Real wages and wage arrears (Dec-1997 = 100, seasonally adjusted)*



** Index of "real" wage arrears is calculated in terms of monthly wage fund.*
Source: Goskomstat.

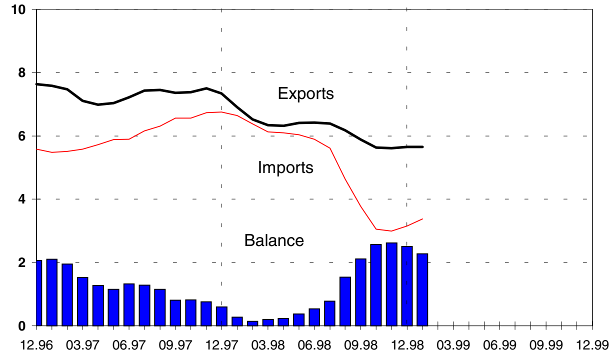
Foreign trade

Trade in the beginning of the year is normally low due to seasonal effects. Compared to December monthly exports fell $2.3 bn in January to $4.8 bn, or 18.6% lower than in January 1998. Imports fell by $0.7 bn, standing at $2.9 bn in January. Compared to the same period last year imports were down 48.2%. However, the fall in exports was more significant than in previous years. The trade surplus fell to $1.9 bn, the lowest since August last year (when seasonally adjusted both imports and exports grew in January; see the graph). Increasing oil prices should, however, have a positive effect on exports and on the trade balance in the coming months.

The government recently decided to amend its export and import duties. This is in line with the wishes of the IMF. In January export tariffs on various scrap metals were set at 10, to be raised to 20%, possibly 30%. On the imports side, the government plans to scrap the 3% surcharge imposed on all imports by the previous government. Duties on food imports have already been eliminated. However, import duties on agricultural products will remain at their current levels. Furthermore, the recent increase in oil prices, to above $12 per barrel, means that the government may reinstate export duties for oil. These were temporary suspended in March as the price of oil fell below $9.8 per barrel. If the price exceeds $21.5 per barrel than the duty should be increased even further.

A measure to prevent capital flight through false import contracts stipulates that importers paying for deliveries in advance now have to deposit the rouble equivalent with a commercial bank. The deposit is returned when the goods have been delivered. The measure effectively means that importers would have to double their working capital. It would thus reduce the number of importers and simplify monitoring. Still, it is not clear how this new rule will be enforced.

Merchandise exports and imports ($ bn, seasonally adjusted)



Source: Goskomstat.

Brent oil price ($ per barrel)

Source: Moscow Times.

Enterprise finances and the banking sector

Modest signs of improvement in the financial condition of enterprises have appeared in some aggregate indicators. A *Russian Economic Barometer* survey shows that the share of industrial enterprises in good and normal financial condition rose to 30% in January 1999, compared to the monthly average of 20% in 1998. According to Goskomstat data the share of loss making companies fell significantly in the first month of 1999. Only 38% of large and medium size industrial firms were loss making in January, compared to an average of 49% in 1998. Both figures however should be taken with a grain of salt since they are estimated from firms' tax returns.

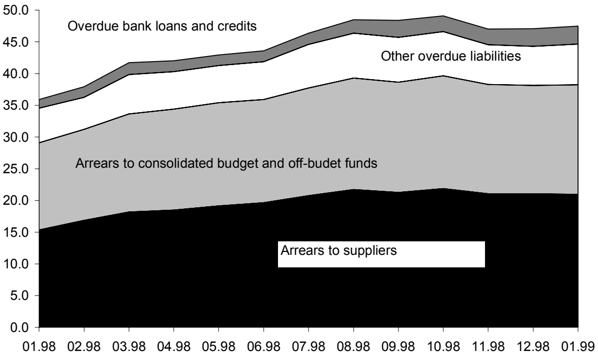
These are likely to signal the improved competitiveness of Russian firms resulting from rouble devaluation. Massive tax off-sets in the last quarter of 1998 also contributed to these positive figures. However, this type of fiscal policy usually discourages firms to pay taxes in cash in the future: Arrears to the budget, especially in industry and transport, increased again in January 1999, after a decline at the end of the previous year.

The outflow of household deposits from commercial banks into cash and Sberbank continued in the first two months of this year. Between end August and end February, the nominal stock of household deposits in commercial banks, excluding Sberbank, declined 34%. Deposits of the population held at Sberbank grew 20% in the same period.

Government-supported transfers of frozen deposits from Most-bank, Mosbiznesbank, Promstroibank, MENATEP, SBS-Agro & Inkombank contributed 6 percentage points to this growth. By the end of February, R7.1 bn was transferred under this program. So far, Sberbank has paid out more than half of these deposits in cash to their holders. In the future, the CBR expects another 18 banks to transfer a total of R3 bn of frozen deposits to Sberbank under this scheme. There is still no sign that banks are compensating Sberbank for assuming their liabilities.

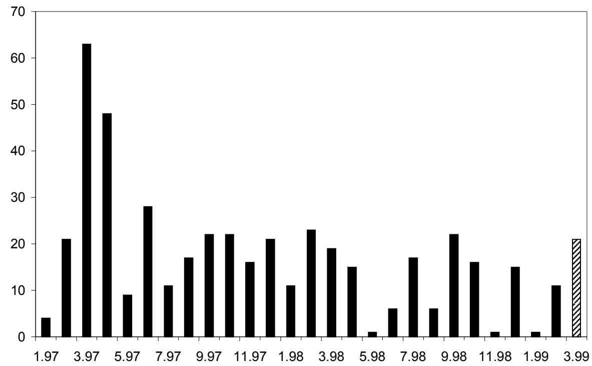
Despite the increased frequency of the special bank supervision committee meetings, the Central Bank barely stepped up withdrawal of licenses from insolvent banks. An estimated 21 licenses were recalled in March, 1/3 above the monthly average in 1998. In the meantime, the cabinet still has to submit the draft of the law on restructuring of credit organisations to the Duma. This month ARCO is launching its first project involving a small number of banks that voluntarily agreed to be restructured by the Agency. The process of decay continues among large problem banks in Moscow and smaller, virtually dead regional banks.

Arrears, % of GDP*



** Data is for 9 main sectors of the economy (see Table 7 in statistical appendix for the list of sectors). September 1998 GDP data were used in calculating October arrears ratio, full year 1998 data were used in calculating November arrears ratio.*
Source: Goskomstat.

Number of bank licences withdrawn by the CBR for violations of banking laws and CBR regulations*



** March 1999 data is a preliminary estimate.*
Source: CBR.

The budget

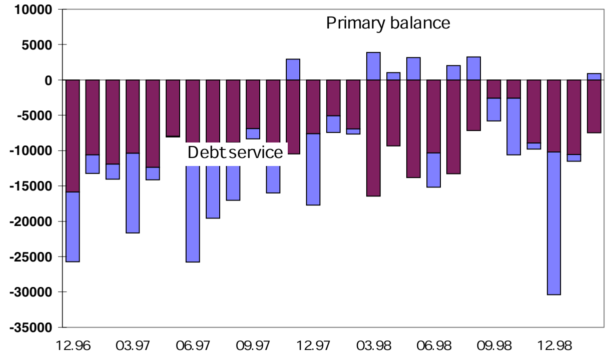
During the first two months of 1999, the federal budget ran a deficit of R18.1 bn (according to IMF definition), which comprises approximately 3.5% of GDP. Revenues and expenditures amounted to R54.3bn and R72.4bn respectively. The primary budget was balanced over the period, with a R1 bn deficit in January and a R1 bn surplus in February. Out of R18.1 bn of interest payments R13.1 bn were payments on foreign debt, most of which were made in January. Federal tax revenues in the period January and February were R48.6 bn. This included R6.5 bn in customs tariffs, of which R4.1 bn was collected in February. R10 bn of the tax revenue derived from Gazprom alone which agreed to pay 80% of its taxes in cash. According to preliminary Ministry of Finance data federal revenues and expenditures in March stood at R33.5 bn R38.6 bn respectively.

In the first two months of this year, regional and local budgets were running a consolidated surplus of R2.5 bn. Revenues equaled R51.8 bn, of which 75% were tax revenues. Revenues from sales tax stood at R1.2 bn, compared to R0.8 bn for the whole 1998, explained by the fact that the first regions introduced this tax in August last year. Consolidated budget expenditures amounted to R49.3 bn for the two months.

An IMF mission arrived in Moscow last week for key talks and will stay till April 24. Some interim agreement has been reached, in particular on the primary surplus figure for 1999.

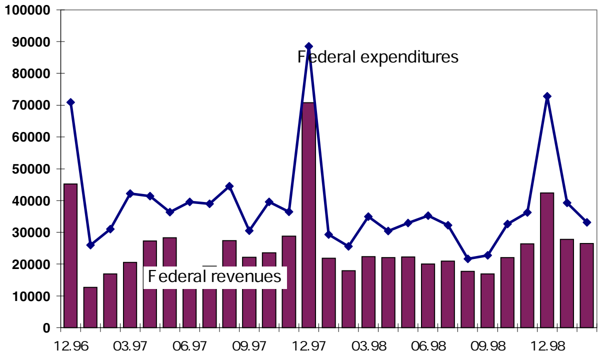
The amendments to the VAT legislation, providing for lowering VAT to 15% starting from July 1, 1999, were vetoed by the President. The law was returned to the Duma with the recommendation to keep the current rate of 20% untill the end of the year.

Federal budget deficit, R mn



Source: Ministry of Finance.

Federal revenues and expenditures, R mn



Source: Ministry of Finance.
IMF definitions of revenues, expenditure and deficit are used.

Financial markets

If Russia's stock market was labelled the worst performing emerging stock market of 1998, the first three months of 1999 told a different story. The Moscow Times dollar index, which fell 87% during the course of 1998 rose 58.9% in the first three months of 1999, making Russia one of the world's best performing markets so far this year. A recent boost was given by expectations of part of the defaulted GKOs being swapped for equity (under the restructuring deal foreign holders of GKO treasury bills will receive 10% in cash which then can be invested in certain shares, decided by the Ministry of Finance, on the stock market) and by progress in the government's negotiations with the IMF. Equally, the recent increase in the world market price of oil has aroused interest in the shares of oil companies. As a result investors are returning to the market, albeit with a certain degree of caution.

In March the Moscow Times $ index grew 20%. It peaked on March 19, at 66.2, the highest level since mid-August last year, after which it started to drop. Between March 19 and April 9 it fell 24% in a response to the Kosovo crisis and a pressured rouble. Furthermore low daily trading, currently ranging between $5-15 mn, enables actors to swing the market using relatively small resources.

Money

Monetary policy remains tight. In March the monetary base increased by R1.2 bn (less than 1%). In the first week of April base money increased another R1.4 bn (less than 1%). Currency in circulation (M0) increased by 1.5% in February, slightly less than the 2.1% growth in base money in the same month. Excess reserves have continued to rise as a consequence of the ongoing crisis and thus commercial banks' lack of investment opportunities. Required reserves in January amounted to R12.3 bn, while excess reserves stood at R71 bn. The latter may show an improvement of the liquidity of the banking sector.

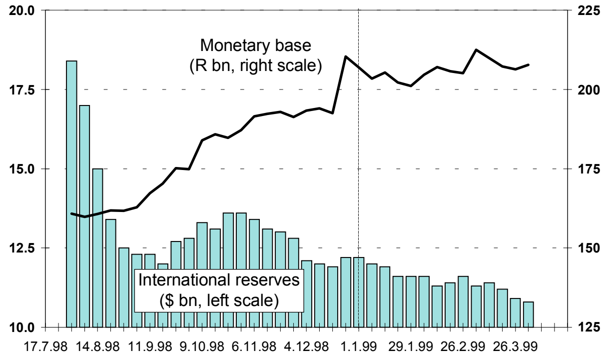
There was an interesting development in net domestic assets (NDA) in the beginning of the year. In January they increased by 36.4% to R340.1bn. The reason was a hard currency loan to the government from the CBR which did not show up in credits to enlarge government but rather in the category 'other' credits.

International reserves fell another $600 mn in March to $10.8, the lowest in four years, of which $6.7 bn is hard currency and $4.1 bn gold. Hard currency reserves are currently covering little more than two months of imports, back to a level seen in 1996-97 as imports have fallen dramatically since the devaluation in August. The decline in reserves observed during March was linked to the CBR's defense of the rouble and payment on government obligations. The development in the near future will depend on several factors. On the positive side exports have gained ground since the devaluation, contributing to the replenishment of reserves, and the recent rising oil prices add to this. However, reserves are supposed to cover imports, as well as external debt payments, leaving little room for the

Moscow Times $ Index (The Russian bubble)

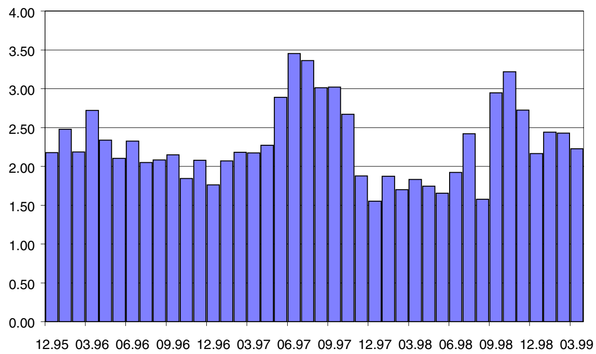
Source: Moscow Times.

Monetary base and gross international reserves (weekly data)



Source: CBR.

Number of months' imports covered by hard currency reserves



Source: Goskomstat, CBR

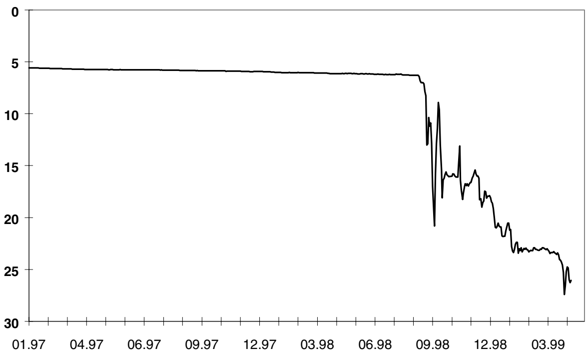
CBR to use reserves for rouble defense. Furthermore, the CBR has stated that it will not use its gold reserve, currently 520 tonnes, to service external obligations. No major debt payments are due in April. Since the beginning of the year international reserves have fallen $1.4 bn.

The exchange rate

In March the official exchange rate depreciated another 5.4% (the CBR rate), while the (afternoon) MICEX rate fell more than 7%. Adding the first week in April the rouble has fallen almost 18% this year. The rouble plunge at the end of March was caused by money emissions, debt payments, and the conflict in Kosovo.

Because of the low level of international reserves (see 'Money' above) there are limits to the scope of CBR interventions. Instead the CBR has focused on the use of administrative measures in defending the rouble. At the end of March temporary restrictions on a number of small and medium commercial banks were imposed. Also, the CBR will step up on-the-spot checks of importers, or banks representing importers, who are buying dollars in the afternoon session to make sure the dollars are bought for imports and not for other needs. In March the CBR raised the reserve requirement for corporate rouble deposits from 5% to 7% as a measure to relieve pressure on the rouble. The requirement for household deposits remains at 5%. If monetary emissions remain moderate this can have a positive effect on the rouble, preventing further fall. In January non-household deposits accounted for 43% of total rouble deposits.

The rouble exchange rate (R/$)*



** MICEX exchange rate till 17th August. CBR rate from then on.*
Source: CBR.