

## CHAPTER 4

# THE COMMONWEALTH OF INDEPENDENT STATES

After a slowdown in 2002, rapid economic growth resumed in the CIS in 2003. According to preliminary estimates, aggregate GDP in the region as a whole increased by 7.6 per cent, 2.4 percentage points more than in 2002. Although the aggregate CIS figure largely reflects developments in the region's largest economy, Russia, economic activity surged throughout the CIS, in some cases at double-digit rates of growth.

The commodity exporting CIS countries benefited substantially from rising world demand and prices for energy and commodities in 2003 and this was an important factor in the acceleration of their output growth. Otherwise CIS growth in 2003 was for the most part generated from within the region itself. The ongoing rapid recovery in domestic demand (especially of private consumption) in virtually all the CIS economies provided solid support for local economic activity. In turn, the simultaneous economic upturn in most of the CIS members strengthened intra-CIS trade, which provided a mutually reinforcing factor of growth throughout the region.

The revival of activity in the CIS region (which has been underway for several years) has been accompanied by progress in economic transformation. The acceleration of systemic reforms in a number of countries has led to many positive changes in their economic environment. In recent years, macroeconomic policy in most of the CIS economies has been marked by increased consistency and prudence and this has contributed to greater macroeconomic stability. Several CIS governments also initiated steps in 2003 towards closer regional economic cooperation and integration.

### 4.1 Macroeconomic policy

#### *A supportive policy stance*

In 2003, macroeconomic policy throughout most of the CIS was generally supportive of economic growth. Thus, a moderate relaxation in the stance of both fiscal and monetary policies in a number of these economies provided a further stimulus to the generally favourable domestic and external conditions.

The progress in systemic and structural reforms in the more advanced CIS economies has allowed greater flexibility in macroeconomic policy. In addition, the fiscal consolidation undertaken in a number of CIS countries in recent years, as well as the general progress towards macroeconomic stability, have increased the

room for policy manoeuvre in these economies. In these cases, the minor relaxation of the policy stance in 2003 did not have any undesirable side effects on macroeconomic equilibrium.

At the same time, the margins for policy activism are still relatively limited in a number of CIS countries, as most of the economies in the region are still rather fragile and susceptible to external shocks. Some CIS economies still have serious problems with high levels of foreign indebtedness, which impose caution in the conduct of macroeconomic policy.<sup>187</sup> Policy makers in the region thus need to maintain (and in some cases strengthen) a prudent stance of policy if they are to keep their economies on course towards greater stability and growth.

#### *Government financial balances are in relatively good shape*

In recent years fiscal policies in most CIS economies have been dominated by the drive to correct large deficits. As a result, general government deficits in the CIS region are, on average, considerably lower than those in eastern Europe. The strong recovery in activity – which has been underway for several years – has also helped improve the public finances throughout the region.

The tentative estimates of the fiscal balances in the CIS in 2003 (table 4.1.1 and chart 4.1.1) suggest that in the main there was no substantial further tightening of fiscal policy.<sup>188</sup> The fiscal deficits increased in some countries such as Armenia and Tajikistan due to a surge in public spending. Moreover, given the cyclical upswing in 2003, the cash deficits reported in table 4.1.1 may not reflect the actual changes in the underlying structural balances of the CIS economies; in some of them the structural fiscal position may have actually worsened despite an improvement in the cash balance in 2003.

<sup>187</sup> The risks that the authorities in some CIS countries are facing in the conduct of macroeconomic policy can be illustrated by the problems experienced by Georgia in 2003. Excessive public borrowing abroad and debt mismanagement led to severe foreign debt servicing problems and by mid-year it was technically in default on its foreign debt, having failed to meet its scheduled debt service payments. The financing problems were compounded in September by the suspension of IMF funding under the Poverty Reduction and Growth Facility, an action that was prompted by the failure of the Georgian authorities to take early preventive measures on the debt problem.

<sup>188</sup> As noted earlier, Georgia is an exception to this pattern as the burden of foreign debt servicing forced the authorities to introduce considerable cuts in public spending in 2003.

TABLE 4.1.1

Consolidated general government deficit (-) / surplus (+) in the CIS,  
1999-2004  
(Per cent of GDP)

	1999	2000	2001	2002	2003 <sup>a</sup>	2004 target
Armenia .....	-7.4	-6.3	-3.8	-2.4	-3.2	-2.3
Azerbaijan .....	-5.1	-1.3	1.2	-0.4	-0.4 <sup>b</sup>	-0.8 <sup>b</sup>
Belarus .....	-2.0	-0.2	-1.9	-1.8	-1.0	-1.5
Georgia .....	-6.7	-4.7	-2.0	-2.2	-1.3	-1.3
Kazakhstan .....	-5.0	-0.8	2.7	1.4	4.0	2.0
Kyrgyzstan .....	-12.0	-9.9	-5.5	-6.3	-4.6	-4.3
Republic of Moldova .....	-5.3	-2.8	-0.5	-2.9	-2.1	1.0 <sup>b</sup>
Russian Federation .....	-1.6 <sup>c</sup>	2.7 <sup>c</sup>	3.0 <sup>c</sup>	0.6 <sup>c</sup>	1.7 <sup>d</sup>	0.6 <sup>d</sup>
Tajikistan .....	-3.1	-0.6	-3.2	-2.8	-3.7	-0.5
Turkmenistan .....	..	..	-1.1 <sup>b</sup>	-0.5 <sup>b</sup>	-0.7 <sup>b</sup>	.. <sup>b</sup>
Ukraine .....	-2.3	-1.1	-0.9	0.5	0.4	-1.2 <sup>b</sup>
Uzbekistan .....	-2.2	..	-1.3	-3.0	-2.0 <sup>b</sup>	-1.0 <sup>b</sup>

*Source:* UNECE secretariat estimates and calculations, based on direct communications from national ministries of finance and IMF country studies (Washington, D.C.).

*Note:* The consolidated general government deficit, or financing requirement, is reported in accordance with the IMF GFS method. National reporting practices may, in some cases, differ from this methodology. Deficits projected at the start of 2004 are official budget deficits, forecast in the initial budget proposals, necessarily involving GDP and inflation projections as well as fiscal data. The definitions of the projected deficits as well as some of the preliminary estimates of the deficits in 2003 may differ from the above definition.

<sup>a</sup> Preliminary estimates.

<sup>b</sup> Central government deficit/surplus.

<sup>c</sup> Consolidated central government (including social security and extrabudgetary funds) plus (without consolidation) regional and local government.

<sup>d</sup> Federal government.

Where government financial balances did improve in 2003, this was mainly a by-product of positive cyclical effects as solid output growth boosted public revenue. In addition, governments in commodity exporting countries, where taxes on commodity exports are price sensitive, benefited from the increase in world market prices. Thus, in Kazakhstan and Russia, increased general government surpluses were largely due to larger than projected oil-related revenue.

The significant revenue flows associated with fuel exports have prompted the governments in several oil exporting CIS countries (Azerbaijan, Kazakhstan and Russia) to establish “stabilization funds” to serve as buffers against the vulnerability of the public finances (and of the economy in general) to rapid changes in world market prices and hence of government revenues.<sup>189</sup> In boom

<sup>189</sup> The State Oil Fund of Azerbaijan (SOFAZ) was established in 1999 with the main task of accumulating and managing efficiently energy-related windfalls, thereby reducing the related risks for the economy. The National Oil Fund of Kazakhstan was created in 2000 with a similar objective. In 2003, after long and difficult policy debates, a Stabilization Fund was finally established in Russia and is due to become operational in 2004. While the oil funds in Azerbaijan and Kazakhstan have broader, economy-wide functions, the central objective of Russia’s Stabilization Fund (which will also accumulate oil related windfalls) in its present form is to guarantee the stability of the public finances.

years, these funds will receive revenue windfalls generated by higher than average world market prices, at the same time insulating the economy from the related inflationary pressure; in bust years, the previously accumulated funds can be used to cushion the economy from the effects of abrupt falls in revenue. Apart from their short-run stabilization role, such funds may also serve as medium-term policy instruments to counter, for example, long-run pressures arising from the “Dutch Disease”, or to support the diversification of economic activities.

Despite a certain relaxation in some countries, government financial balances in most CIS countries remained in relatively good shape in 2003. With the possible exception of Kyrgyzstan, fiscal balances do not seem at present to be a source of major policy concern.<sup>190</sup> Moreover, most countries with relatively large deficits (such as Armenia, Kyrgyzstan, the Republic of Moldova, Tajikistan and Uzbekistan) envisage their further reduction in 2004 (table 4.1.1).

The available data on public debt in the CIS (table 4.1.2) are rather scarce and, with the exception of Kyrgyzstan, exclude some of the countries which are known to have had problems in the servicing of their foreign debt.<sup>191</sup> But even in the more heavily-indebted countries, the policies aimed at fiscal consolidation, coupled with the strong output recovery in recent years, appear to have contributed to an easing of the burden of debt service.

### A moderate monetary relaxation

Progress in macroeconomic stabilization and the general lowering of inflationary expectations in the region allowed the central banks in a number of CIS countries to relax their monetary policies in 2003.<sup>192</sup> In Russia, where there was a very large capital inflow in 2003 (mostly due to the windfall revenue gains of oil exporters), the significant monetary relaxation was mainly prompted by concerns about an excessive real appreciation of the rouble.<sup>193</sup> In some cases (Azerbaijan and Ukraine) the central

<sup>190</sup> In Kyrgyzstan, expansionary policies in the 1990s (associated with an ambitious public investment programme) generated large and persistent fiscal deficits and led to the accumulation of a large public debt (table 4.1.2). More recently, large tax arrears have added to the country’s fiscal problems. But since 2000, public investment has been scaled down and there has been a gradual reduction in the public sector deficit (table 4.1.1).

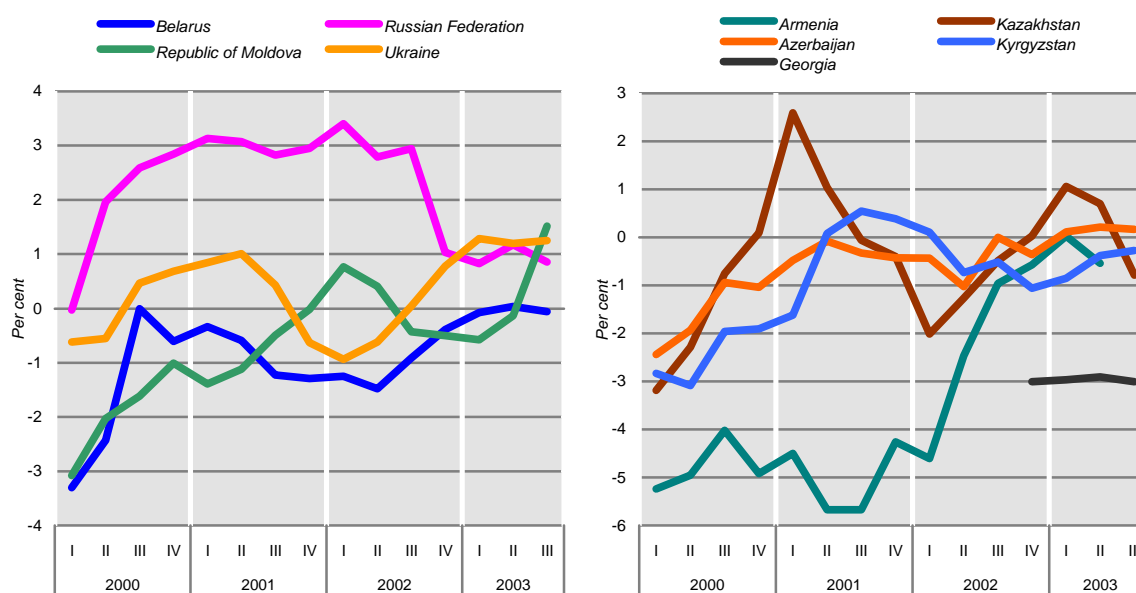
<sup>191</sup> Armenia, Georgia, Kyrgyzstan, the Republic of Moldova and Tajikistan have all at one time or another had problems in servicing their foreign debt, most of which is public debt.

<sup>192</sup> Thus in 2003, the 60-day refinancing rate (which is the key central bank intervention rate in most CIS economies) was lowered in Armenia from 13.5 to 9 per cent, in Belarus from 38 to 28 per cent, in Kazakhstan from 7.5 to 7 per cent, in Russia from 21 to 16 per cent (and in January 2004 to 14 per cent) and in Tajikistan from 24.8 to 8.2 per cent.

<sup>193</sup> Throughout the year, the Bank of Russia conducted massive unsterilized intervention in the foreign exchange market. As a result, the central bank’s foreign exchange reserves increased from \$47.8 billion at the beginning of January 2003 to \$77.8 billion at the end of December. At the same time the stock of broad money grew by some 40 per cent (year-on-year). While the acceleration of money supply growth contributed to the ongoing remonetization of the economy (table 4.1.4), it also fuelled inflationary pressure.

CHART 4.1.1

Fiscal deficits <sup>a</sup> in selected CIS economies, 2000-2003  
(Per cent of GDP)



**Source:** UNECE secretariat calculations, based on the data from national ministries of finance, central banks and national statistical offices; IMF, *International Financial Statistics* (Washington, D.C.), various issues; TACIS publications; EIU country reports.

**Note:** The data presented in the chart are based on current (monthly) reporting of the fiscal deficit. Both the coverage and the methodology of the current reporting may differ from the annual data in table 3.1.3 even when both refer to the same level of reporting. Due to this the deficit levels presented in table 4.1.1 and chart 4.1.2 may differ for some countries. Definition of public deficit/surplus: consolidated general government deficit/surplus – Armenia, Azerbaijan, Kazakhstan, Republic of Moldova, the Russian Federation and Uzbekistan; central government deficit/surplus – Belarus (including social security and extrabudgetary funds), Kyrgyzstan and Ukraine.

<sup>a</sup> The quarterly deficits in the chart are 12-month moving averages.

TABLE 4.1.2

Public debt in selected CIS economies, 2000-2003  
(End of period values, per cent of GDP)

	Total public debt						Of which: foreign public debt					
	2000	2001	2002	2003			2000	2001	2002	2003		
				Mar.	Jun.	Sept.				Mar.	Jun.	Sept.
Armenia .....	..	..	..	..	..	..	35.6	33.7	..	34.3	..	..
Azerbaijan .....	..	..	..	..	..	..	22.5	..	..	..	..	..
Belarus <sup>a</sup> .....	15.0	..	13.1	12.7	10.8	10.6	10.5	..	6.1	5.7	5.3	4.8
Kazakhstan <sup>b</sup> .....	25.5	20.4	17.8	16.6	15.7	16.0	18.3	15.1	12.2	11.4	10.7	10.6
Kyrgyzstan .....	112.4	100.4	103.2	..	..	..	102.4	91.4	92.9	..	..	..
Republic of Moldova .....	73.2	60.7	56.9	57.8	55.3	49.7	60.5	48.1	44.4	45.5	43.6	38.4
Russian Federation .....	63.3	50.3	43.1	40.2	36.1	34.4	55.7	44.4	36.8	34.1	30.3	28.1
Ukraine .....	..	31.0	29.2	27.3	28.0	26.8	..	20.7	19.5	18.0	19.2	18.3

**Source:** UNECE secretariat calculations, based on data from national ministries of finance, central banks and national statistical offices; IMF, *International Financial Statistics* (Washington, D.C.), various issues; TACIS publications.

**Note:** Definition of public debt: central government debt for Belarus, Kyrgyzstan and the Russian Federation; consolidated general government debt for Armenia, Azerbaijan, Kazakhstan, Republic of Moldova and Ukraine.

<sup>a</sup> Consolidated central government (including social security and extrabudgetary funds).

<sup>b</sup> Including government guaranteed debt.

banks kept their intervention rates unchanged (at 7 per cent in both cases). The Republic of Moldova was among the few CIS economies where monetary policy was tightened somewhat in 2003.<sup>194</sup> This was mostly a

response to a resurgence of inflation but it also sought to prevent a further escalation of the current account deficit in view of the precarious state of the country's external finances.<sup>195</sup> Uzbekistan does not publish a comprehensive

<sup>194</sup> The central bank increased its 60-day refinancing rate from 9.4 to 11 per cent and the mandatory reserves for commercial banks from 10 to 12 per cent.

<sup>195</sup> In July, the IMF suspended its operations under the Poverty Reduction and Growth Facility in the Republic of Moldova due to the

TABLE 4.1.3  
Short-term interest rates in selected CIS economies, 2001-2003  
(Per cent per annum)

	Short-term credits						Short-term deposits						Average yield on short-term government securities		
	Nominal			Real			Nominal			Real			2001	2002	2003 <sup>a</sup>
	2001	2002	2003 <sup>a</sup>	2001	2002	2003 <sup>a</sup>	2001	2002	2003 <sup>a</sup>	2001	2002	2003 <sup>a</sup>			
Armenia .....	26.7	21.1	20.7	27.2	18.2	18.2	14.9	9.6	7.1	11.4	8.4	3.2	19.9	14.7	12.6
Azerbaijan .....	19.7	17.4	15.5	17.6	15.1	13.3	8.6	8.7	9.8	7.0	5.7	7.8	16.4	14.4	8.2
Belarus .....	47.0	37.3	25.7	-14.5	-2.2	-10.3	34.2	27.2	19.1	-16.7	-10.8	-7.7	61.3 <sup>b</sup>	47.5 <sup>b</sup>	34.0 <sup>b</sup>
Georgia .....	27.3	31.8	32.9	22.8	24.4	30.3	7.8	9.8	8.7	2.9	4.0	4.3	..	..	..
Kazakhstan .....	17.6	15.8	..	10.9	11.3	..	14.7	11.4	..	5.8	5.2	..	13.7 <sup>b</sup>	8.1 <sup>b</sup>	7.3 <sup>b</sup>
Kyrgyzstan .....	40.5	36.2	24.6	28.8	29.4	16.7	13.7	7.9	5.6	6.4	5.7	3.2	19.0	10.2	8.0
Republic of Moldova .....	28.7	23.5	19.3	14.6	18.0	10.3	20.9	14.2	12.1	10.3	8.6	1.9	14.2	5.9	13.9
Russian Federation .....	17.9	15.7	13.2	6.5	-1.2	-3.0	4.9	5.0	4.5	-11.6	-8.8	-8.3	13.1	12.7	5.6
Tajikistan .....	21.3	14.2	16.6	-4.3	4.5	0.9	3.7	9.2	9.1	-24.0	-0.9	-6.4	20.2 <sup>b</sup>	22.6 <sup>b</sup>	22.8 <sup>b</sup>
Ukraine .....	32.3	25.4	17.9	21.7	21.7	10.0	11.0	7.9	6.8	-0.9	7.1	2.3	19.5 <sup>b</sup>	9.5 <sup>b</sup>	7.0 <sup>b</sup>

*Source:* National statistics and direct communications from national statistical offices to the UNECE secretariat; IMF, *International Financial Statistics* (Washington, D.C.), various issues.

*Note:* Definition of interest rates:

*Credits* – Armenia: weighted average rate charged by commercial banks on new loans in domestic currency with maturities of 15 days to less than a year; Azerbaijan: weighted average rate charged by commercial banks on 12-month loans in national currency; Belarus: weighted average rate on short-term loans; Georgia: weighted average rate charged by commercial banks on three-month loans in national currency; Kazakhstan: weighted average interest rates for new credits; Kyrgyzstan: weighted average rate on loans in sums for one- to three-month maturities; Russian Federation: weighted average rate on loans of up to one-year maturity; Tajikistan: prior to January 2002, data (end-of-period) refer to weighted average rate on commercial bank loans of all types and maturities in national currency to non-bank sectors. The rate is weighted by the outstanding amount of loans. Beginning in January 2002, data (period average) refer to weighted average rate charged by commercial banks on loans of all types and maturities in national currency to non-bank sectors; Ukraine: weighted average rate on short-term loans. The real lending rates are the nominal rates discounted by the average rate of increase in the PPI for the corresponding period.

*Deposits* – Armenia: weighted average rate charged by commercial banks on new deposits in domestic currency with maturities of 15 days to less than a year; Azerbaijan: weighted average rate offered by commercial banks on 12-month deposits in national currency; Belarus: weighted average rate on short-term deposits; Georgia: weighted average rate offered by commercial banks on three-month deposits in national currency; Kazakhstan: weighted average interest rate (for new deposits); Kyrgyzstan: weighted average rate offered on time deposits of three-month maturities; Russian Federation: prevailing rate for time deposits with maturity of less than one year; Tajikistan: prior to January 2002, data (end-of-period) refer to weighted average rate charged by commercial banks on demand deposits and time deposits of all maturities in national currency. The rate is weighted by the outstanding amount of deposits. Beginning in January, 2002 data (period average) refer to weighted average rate offered by commercial banks on time and savings deposits of various maturities in national currency; Ukraine: weighted average rate on short-term deposits. The real deposit rates are the nominal rates discounted by the average rate of increase in the CPI for the corresponding period.

*Yields of government securities* – Kyrgyzstan: weighted average rate on three-month treasury bills sold in the primary market; Russian Federation: weighted average rate on government short-term obligations (GKO) with remaining maturity of up to 90 days.

<sup>a</sup> January-September.

<sup>b</sup> Central bank 60 day refinancing rate.

monetary survey but, according to anecdotal evidence, monetary policy was also rather tight in 2003, in preparation for the introduction of currency convertibility in October.<sup>196</sup>

Despite the general trend towards monetary loosening in 2003, real interest rates on bank credit remained relatively high in most CIS countries; however, this mostly reflected the high business risk premia still charged by local banks (table 4.1.3). Belarus and, partly, Russia are exceptions to this pattern but for different reasons. The banking system in Belarus is still largely unreformed and the authorities have continued to intervene directly in its day-to-day operations. The steady flows of directed soft credit to local enterprises at negative real interest rates – allocated under political pressure – are effectively implicit subsidies to these

firms, that is, they represent quasi-fiscal activities implemented through the banking system.<sup>197</sup> The result is a very weak banking system and persistent inflationary pressure generated by the excessive money creation.<sup>198</sup> In Russia, the negative real interest rates on bank credit in 2002 and 2003 reflected the substantial loosening of monetary policy in these years when the main preoccupation of the monetary authorities, as already noted, was to prevent an excessive real appreciation of the rouble even at the expense of higher rates of inflation.

In general, the banking reforms in most CIS economies have not made much progress compared with that in eastern Europe and financial intermediation through the banking systems still plays a relatively

considerable delays in implementing the structural reforms that are part of the funding programme.

<sup>196</sup> Economist Intelligence Unit (EIU), *Country Report. Uzbekistan* (London), December 2003, p. 11. Reportedly, the monetary tightening resulted in cash shortages throughout the economy.

<sup>197</sup> In turn, part of the cost is passed on to depositors who incur systematic losses due to the negative real deposit rates.

<sup>198</sup> Thus, according to the policy guidelines for 2003 adopted jointly by the Belarusian government and the National Bank of Belarus, money supply in 2003 was supposed to increase by between 28 and 35 per cent. The actual increase, however, was 59 per cent [www.nbrb.by/statistics/monsurvey/monsurvey.asp].

TABLE 4.1.4  
Monetization<sup>a</sup> in selected CIS economies, 2000-2003  
(Per cent of GDP)

	<i>M1</i> <sup>b</sup>				<i>Total broad money</i> <sup>c</sup>				<i>Total credit</i> <sup>d</sup>			
	2000	2001	2002	2003 <sup>e</sup>	2000	2001	2002	2003 <sup>e</sup>	2000	2001	2002	2003 <sup>e</sup>
Armenia .....	5.2	5.7	5.9	6.4	11.9	13.2	12.2	12.4	9.9	8.5	6.7	5.6
Azerbaijan .....	5.9	5.5	5.6	4.1	11.0	10.3	11.2	8.9	8.0	7.2	6.4	7.7
Belarus .....	4.0	3.9	4.1	4.6	11.6	12.0	12.5	13.7	5.7	6.7	7.1	8.6
Georgia .....	4.9	5.5	5.5	5.5	8.6	10.0	10.6	11.2	7.8	8.0	9.1	9.9
Kazakhstan .....	8.0	7.8	7.4	8.7	12.4	14.4	16.0	18.0	9.2	13.1	15.8	17.9
Kyrgyzstan .....	6.5	6.5	8.6	10.4	10.7	10.0	12.5	14.7	3.9	3.7	3.8	4.1
Republic of Moldova .....	10.4	11.2	12.7	13.7	18.7	21.5	24.9	27.8	12.1	13.9	15.8	18.1
Russian Federation .....	9.1	11.0	11.4	12.4	17.3	20.2	21.9	24.0	10.0	13.2	16.0	17.4
Tajikistan .....	3.2	2.3	1.7	3.9	6.2	4.5	4.6	7.0	11.8	19.4	18.6	18.0
Ukraine .....	9.9	11.7	15.1	16.8	15.4	17.9	23.9	29.2	10.0	12.5	14.6	19.3

*Source:* National statistics and direct communications from national statistical offices to the UNECE secretariat; IMF, *International Financial Statistics* (Washington, D.C.), various issues.

<sup>a</sup> Averages of monthly or quarterly figures.

<sup>b</sup> Currency in circulation plus demand deposits.

<sup>c</sup> M1 plus time deposits in domestic currency and foreign currency deposits.

<sup>d</sup> Total outstanding claims on firms and households (except claims on government).

<sup>e</sup> January-September.

limited role in these countries. The level of monetization is also still relatively low (table 4.1.4). Obviously, this is one of the policy areas where an acceleration of the reform process could bring significant and tangible economic benefits to the population at large. As shown by the experience of some east European countries, bank credit can operate as an important engine for the revitalization and modernization of the transforming economies.

#### *Exchange rates squeezed between the dollar and the rouble*

The exchange rate regimes in most CIS economies fall into the category of “managed float”, with the dollar serving as the target currency.<sup>199</sup> In 2003, exchange rates in the CIS outside Russia were under the joint influence of two countervailing developments: the depreciation of the dollar (the target currency) against all major international currencies and the appreciation of the Russian rouble (Russia being an important trading partner for all the other CIS countries).<sup>200</sup> As a result, the prevailing trend in most of these economies in 2003 was towards a depreciation of the price-based real effective exchange rates (chart 4.1.2). In cases where there was

some appreciation in these rates, it was caused by various country-specific developments.<sup>201</sup>

The oil-related funds established by some of the fuel exporting CIS economies, mostly intended to stabilize the public finances, also played a role in stabilizing exchange rates. Thus, in Azerbaijan and, especially, in Kazakhstan, a large part of the revenue windfalls which are diverted to these funds do not enter the national money supply at all.<sup>202</sup> With the launch in 2004 of the newly created Stabilization Fund, the Russian authorities will also acquire an additional instrument to enable them to manage the exchange rate more efficiently.

The plan of Belarus and Russia to establish a single currency in 2005 is notionally still on course but numerous important policy issues (such as the issuing power of the two central banks after the unification) are still unresolved. The degree of macroeconomic stabilization (as evidenced by their prevailing inflation rates) and the progress in transformation reforms in the two economies also differ considerably. It therefore remains to be seen whether during the limited remaining time the two countries will be able to agree on a mutually acceptable and workable programme for the unification of the two currencies.<sup>203</sup>

<sup>199</sup> At present Turkmenistan is the only CIS country that applies strict currency controls. In October 2003, Uzbekistan (where currency controls had also been in place) announced the introduction of currency convertibility for current account transactions and the abolition of the system of multiple exchange rates. The unification of the exchange rate was achieved through a contraction in the money supply, which suppressed the demand for foreign exchange in the black market (causing an appreciation of the black market rate). EIU, *Country Report. Uzbekistan* (London), December 2003.

<sup>200</sup> The average annual nominal appreciation of the Russian rouble against the dollar in 2003 was some 2 per cent. The CPI-based real appreciation of the rouble against the dollar was some 14 per cent.

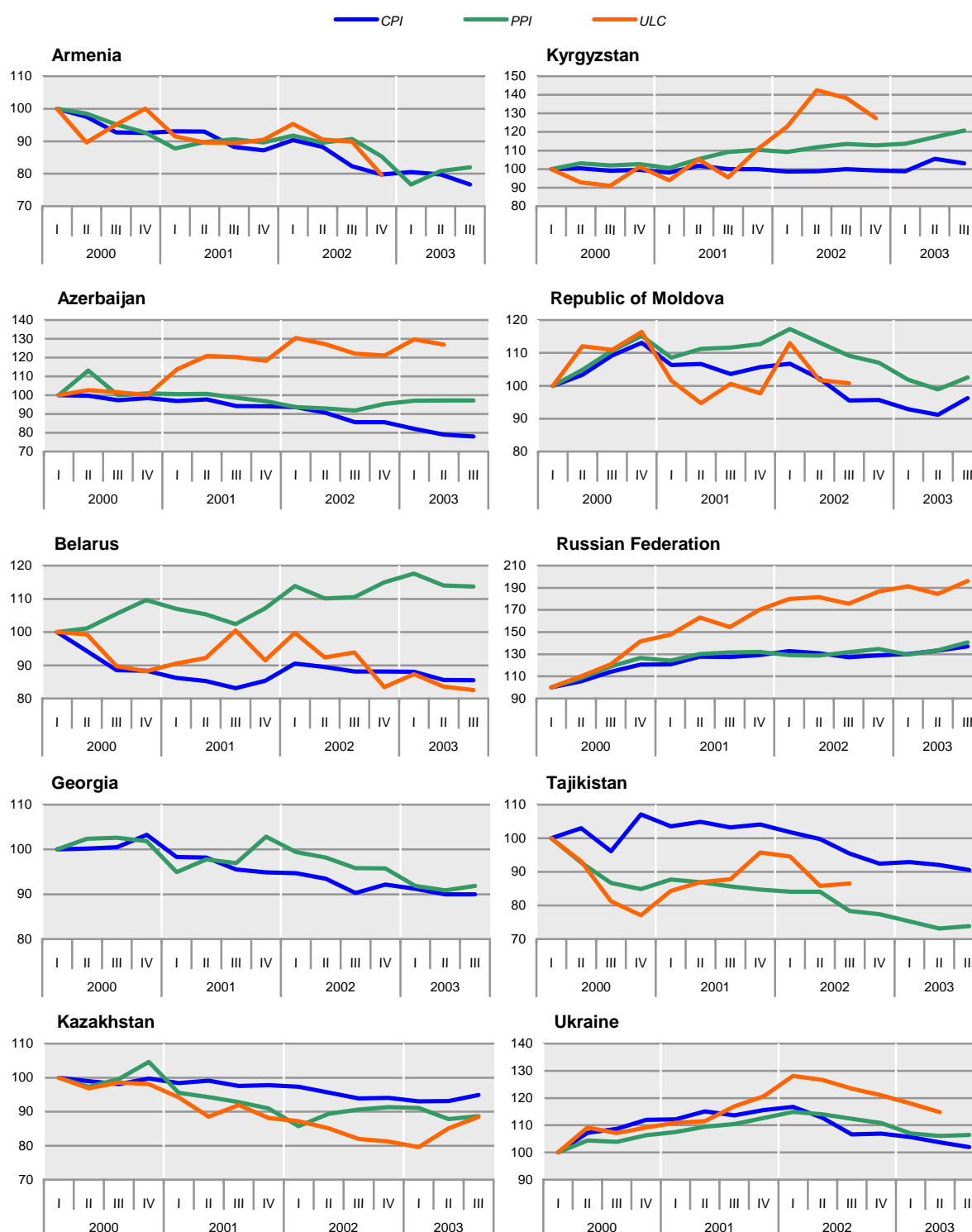
<sup>201</sup> Thus, in the Republic of Moldova the real appreciation in the second half of the year was triggered by the tightening of monetary policy. In Kyrgyzstan, the appreciation of the price-based real effective exchange rate reflected higher than expected inflation, particularly of producer prices.

<sup>202</sup> In addition, the central banks of these countries apply partial sterilization of the capital inflows in order to reduce the degree of monetary expansion associated with these inflows (or, at least, to have some control over this process).

<sup>203</sup> According to current plans, the exchange rate of the Belarusian rouble will be firmly fixed to the Russian rouble in the second half of 2004 in order to ensure a smooth transition to the currency changeover.

CHART 4.1.2

Real effective exchange rates in selected CIS economies, 2000-2003  
(Indices, first quarter 2000=100)



Source: National statistics; UNECE Common Database.

Note: The real effective exchange rates were computed from the nominal exchange rates against the euro and the dollar, deflated respectively by the domestic and European Union or United States consumer and producer price indices, and by indices of estimated unit labour costs in industry, while the shares of the EU and the rest of the world in total exports of individual transition economies were used to determine the euro and the dollar trade weights, respectively. An increase in the index denotes a real appreciation and vice versa.

## 4.2 Output and demand

GDP growth in the CIS picked up in 2003 to some 7.6 per cent, more than 2 percentage points higher than in 2002 and putting the region among the most dynamic in the world. It was broadly based on exports, consumption and investment. Aggregate labour productivity accelerated sharply in most CIS economies as rising production was accompanied by declining employment, the result of a restructuring process encouraged by hardening budget constraints.

The immediate causes of the acceleration in 2003 include high international energy prices, new or restored capacity in resource-based and manufacturing industries coming on-stream, and supportive macroeconomic policies. The principal underlying factor has been a gradual implementation of structural reforms in product and labour markets. Whereas the external environment remains favourable for further expansion, the still fragile nature of private property rights poses the principal threat to economic growth in the longer term.

### *Robust consumption, exports and investment*

The growth of real GDP and industrial output accelerated in 2003 in most CIS countries. Output growth decelerated somewhat in the third quarter of 2003 in the three largest CIS economies (Kazakhstan, Russia, Ukraine) and in some of the smaller ones (table 4.2.1). The deceleration partly reflects the relatively high base level of output in 2002 but there was also a slump in agricultural production due to bad weather in Russia and Ukraine. But year-on-year growth rates of real GDP and industrial production picked up again in the fourth quarter, and this boosted the outcomes for the year as a whole. Strong wage growth and increases in pensions above the rate of inflation led to a significant rise in household incomes and real consumer spending increased rapidly.

Quarterly national accounts for 2003 are available for only seven CIS economies. The provisional picture they show is that private consumption grew rapidly in all of them, while government consumption increased in six (table 4.2.2). The volume of retail sales grew rapidly in all CIS countries except Uzbekistan (table 4.2.3). The continued strong growth of incomes and consumption may have led to some fall in poverty rates throughout the CIS, poverty remaining one of the most acute social problems in the region (see chapter 7). Its incidence remains alarmingly high in Russia despite a decline in 2003.<sup>204</sup> It is possible that poverty has continued to diminish throughout the region as growth in the seven low-income countries appears to have been sustained and to

have exceeded the CIS average in four of them (Armenia, Azerbaijan, Georgia, Tajikistan).<sup>205</sup> Uzbekistan may be an exception as its growth rate has not only been the lowest in the CIS but may possibly be overestimated by the authorities.<sup>206</sup>

Exports of goods and services continued to rise in a number of CIS economies and made a large contribution to output growth everywhere except Kyrgyzstan (chart 4.2.1). This contribution of exports exceeded that of final consumption in Russia, Belarus, Armenia and perhaps the Republic of Moldova. The exports of Russia were driven by increased shipments of oil and natural gas. Large increases in exports of hydrocarbons were also important for the resource-based economies of Azerbaijan, Kazakhstan and Turkmenistan. Exports grew rapidly in Ukraine and contributed 5½ percentage points to output growth in the first three quarters of 2003, much the same as in Russia. The structure of exports from Ukraine, however, was mainly based on manufactured goods rather than hydrocarbons, although over one half of its exports are highly energy intensive (see section 4.5).

Capital spending on fixed assets accelerated last year in a number of CIS countries while remaining strong in most (table 4.2.4). In Russia, real investment on a seasonally adjusted basis has increased uninterruptedly since April 2003, driven by the improved profitability of export-oriented businesses, especially in the fuels sector.<sup>207</sup> A very large increase of investment spending in Azerbaijan is related to the construction of new oil and gas export pipelines. Capital formation in the non-energy sector has also started to recover. Fixed investment was typically one of the important sources of growth throughout the CIS region.

The strong growth of exports and domestic demand meant that imports of goods and services also increased rapidly and, in contrast to 2002, the contribution of real net exports to overall economic growth turned negative in a number of CIS economies including Russia and Ukraine (chart 4.2.1). Among the seven CIS economies with quarterly national accounts, Kazakhstan remained the only one with a positive, albeit declining, net export contribution to GDP growth.

<sup>204</sup> According to the authorities, the number of Russians living below the official poverty line fell from 33 million at the beginning of 2003 to 29 million at the year's end. *Interfax Investment Report*, 9 January 2004, reported in Dow Jones Reuters Business Interactive (Factiva).

<sup>205</sup> Low-income CIS countries, listed in table 4.2.1, are those with per capita GDP levels, expressed in dollars adjusted for purchasing power parity, below \$4,000 per annum. UNECE calculations indicate that the per capita GDP values ranged in 2002 from \$1,356 in Tajikistan to \$3,677 in Georgia.

<sup>206</sup> The World Bank resident office in Uzbekistan has estimated that GDP grew by only 1 per cent in the first 3 quarters of 2003 (over the corresponding period of 2002). *Interfax Central Asia News Report*, 7 November 2003, reported in Dow Jones Reuters Business Interactive (Factiva). The World Bank estimate is in line with the official data on retail sales shown in table 4.2.3.

<sup>207</sup> Central Bank of the Russian Federation, *Social and Economic Situation in January-September 2003* ([www.cbr.ru/eng/analytics](http://www.cbr.ru/eng/analytics)).

TABLE 4.2.1

**GDP and industrial output in CIS economies, 2002-2003**  
(Percentage change over the same period of the preceding year)

	GDP								Industrial output							
	2002		2003		2002		2003		2002		2003		2002		2003	
	2002	2003 <sup>a</sup>	QIII	QIV	QI	QII	QIII	QIV	2002	2003 <sup>a</sup>	QIII	QIV	QI	QII	QIII	QIV
<b>CIS</b> .....	5.2	7.6	5.3	5.1	7.0	7.6	6.6	8.5	4.8	8.3	6.1	4.6	7.0	8.4	8.6	9.0
Armenia .....	12.9	13.0	11.5	17.4	11.4	16.9	15.6	10.0	14.2	17.0	9.0	23.7	10.6	26.1	24.0	7.7
Azerbaijan .....	10.6	11.2	12.6	12.9	7.9	12.2	11.3	13.2	3.6	6.1	4.7	5.6	5.9	6.5	5.1	6.9
Belarus .....	5.0	6.8	4.7	5.5	5.6	4.7	7.3	8.9	4.5	6.8	4.0	6.3	6.5	5.6	6.3	7.4
Georgia .....	5.5	8.6	7.1	8.7	6.3	11.0	7.5	8.5	4.9	10.6	8.0	11.4	2.8	14.8	13.1	11.4
Kazakhstan .....	9.9	9.1	9.5	11.5	10.5	9.6	7.8	9.0	10.5	8.8	10.6	10.8	10.4	8.8	4.4	11.3
Kyrgyzstan .....	-	6.7	0.3	4.8	5.2	-0.1	7.9	11.6	-10.9	17.0	-22.5	-1.5	7.5	-3.5	32.0	23.9
Republic of Moldova .....	7.8	6.3	5.3	12.3	5.4	7.3	5.9	8.4	10.8	16.0	13.0	9.1	12.8	22.6	21.1	10.4
Russian Federation .....	4.7	7.3	4.6	5.2	6.8	7.2	6.2	8.0	3.7	7.0	5.5	2.6	6.1	7.5	6.9	7.4
Tajikistan .....	9.5	10.2	10.1	9.7	12.1	5.2	6.6	16.8	8.2	10.2	2.6	9.6	14.1	9.2	1.8	15.8
Turkmenistan .....	19.8	17.0	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine .....	5.2	8.5	6.8	-3.0	7.9	9.3	6.6	10.3	7.0	15.8	6.8	9.2	10.7	14.0	20.5	17.4
Uzbekistan .....	4.2	5.0	0.7	7.8	2.2	5.4	4.4	5.9	8.5	6.0	17.6	8.6	4.0	7.0	6.9	6.0
<i>Memorandum items:</i>																
<b>CIS without Russian</b>																
<b>Federation</b> .....	6.5	8.2	6.7	4.7	7.5	8.3	7.3	9.5	7.3	11.3	7.4	9.0	9.2	10.4	12.3	12.6
<b>Low-income CIS countries</b> ....	6.2	7.6	5.0	9.6	5.2	7.9	7.5	9.1	5.2	9.3	6.6	8.1	6.5	9.2	11.2	9.5

*Source:* National statistics; CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat.

*Note:* Aggregates shown are: CIS (the 12 member countries of the Commonwealth of Independent States) and low-income CIS countries (Armenia, Azerbaijan, Georgia, Kyrgyzstan, Republic of Moldova, Tajikistan and Uzbekistan).

<sup>a</sup> Preliminary results.

TABLE 4.2.2

**Components of real demand in selected CIS economies, 2001-2003**  
(Percentage change over the same period of the preceding year)

	Private consumption expenditure <sup>a</sup>			Government consumption expenditure <sup>b</sup>			Gross fixed capital formation			Exports of goods and services			Imports of goods and services		
	2002		2003	2002		2003	2002		2003	2002		2003	2002		2003
	2001	2002	QI-QIII	2001	2002	QI-QIII	2001	2002	QI-QIII	2001	2002	QI-QIII	2001	2002	QI-QIII
Armenia .....	7.5	9.1	9.7	4.3	3.2	19.9	5.3	22.2	42.4	27.0	34.9	35.5	6.4	18.8	34.9
Azerbaijan .....	9.8	..	..	5.3	..	..	20.6	..	..	34.1	..	..	48.0	..	..
Belarus .....	17.3	10.9	7.9	3.3	0.4	0.4	-2.3	6.6	16.8	10.5	10.1	..	12.4	9.1	..
Kazakhstan .....	6.5	12.6	6.9	19.2	-4.3	12.3	25.2	10.2	10.4	-1.9	21.8	4.5	-1.7	2.1	-6.9
Kyrgyzstan .....	2.2	9.4	7.6	-1.3	-4.0	-0.1	-1.9	-0.4	3.9	-3.2	7.9	-2.5	-13.8	21.2	3.5
Republic of Moldova .....	6.1	6.3	12.4	-6.2	30.3	4.3	17.3	5.7	20.9	17.2	19.0	25.5	10.6	15.7	28.8
Russian Federation .....	9.9	8.7	7.3	-0.8	2.6	2.1	12.3	3.0	11.8	4.2	9.9	12.5	19.8	14.5	21.1
Ukraine .....	8.9	4.9	13.8	10.4	2.5	13.1	6.2	6.3	17.9	3.5	9.1	9.5	6.0	3.6	16.5

*Source:* National statistics and CIS Statistical Committee data.

<sup>a</sup> Expenditures incurred by households and non-profit institutions serving households.

<sup>b</sup> Expenditures incurred by the general government on both individual consumption of goods and services and collective consumption of services.

### Supply-side developments and issues

On the basis of the available data, labour productivity in Russia surged by about 8 per cent in 2003, a result of strong output growth and falling employment.<sup>208</sup> A similar pattern of productivity growth in industry reflects the acceleration of economic

restructuring induced by market-oriented reforms in recent years. The same development appears to have taken place in most of the other CIS economies, where employment has either declined or stagnated in a context of rapid economic growth, implying some degree of overemployment. Kazakhstan was the major exception in 2003, being the only CIS economy with job-rich growth. Nonetheless, aggregate labour productivity still increased by 5 per cent.

Despite a significant improvement in industry and strong growth in the construction sector, market services continued to make the biggest contribution to GDP

<sup>208</sup> The Russian Goskomstat published revised annual national accounts in early January 2004, increasing the real GDP growth rates for 2001 and 2002. This revision brings the national accounts aggregates more into conformity with the standard SNA methodology. Compatible quarterly data are to be released in March 2004.



TABLE 4.2.3

Volume of retail trade in CIS economies, 2001-2003  
(Percentage change over the same period of the preceding year)

	2001	2002	2003 <sup>a</sup>
Armenia .....	15.5	15.6	14.4
Azerbaijan .....	9.9	9.6	10.9
Belarus .....	28.2	12.9	9.9
Georgia .....	7.3	3.7	8.7
Kazakhstan .....	15.7	8.2	10.0
Kyrgyzstan .....	6.2	8.2	13.5
Republic of Moldova .....	14.8	22.3	8.4
Russian Federation .....	10.7	9.2	8.0
Tajikistan .....	1.6	17.5	24.5
Turkmenistan .....	32.0	40.0	27.0
Ukraine .....	11.6	16.6	19.5
Uzbekistan .....	9.6	1.7	0.3

*Source:* National statistics, CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat.

*Note:* Retail trade covers mainly goods in Kazakhstan and the Russian Federation; it comprises goods and catering in other CIS countries. The coverage in 2003, based on current monthly statistics, may differ from the coverage of annual statistics.

<sup>a</sup> January-May for Turkmenistan; January-June for Uzbekistan; January-September for the Republic of Moldova; January-November for Armenia and the Russian Federation; January-December for Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan and Ukraine.

growth in Russia in the first three quarters of 2003 (chart 4.2.2). The performance of the market services sector reflects the sustained growth of private and foreign direct investment.<sup>209</sup> The available statistics show that the services sector also made the largest contribution to GDP growth in other CIS economies. Both industry and market services (trade and transport) contributed strongly to GDP growth in Ukraine.<sup>210</sup> Industry was a major source of growth in Belarus, Kazakhstan and particularly in Kyrgyzstan where the previous year's disruptions in mining and hydroelectric generation were reversed in 2003 (table 4.2.1).<sup>211</sup> In Georgia, market services and industry contributed some 4 and 1.5 percentage points, respectively, to GDP growth in 2003. The contribution of agriculture to GDP was close to 2 percentage points. In contrast, the contribution of agriculture was negative in the European CIS economies that were affected by the exceptionally dry weather in the summer.

In Russia, the fuels sector has continued to be the most dynamic part of industry, followed by ferrous metallurgy and the engineering sector, the latter including the armaments industry.<sup>212</sup> In contrast, the output of light

industry has continued to decline since November 2002 as domestic suppliers have struggled with strong competition from abroad. The growth of manufacturing exceeded the average for industry in all the CIS countries that regularly publish detailed industrial data,<sup>213</sup> with Azerbaijan and Georgia showing the largest increases. Mining output picked up strongly in Georgia, while the production in the utilities sector accelerated rapidly in Azerbaijan.

Unfinished industrial restructuring is still the major supply-side issue. Even in the relatively advanced Russian economy, the duality between the dynamic export-oriented sector and the rest of industry remains stark.<sup>214</sup> Official statistics indicate that payment arrears continue to diminish but loss makers still account for 43 per cent of Russian companies. The situation in Ukraine appears to be similar and it is probably worse in Belarus where about one half of all firms are losing money. The underdeveloped banking sector is unable to channel effectively private savings to those engaged in business investment. Bank credits account for only 5 per cent of investment in Russia where the proportions financed by retained earnings (55 per cent) and the federal government (20 per cent) are much more significant. In Belarus and Ukraine, bank credits to enterprises have grown rapidly but may have been misallocated. In the former, the banks are still directed by the state as to which enterprises to finance. In the latter, the rapid credit expansion may have dangerously increased the exposure of undercapitalized banks to the risk of loan default. The growth of bank credits to firms slowed somewhat in Kazakhstan where the central bank has acted to curb excessive risk lending.<sup>215</sup> The financing problems are even worse in the low-income CIS economies.<sup>216</sup>

Industrial restructuring is also hampered by comparatively low levels of foreign direct investment in the non-energy sector. The perceived instability of institutions and lack of effective protection from organized crime

of weapons in the world market in 2002, with deliveries growing rapidly from 1998. This implies that export-oriented defence firms have recovered gradually from the post-Cold War slump over the last five years. *SIPRI Yearbook 2003* (Stockholm), p. 440.

<sup>213</sup> Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, the Republic of Moldova, Russia and Ukraine.

<sup>214</sup> This divide can be observed in both the civilian and military parts of the key machine building and metalworking sector. According to the First Deputy Minister of Industry, Science and Technology, output growth in the defence sector exceeded the industrial average by about 1 percentage point in the first 9 months of 2003. However, a significant number of arms-producing enterprises have struggled with restructuring and 96 are effectively bankrupt. "Russia posts production rise in defence sector", *BBC Monitoring Former Soviet Union*, 6 November 2003, reported in Dow Jones Reuters Business Interactive (Factiva).

<sup>215</sup> The share of non-performing loans in Kazakhstan has stabilized at a relatively high level (one third of total loans). EBRD, *Transition Report 2003* (London), p. 157.

<sup>216</sup> G. De Nicoló, S. Geadah and D. Rozhkov, "Bridging the great divide. Poorly developed financial systems in the CIS-7 countries may jeopardize their sustained growth", *Finance and Development*, Vol. 40, No. 4, December 2003.

<sup>209</sup> Troika Dialog Research, *Russia Economic Monthly*, December 2003-January 2004, p. 18.

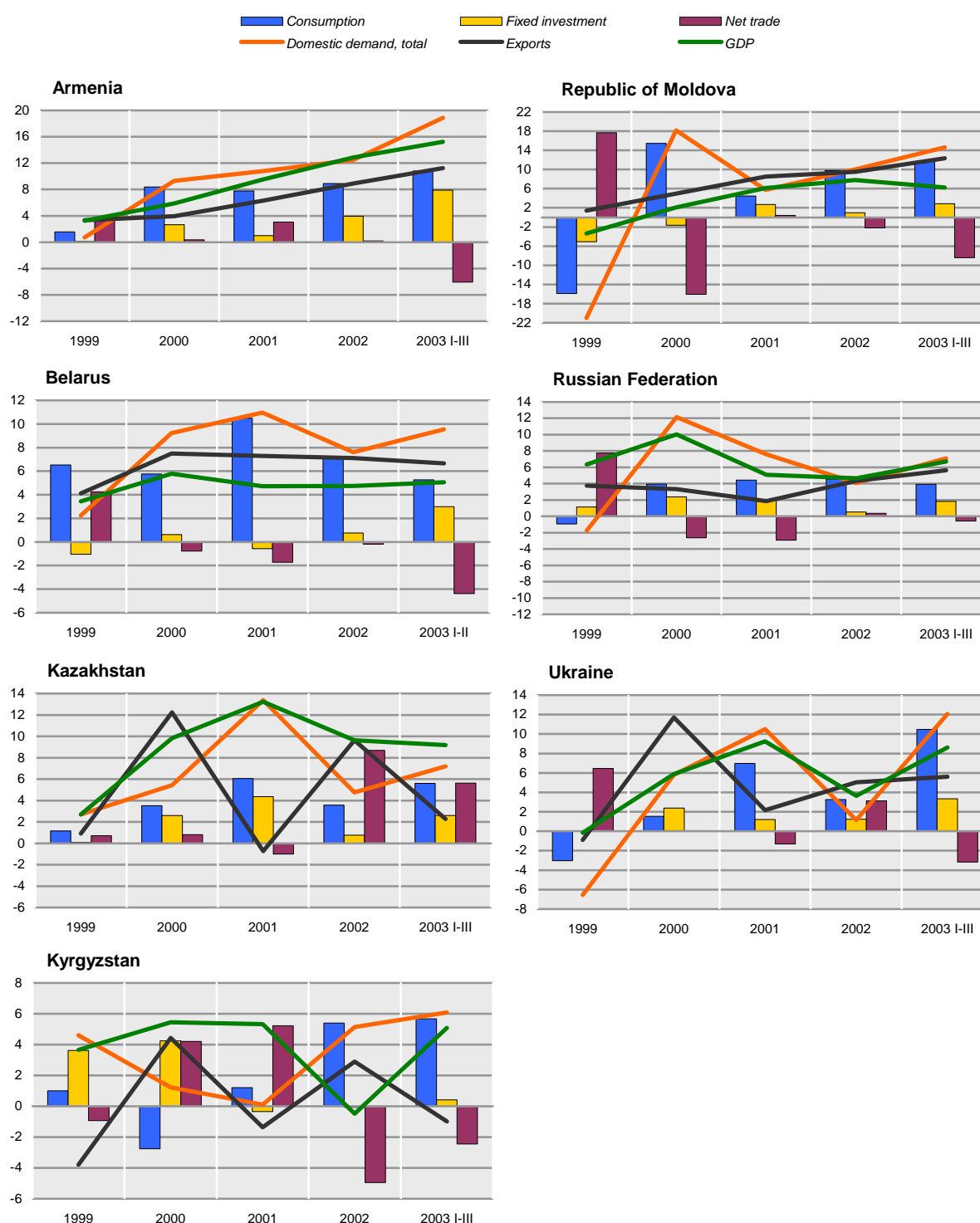
<sup>210</sup> Institute for Economic Research and Policy Consulting, *Monthly Economic Monitor Ukraine*, No. 12, December 2003 (www.ier.kiev.ua).

<sup>211</sup> According to the Kyrgyz statistical agency, the resumption of production at the Kumtor gold mine contributed 1.8 percentage points to GDP growth in 2003. "Kyrgyz 2003 GDP rises 6.7 pct yr/yr", *Reuters*, 12 January 2004, reported in Dow Jones Reuters Business Interactive (Factiva).

<sup>212</sup> Arms export data published by the Stockholm International Peace Research Institute (SIPRI) show that Russia became the largest supplier

CHART 4.2.1

Contribution of final demand components to real GDP growth in selected CIS economies, 1999-2003  
(Percentage points)



Source: UNECE secretariat calculations, based on quarterly national accounts.

discourage many potential investors. When perceptions change for the worse, inflows of FDI fade rapidly. This happened in Russia in the second half of 2003 despite a record FDI inflow in the preceding semester. The inhospitable environment for takeovers and Greenfield

projects by foreign investors, the continued weakness of the banking system and underdeveloped capital markets obstruct any rapid diversification of the CIS economies. To date, the need for diversification has been acknowledged repeatedly by the authorities but the reforms of financial

TABLE 4.2.4

Real investment outlays in selected CIS economies, 2001-2003  
(Annual percentage change)

	2001	2002	2003 <sup>a</sup>
Armenia .....	6.0	43.3	51.9
Azerbaijan .....	21.0	84.2	71.2
Belarus .....	-6.1	3.0	17.7
Georgia .....	11.0	18.0	1.0
Kazakhstan .....	44.7	10.6	10.6
Kyrgyzstan .....	-14.5	-9.6	-8.6
Republic of Moldova .....	11.0	11.0	23.0
Russian Federation .....	8.7	2.6	12.5
Turkmenistan .....	..	..	21.0
Ukraine .....	20.8	8.9	33.0
Uzbekistan .....	3.7	3.8	2.6

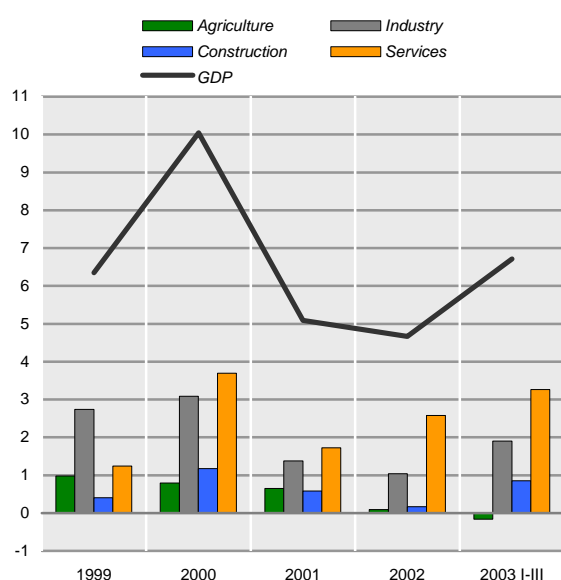
**Source:** National statistics and CIS Statistical Committee data; direct communications from national statistical offices to UNECE secretariat.

**Note:** "Investment outlays" (also called "capital investment" in some transition economies) mainly refers to expenditure on construction and installation works, machinery and equipment. Gross fixed capital formation is usually estimated by adding the following components to "capital investment": net changes in productive livestock, computer software, art originals, the cost of mineral exploration and the value of major renovations and enlargements of buildings and machinery and equipment (which increase the productive capacity or extend the service life of existing fixed assets).

<sup>a</sup> Q1 for Turkmenistan; Q1-QII for Uzbekistan; Q1-QIII for Armenia, Georgia, the Republic of Moldova and Ukraine; Q1-QIV for Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan and the Russian Federation.

CHART 4.2.2

Contribution of producing sectors to real GDP growth in the Russian economy, 1999-2003  
(Percentage points)



**Source:** UNECE secretariat calculations, based on quarterly national accounts.

markets necessary to achieve this objective have fallen behind those of the product markets.<sup>217</sup>

<sup>217</sup> EBRD, op. cit., p. 16.

TABLE 4.2.5

Employment and productivity growth paths in selected CIS economies, 2003-2012  
(Annual average growth rates, per cent)

	Employment <sup>a</sup>	Labour productivity <sup>b</sup>	Potential GDP	Targeted GDP <sup>c</sup>
Kazakhstan .....	0.6	6.3	6.9	7.3
Russian Federation .....	-0.2	5.9	5.7	7.2
Ukraine .....	-0.4	8.3	7.8	6.5

**Source:** Kazakhstan [www.president.kz], the Russian Federation [www.kremlin.ru], Ukraine [www.president.gov.ua], UNECE databases.

<sup>a</sup> Employment/working-age population rates are frozen at 2000 levels. The working-age population (15-64 years) grows in line with United Nations population projections.

<sup>b</sup> Labour productivity trend growth is set at 1.5 per cent and the catch-up parameter at 2 per cent per annum.

<sup>c</sup> Growth rates are consistent with official long-term objectives (Kazakhstan and the Russian Federation) or with extrapolations based on medium-term objectives (Ukraine).

### Long-term growth targets and prospects

Economic growth has been strong in the CIS region since the late 1990s. Sustained growth in the three largest economies, Kazakhstan, Russia and Ukraine, was triggered by a fortuitous combination of strong export demand and exceptional cost competitiveness. In the case of Russia, competitiveness was enhanced by the sharp depreciation of the exchange rate and a large fall in real wages in the aftermath of the 1998 financial crisis. The most important factors underlying the recovery have been the microeconomic reforms leading to an improved functioning of the private sector and fiscal consolidation.<sup>218</sup> Nevertheless, the institutional foundations, including the protection of private property rights, remain more fragile than in central Europe and the Baltic states.<sup>219</sup> Even if the three CIS countries mentioned above accede to the WTO within a few years and benefit from the policy disciplines imposed by membership,<sup>220</sup> the institutional gap is unlikely to disappear rapidly. Nevertheless, given the considerable natural and human resources of the economies investigated, their long-term growth prospects are potentially very good, providing that institutional modernization can be sustained.

<sup>218</sup> The EBRD transition indicators of microeconomic reforms show similar degrees of progress in all three economies. However, fiscal consolidation has been more successful to date in Kazakhstan and Russia than in Ukraine.

<sup>219</sup> For a discussion of the principal issues related to property rights in Russia, see the transcript of an IMF Economic Forum, *Russia Rebounds*, 11 December 2003 [www.imf.org/external/np/tr/2003/tr031211.htm]. See also UNECE, *Economic Survey of Europe, 2003 No. 1*, chap. 5.

<sup>220</sup> Russia and Ukraine applied for WTO membership in 1993, Kazakhstan in 1996. Detailed negotiations started during 1997 and 1998. For a comparison of the advantages and disadvantages of membership, see A. Chowdhury, *WTO Accession: What's in it for Russia?*, University of Michigan, William Davidson Institute, Working Paper, No. 595, July 2003.

## Box 4.2.1

## Potential versus targeted growth

Kazakhstan, Russia and Ukraine account for some 85 per cent of economic activity in the CIS. Their GDP has expanded considerably over the last five years. Kazakhstan and Russia may have come close to their potential, with aggregate output growing on average by some 9 and 6.5 per cent per annum, respectively. Ukraine has apparently underperformed, its real GDP expanding on average by 5¼ per cent. However, this is mostly due to its delayed recovery. Between 2000 and 2003 the average growth rates in Russia and Ukraine were practically equal so that the latter is no longer falling behind in terms of per capita GDP.

Assuming a gradual long-run convergence to American productivity levels, rapid productivity growth can be expected over the next decade if actual production is in line with trend. A simple productivity catch-up model used to analyse the matter at hand is defined by the following equation:  $C(t) = (1+\alpha)*C(t-1) + \beta*[A(t-1) - C(t-1)]$ .  $C$  and  $A$  denote labour productivity, measured by GDP per worker, in the relevant CIS country and the United States,  $\alpha$  refers to the productivity growth trend of 1.5 per cent per annum,  $t$  indexes time and  $\beta$  is a catch-up parameter. GDP levels are expressed in comparable purchasing power parity terms. Labour productivity levels in the early 2000s were close to one fifth of the United States benchmark in Kazakhstan and Russia and one seventh in Ukraine.

Russia is bound to remain the key CIS economy, given its comparatively large size, human and natural resources, and military capability. However, Russia's population and level of employment are likely to decline, slowing its potential growth to 5.7 per cent per year during the period 2003-2012 (table 4.2.5).<sup>1</sup> In Kazakhstan both population and employment are projected to rise so that the growth path predicted by the catch-up model is significantly higher than that for Russia. In spite of its comparatively low productivity level and unfavourable demographic trends, Ukraine has the highest growth potential of the three economies.

How feasible are the projected expansion paths? Potential growth presupposes that the economy uses its resources more efficiently over time. In Russia, the recent policy emphasis on equity by increasing the extra legal pressure on profitable corporations to behave *responsibly* may well prevent the economy from reaching its potential growth path. The problem with the emphasis on equity is not the objective per se but that the methods used to pursue it create a climate of uncertainty and undermine the still fragile property rights. Instead, the authorities might be better advised to pursue a more equitable income distribution by the means that have been tried and proven to work in the advanced market economies. Growth in line with potential could materialize in Kazakhstan, provided that the authorities continue with structural reforms and ensure a more attractive environment for foreign investment in the non-energy sector in order to diversify the vulnerable resource-based economy. Ukraine needs to restart the major structural reforms that were abandoned in 2001 if it is to unleash its considerable growth potential. In all three economies, improved job creation by the still underdeveloped small business sector would probably improve trend growth rates, while reducing the growth of productivity to some extent. However, the increased utilization of labour may be difficult to achieve, given the serious threats to labour supply posed by the rapid spread of HIV infection and, so far, the inadequate response of the public health authorities.<sup>2</sup>

<sup>1</sup> Another optimistic catch-up scenario for Russia, based on a Cobb-Douglas production function, projects an annual average growth rate of real GDP over the period 2003-2012 of 4.6 per cent. This rate is consistent with annual labour productivity growth in the United States of 2 per cent and a catch-up factor of 1.5 per cent. D. Wilson and R. Purushothaman, *Dreaming with BRICs: The Path to 2050*, Goldman Sachs, Global Economics Paper, No. 99, October 2003.

<sup>2</sup> For an estimation of long-term growth effects of the HIV epidemic, see C. Rühl, V. Pokrovsky and V. Vinogradov, "The economic consequences of HIV in Russia", The World Bank Russia Country Office ([www.worldbank.org.ru](http://www.worldbank.org.ru)), 15 May 2002. See also this *Survey*, chap. 7.3(iv).

However, the discussion presented in box 4.2.1 indicates that the official long-term growth target in Russia (doubling GDP within a decade) exceeds the potential growth trend and is thus unlikely to be met.<sup>221</sup> The long-term objective of Kazakhstan is to increase real GDP by 2.5 times by 2015. The implied growth path in this case is not far from the estimated potential trend and is therefore possibly attainable. Ukraine has set a comparatively modest target of achieving an annual growth rate of 6.5 per cent over the medium term. As its potential growth trend is considerably higher than this, Ukraine should be able to achieve the targeted growth rate with ease as long as the economic reforms, stalled since 2001, are restarted.

<sup>221</sup> High-ranking officials of the IMF and the World Bank have presented a more optimistic assessment, without specifying the underlying productivity and employment growth assumptions.

## 4.3 Costs and prices

### *A resurgence in inflationary pressure...*

The downward trend in inflation, which started in 2000 and accelerated through 2002, came to a halt in 2003. With few exceptions, the increases in consumer prices were larger than in 2002 and they exceeded even the more pessimistic official forecasts made in the second half of the year. Bad harvests, both in the spring and autumn, led to large increases in the prices of food (by far the largest single item in the consumer baskets).

Given the weakness of the dollar (the target currency in most of the CIS) against all the major currencies, the nominal effective exchange rates of all the CIS countries, except Kyrgyzstan, depreciated. Imported inflation therefore remained a source of cost pressure, albeit at varying intensity, in most countries in 2003.

TABLE 4.3.1  
Consumer prices in the CIS, 2002-2003  
(Percentage change)

	Consumer prices, total							Food	Non-food	Services	
	Annual average		2003, year-on-year				December over previous December		December over previous December		
	2002	2003	QI	QII	QIII	QIV	2002	2003	2003	2003	2003
Armenia <sup>a</sup> .....	1.0	4.3	3.3	2.9	5.1	..	-1.6	3.2	4.6	-0.1	1.5
Azerbaijan <sup>a</sup> .....	2.8	2.0	2.6	1.5	1.6	..	2.6	1.9	3.0	0.8	-0.2
Belarus <sup>a</sup> .....	42.8	28.8	30.8	28.3	28.3	..	30.7	23.1	21.8	16.3	34.3
Georgia <sup>a</sup> .....	5.7	4.7	4.4	3.2	5.2	..	3.8	6.8	..	..	..
Kazakhstan .....	6.0	6.6	7.2	6.5	5.8	7.1	6.7	7.0	7.2	7.0	6.2
Kyrgyzstan .....	2.1	3.0	2.8	3.2	1.1	5.0	2.3	5.5	5.3	1.8	18.6
Republic of Moldova <sup>a</sup> .....	5.3	11.3	6.7	8.2	15.2	..	2.5	15.0	19.1	10.6	12.5
Russian Federation .....	16.0	13.6	14.6	14.0	13.5	12.5	15.1	12.0	10.2	9.3	22.3
Tajikistan .....	12.2	16.3	18.1	17.4	14.3	15.5	14.5	13.7	10.0	8.4	53.2
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..	..
Ukraine .....	0.8	5.2	2.2	4.5	6.5	7.8	-0.6	8.2	10.9	1.5	5.4
Uzbekistan .....	..	..	..	..	..	..	..	..	..	..	..

Source: UNECE secretariat estimates, based on national statistics.

<sup>a</sup> January-November data for 2003.

In a number of CIS members fiscal and monetary policies were relaxed somewhat. In addition, much larger than expected increases in oil-related revenue in several countries led to large additions to foreign exchange reserves and to monetary aggregates.<sup>222</sup>

On the costs side, labour productivity growth accelerated in the CIS, to double-digit rates in many countries. Nevertheless, even these impressive gains could not fully offset the cost pressure arising from the continued surge in wage inflation: in 2003 wages in most economies grew at rates far above the increase in prices. As a result, real household disposable incomes increased in most of the region in spite of growing rates of unemployment. In fact, private consumption increased considerably,<sup>223</sup> suggesting intensified demand pressure on consumer prices in 2003.

Annual inflation rates in 2003 would have been even higher if several governments had not resorted to price controls, particularly in the closing months of the year when the food prices were rising strongly. Such short-term remedies to keep inflation rates artificially low only postpone the larger relative price corrections, which are needed for the efficient functioning of product, capital and labour markets. Hence, at the start of 2004, achieving a sustainable degree of price stability through the moderation of domestic-demand pull and cost-push pressures remains a challenge for the CIS economies. Although the increase of job insecurity may start to erode consumer confidence, the prevailing inflationary expectations continue to generate supply-side cost pressures through higher wage demands.

Furthermore, real wages still remain below their pre-transition levels in most of the CIS where the working poor and poverty in general are pressing economic and social concerns. Further increases in productivity remain the principal remedy for lowering the underlying rate of inflation in the CIS. This, in turn, requires a stronger commitment to institutional and other reforms and perseverance in implementing coherent and consistent macroeconomic policies.<sup>224</sup>

#### ...brings consumer price disinflation to a halt

Consumer price inflation accelerated in early 2003 and continued to do so throughout the year, especially in the closing months when grain prices rose sharply. Consumer price inflation, measured on a 12-month cumulative basis, moderated in 2003 only in Azerbaijan, Belarus, Russia and Tajikistan (table 4.3.1). The acceleration was greatest in the Republic of Moldova and Ukraine. During 2003, most CIS governments and central banks raised their inflation forecasts several times. The main exception was Russia, where the 12-month cumulative rate in December of 12 per cent was at the upper end of the government's inflation target band. However, this was due to a sharp slowdown in November and December, which in turn reflected some easing of planned increases in regulated tariffs. In fact, a similar postponement of scheduled price increases was made in the other CIS economies as well. Hence, the official inflation rates for 2003 do not fully reflect the real impact of inflationary pressures during the year.

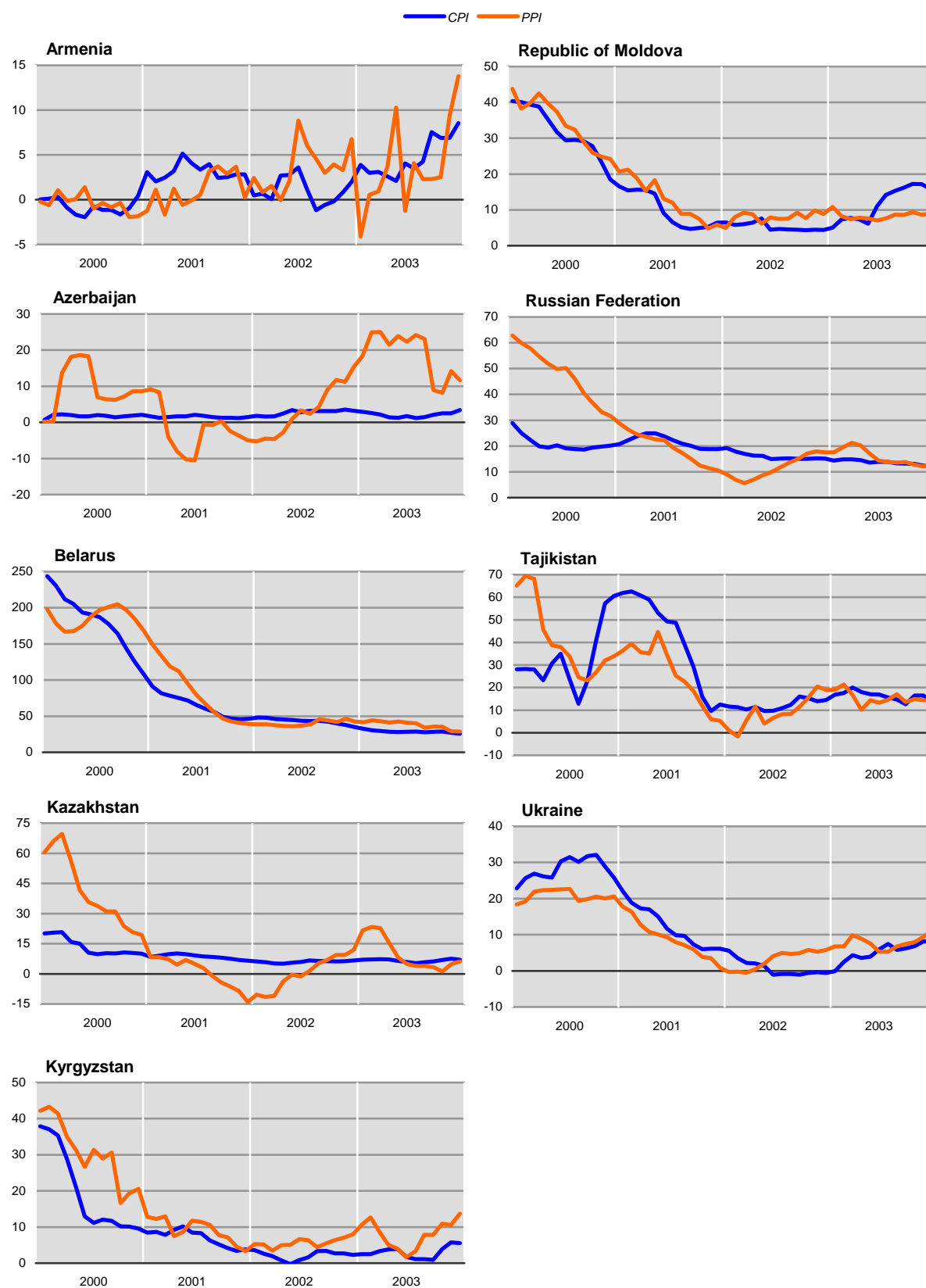
<sup>222</sup> See section 4.1(i) above for a discussion of stabilization funds in Azerbaijan, Kazakhstan and Russia. In Azerbaijan and Kazakhstan the inflationary effects of this monetary expansion were partly sterilized by diverting revenues to these "stabilization funds".

<sup>223</sup> See section 4.2 above.

<sup>224</sup> If the monetary policy focus shifts from inflation to exchange rate targeting (i.e. aiming to contain the appreciation of the currency), it may be difficult to achieve the initial inflation target, with just the usual monetary policy instruments. This appears to have been the problem in Russia in 2003; subsequently the government intervened to suppress the rate of inflation by postponing a number of regulated tariff increases.

CHART 4.3.1

Consumer and industrial producer prices in the CIS, 2000-2003  
(Monthly, year-on-year percentage change)



Source: National statistics and UNECE secretariat estimates.

TABLE 4.3.2

Producer prices, wages and unit labour costs in industry<sup>a</sup> in the CIS, 2002-2003  
(January-September over same period of previous year, percentage change)

	Producer prices <sup>b</sup>		Nominal wages <sup>c</sup>		Real product wages <sup>d</sup>		Labour productivity <sup>e</sup>		Unit labour costs <sup>f</sup>		Real unit labour costs <sup>g</sup>	
	2002	2003	2002	2003	2002	2003	2002	2003	2002	2003	2002	2003
Armenia .....	3.6	3.7	11.6	21.5	8.1	19.1	9.3	..	2.2	..	-1.1	..
Azerbaijan .....	3.3	18.6	21.2	21.5	20.9	0.2	0.1	5.0	21.1	15.8	20.8	-4.5
Belarus .....	40.6	37.5	59.6	31.1	14.6	-6.5	7.4	10.8	48.6	18.3	6.7	-15.6
Georgia .....	6.0	2.6	..	..	..	..	..	..	..	..	..	..
Kazakhstan .....	0.3	9.5	18.1	14.3	21.5	2.6	11.0	4.4	6.4	9.5	9.5	-1.8
Kyrgyzstan .....	5.7	8.0	14.8	19.3	9.1	11.7	-16.5	13.2	37.6	5.3	30.8	-1.3
Republic of Moldova .....	8.0	8.4	30.5	32.8	21.2	22.8	7.2	20.0	21.8	10.7	13.1	2.3
Russian Federation .....	11.8	15.6	36.5	23.8	24.4	6.1	1.6	7.4	34.4	15.2	22.4	-1.2
Tajikistan .....	9.1	15.3	35.8	36.1	28.0	17.8	6.7	9.4	27.3	24.3	20.0	7.6
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine .....	3.1	7.8	21.7	22.5	19.1	14.3	3.5	21.4	17.6	0.9	15.1	-5.9
Uzbekistan .....	..	..	..	..	..	..	..	..	..	..	..	..

Source: UNECE secretariat estimates, based on national statistics and direct communications from national statistical offices.

Note: Annual averages are calculated on the basis of monthly data, except for employment which are quarterly.

<sup>a</sup> Industry = mining + manufacturing + utilities.

<sup>b</sup> January-December over same period of previous year.

<sup>c</sup> Average gross wages in total economy.

<sup>d</sup> Nominal wages deflated by producer price index.

<sup>e</sup> Gross industrial output deflated by industrial employment.

<sup>f</sup> Nominal gross wages deflated by productivity.

<sup>g</sup> Real product wages deflated by productivity.

### **But growing productivity reins in labour costs**

In contrast to consumer prices, the disinflation of producer prices, which was interrupted in mid-2002, resumed in the second half of 2003 in most of the CIS albeit only modestly (chart 4.3.1). Average annual rates of change, however, were higher than in 2002 (table 4.3.2) and also generally more than the increase in consumer prices.

Wage inflation in industry in the first three quarters of 2003 remained strong or even accelerated (table 4.3.2). Wages rose much faster than the sector's producer prices, except in Azerbaijan and Belarus, and real product wages increased at double-digit rates in most countries.<sup>225</sup>

Surging industrial production<sup>226</sup> accompanied by generally weak or falling employment throughout the CIS led to a significant improvement in the measured labour productivity. Kazakhstan was the only country where it decelerated sharply, mainly reflecting an increase of more than 3 per cent in industrial employment. Rates of

growth in productivity exceeded 20 per cent in the Republic of Moldova and Ukraine. In Ukraine, labour productivity in 2003 was nearly double its level in 1998, the year of the rouble crisis.<sup>227</sup>

Those large gains in productivity allowed a sharp deceleration in the growth of unit labour costs although it still remained in double digits except in Kyrgyzstan and Ukraine. Nevertheless, given the continued acceleration in producer prices in the first half of the year, real unit labour costs (or, in other words, labour's share in value added), fell or increased more slowly than in 2002. This suggests that, *ceteris paribus*, unit gross operating profits in the CIS industries were subject to less of a squeeze and may even have recovered somewhat in 2003. An improvement in gross profits is indispensable for raising the internal resources required for fixed capital investment, particularly in those countries where bank lending is scarce, financial markets are thin or non-existent and FDI inflows are limited to a few natural resource-related sectors.

<sup>225</sup> It is worth noting that over the last three years, real product wages, which had collapsed throughout the previous decade, recovered by 50 per cent or more, and by as much as 70 per cent in the Republic of Moldova and Ukraine and 80 per cent in Tajikistan.

<sup>226</sup> See section 4.2 above.

<sup>227</sup> In the other two largest CIS economies, Kazakhstan and Russia, labour productivity growth during the same period was less striking although productivity still exceeded its 1998 level by some two thirds and two fifths, respectively. See box 4.2.1 for a discussion of potential and targeted long-term growth trends in Kazakhstan, Russia and Ukraine.

## 4.4 Labour markets

### *Modest job creation amidst a robust recovery*

Current labour market data for the CIS countries remain generally unreliable and this limits any comprehensive analysis of recent developments. Quarterly data on employment are incomplete and in some cases are only reported with long delays. Moreover, registered unemployment, which is the only available series for most of these countries is not only unreliable but sometimes even misleading since a large proportion of the jobless, although willing to work, do not register as unemployed.<sup>228</sup>

Given an average GDP growth of more than 7 per cent in the region, some improvement in the labour markets of the CIS countries might have been expected in 2003. However, the available quarterly data on total employment suggest that the recovery did not generate many new jobs. Moreover, in contrast to 2001 and 2002 when employment was rising, labour demand actually seems to have fallen in many countries in the first half of 2003 and the weakening of employment became widespread by the third quarter of the year. Kazakhstan was the only country in the region where there was a sizeable (over 3 per cent) increase in employed labour (table 4.4.1).<sup>229</sup> There were small increases in Azerbaijan and Kyrgyzstan but elsewhere the trend was negative. The largest fall in the number of employed persons, over 2 per cent, was in Belarus. In industry, the rate of decline was generally higher than for total employment, possibly reflecting the acceleration of enterprise restructuring.

Registered unemployment, which is the only available series on joblessness for most of these countries,<sup>230</sup> shows little change in the 12 months to November 2003 (table 4.4.2). Registered unemployment rates remained very low, varying mostly between 1.4 per cent (Azerbaijan) and 3.5 per cent (Ukraine), the main outlier being Armenia (9.9 per cent). However, these data are unreliable, and misleading as to levels and changes in unemployment.

The available labour force survey (LFS) data for some CIS countries portray a different and probably more realistic picture of labour market developments in the

region. Primarily, the LFS data indicate much higher rates of unemployment. In the third quarter of 2003, in the countries conducting a regular quarterly LFS, the unemployment rate varied between some 7 per cent (the Republic of Moldova)<sup>231</sup> and 9 per cent (Ukraine). Less frequently reported LFS data indicate unemployment rates in Georgia and Kyrgyzstan above 12 per cent of the labour force and around 30 per cent in Armenia (table 4.4.2). In all the CIS countries, the LFS unemployment rates are three to five times higher than the registered ones.<sup>232</sup> Furthermore, the LFS unemployment data suggest that despite the continued strong economic recovery in these countries there was no improvement in the first three quarters of 2003. The unemployment rate only continued to decline (for the third year in a row) in Kazakhstan where, in the third quarter of 2003, it stood at 7.9 per cent, 0.4 percentage points lower than that a year earlier.<sup>233</sup> In Ukraine, the rate was unchanged from a year earlier but it increased in the Republic of Moldova<sup>234</sup> and the Russian Federation.

### *A slow adjustment in the CIS labour markets*

Thus, in contrast to developments in eastern Europe, the recovery in the CIS is so far characterized by "jobless growth". One of the possible explanations for this is that it partly reflects a delayed adjustment due to the considerable levels of excess employment, mainly in the form of unpaid administrative leave and part-time employment in the CIS economies. This type of labour hoarding has largely disappeared in most of eastern Europe but in the CIS the relocation of this excess labour is only slowly getting underway in some of these countries.

Russia is a good example. Despite a strong economic recovery, employment started falling in 2003 and the unemployment rate rose again in late 2002 and early 2003.

<sup>228</sup> Among the main reasons for this are the low unemployment benefits (often paid in arrears), and the inefficiency of local labour offices. For a more detailed discussion see UNECE, *Economic Survey of Europe, 2003 No. 1*, pp. 197-198; see also box 3.4.1 in chap. 3 above.

<sup>229</sup> The expansion in employment can be traced across all sectors, except agriculture, but it was particularly pronounced in construction, the extractive industries and the service sector.

<sup>230</sup> So far only Kazakhstan, the Republic of Moldova, Russia and Ukraine conduct regular quarterly labour force surveys. Kyrgyzstan started to conduct an integrated household survey in 2003 and this also covers participation in the labour market. However, data are so far available only for the first quarter. In Georgia, labour force surveys have been conducted since 1998, but the results are not published regularly due to financial constraints.

<sup>231</sup> A relatively low (in comparison with the other CIS countries) unemployment rate in the Republic of Moldova can be partially explained by the large agricultural sector that employs nearly half of the total labour force and provides "temporary" employment for workers made redundant in other sectors of the economy. But another important reason is that a large proportion of the Moldovan workforce is employed abroad, often illegally, in western Europe and Russia. The scale of this emigration has been estimated at one quarter to one fifth of the workforce. EIU, *Country Report. Moldova* (London), November 2003.

<sup>232</sup> See box 3.4.1 in chap. 3 above.

<sup>233</sup> The falling unemployment rate must nonetheless be seen within the context of extensive overemployment in the economy, especially in large unstructured industrial enterprises. As a result, the true unemployment rate is likely to be higher than reported, even using the fairly comprehensive ILO methodology. In large enterprises many workers remain on unpaid administrative leave or part-time employment, so as to maintain access to company nurseries for their children or clinics for their families.

<sup>234</sup> In the Republic of Moldova, the two measures of unemployment point in opposite directions. According to registration data, unemployment fell in the 12 months to November 2003 (from 1.6 to 1.3 per cent of the labour force). But according to the most recent labour force survey, it rose to 6.6 per cent in the third quarter, compared with 5.8 per cent a year earlier.



TABLE 4.4.1

**Total and industrial employment in selected CIS countries, 2002-2003**  
(Percentage change over the same period of preceding year)

	Total employment <sup>a</sup>					Employment in industry <sup>a</sup>				
	2002		2003			2002		2003		
	Annual	QIV	QI	QII	QIII	Annual	QIV	QI	QII	QIII
CIS .....	1.2	1.4	-0.8	-0.2	-0.9	1.0	0.9	0.7	-3.7	-1.8
Armenia .....	1.3	1.1	-0.4	-0.4	..	1.4	1.2	..	..	..
Azerbaijan .....	0.3	0.6	0.5	0.5	0.6	1.9	-0.4	-	1.6	0.8
Belarus .....	-0.8	-1.3	-2.0	-2.2	-1.5	-3.4	-4.0	-4.4	-4.2	-2.9
Georgia .....	-2.1	..	..	..	..	..	..	..	..	..
Kazakhstan .....	0.2	-	2.2	4.0	4.0	-0.8	1.2	2.4	3.9	3.4
Kyrgyzstan .....	1.5	1.5	1.0	1.0	1.0	-0.8	-0.7	0.7	0.7	0.7
Republic of Moldova .....	0.4	0.1	..	..	..	3.6	2.9	-	1.8	-3.6
Russian Federation .....	1.0	1.7	-1.5	-0.7	-1.2	-1.1	2.0	2.8	-3.6	-0.9
Tajikistan .....	1.5	1.7	-0.5	-1.2	-2.8	-0.7	0.8	0.4	-1.2	-2.0
Ukraine .....	1.7	1.4	1.0	1.3	-1.2	-2.2	-1.1	-4.7	-5.5	-5.1

*Source:* National statistics and direct communications from national statistical offices to UNECE secretariat.

*Note:* Changes in employment based on quarterly statistics are not always fully comparable with annual data due to differences in coverage.

<sup>a</sup> Regional quarterly aggregates for total employment exclude Georgia, Turkmenistan and Uzbekistan for which data are not available; in addition, those for industry exclude Armenia.

TABLE 4.4.2

**Registered and labour force survey unemployment in selected CIS economies, 2000-2003**  
(Per cent of labour force)

	Registered unemployment						Labour force survey unemployment						
	2000		2001		2002		2002		2003		2003		
	Nov.	Nov.	Nov.	Sep.	Oct.	Nov.	QI	QII	QIII	QIV	QI	QII	QIII
CIS <sup>a</sup> .....	2.3	2.1	2.3	2.5	2.4	2.5	..	..	..	..	..	..	..
Armenia .....	11.0	10.0	9.2	9.8	10.0	9.9	..	..	..	31 <sup>b</sup>	..	..	..
Azerbaijan .....	1.2	1.3	1.3	1.4	1.4	1.4	..	..	..	..	..	..	..
Belarus .....	2.2	2.4	3.0	3.2	3.2	3.1	..	..	..	..	..	..	..
Georgia .....	..	..	..	..	..	..	..	12.7 <sup>c</sup>	..	..	..	12.4 <sup>c</sup>	..
Kazakhstan .....	3.8	2.8	2.7	2.0	1.9	1.9	10.7	8.8	8.3	10.2	9.3	8.3	7.9
Kyrgyzstan .....	3.1	3.1	3.1	3.0	3.0	2.9	..	..	..	12.5 <sup>d</sup>	12.4 <sup>e</sup>	..	..
Republic of Moldova .....	1.9	2.0	1.6	1.5	1.4	1.3	7.9	6.3	5.8	7.3	9.8	6.9	6.6
Russian Federation .....	1.4	1.5	1.7	2.1	2.1	2.2	8.2	7.7	7.6	8.8	8.9	8.0	7.9
Tajikistan .....	3.0	2.6	2.7	2.5	2.5	2.5	..	..	..	..	..	..	..
Ukraine .....	4.2	3.6	3.6	3.5	3.4	3.5	10.6	9.7	9.2	11.2	9.4	8.8	9.2

*Source:* National statistics and direct communications from national statistical offices to UNECE secretariat.

<sup>a</sup> The regional aggregate of registered unemployment excludes Georgia, Turkmenistan and Uzbekistan.

<sup>b</sup> Estimate by the National Statistical Service based on household surveys for the year as a whole.

<sup>c</sup> The National Bank of Georgia; average for the first half of the year.

<sup>d</sup> November.

<sup>e</sup> February-April, preliminary estimates.

Although the rate started to decline after February (when it reached a 22-month high of 9.3 per cent), in September it was still 0.3 percentage points higher than a year earlier. There are several possible explanations for this reversal. First, starting in 2003, the Russian Goskomstat for the first time included the Chechen Republic, a region with very high unemployment, in the nation-wide unemployment rate. Second, and more important, is that a large number of Russian firms in various sectors (now mostly in private ownership) are undergoing modernization and reorganization. Under the growing competitive pressures on the domestic market, firms have started to rationalize their labour forces and adopt a more aggressive policy regarding excess staff. And third, this

process was intensified in 2003 by the real appreciation of the rouble: as some Russian enterprises (mainly large and medium size) were losing competitiveness against imported goods they tried to reduce costs partly by laying off staff.<sup>235</sup> In assessing labour market developments in Russia it should also be noted that there is a large and increasing number of illegal foreign workers (mainly

<sup>235</sup> In the first three quarters of 2003, employment in large and medium-size enterprises (which still account for nearly 60 per cent of total employment) fell by more than 2 per cent (year-on-year) whereas the total employment declined by only 1 per cent. Although new jobs were created in small firms, they were not enough to offset the 1.2 million jobs lost in the large enterprise sector.

from the CIS countries) in the Russian economy.<sup>236</sup> The government has recently taken measures to reduce the scale of this phenomenon.<sup>237</sup>

## 4.5 Foreign trade and payments

### (i) Current account developments

#### *Divergent patterns of current account performance*

The differences between resource-rich countries and the rest of the CIS economies with respect to the state and dynamics of external financial balances have been widening in 2002-2003. Thus, five natural resource commodity exporting economies (Kazakhstan, Russia, Turkmenistan, Ukraine and Uzbekistan),<sup>238</sup> representing altogether some 94 per cent of aggregate CIS GDP, were in current account surplus at the end of October 2003, in contrast to the rest of the CIS (table 4.5.1). The current account balance of Azerbaijan (another fuel exporting country) was negative but this was due to traditionally large deficits in services and factor incomes that more than offset the trade surplus. The aggregate surplus of the five exporters of primary commodities amounted to \$33 billion in the first nine months of 2003, which was larger than that for the whole of 2002, and was approaching 8.5 per cent of GDP. In contrast, the aggregate current account deficit for the remaining seven countries continued to widen for the third consecutive year, increasing from 3.9 per cent of GDP in 2001 to 8.5 per cent in the first three quarters of 2003. The negative balance in services generally deepened throughout the region and especially in the Caucasian and some central Asian countries, where it was often combined with a mild worsening of the deficits on the factor income accounts. The surpluses on current transfers did not increase very much in the majority of countries and their effect on the CIS economies has been generally low, except for Armenia, Georgia and Ukraine. The rising deficits of private transfers in Kazakhstan and Russia reflects the fact that in both countries the number of migrant workers from other CIS countries is growing.

#### *Russia's chronic current account surplus*

The large current account surplus has been a feature of the Russian economy since 1991 (appendix table B.16) and in recent years the surplus has grown in both absolute and relative terms. It is difficult to explain such long-

term developments (either in Russia or in the other natural resource commodity exporting countries) on macroeconomic grounds alone. The net export of capital from countries suffering from a severe scarcity of funds (needed for the restructuring of their economies, to support their frail public finances and to raise the low levels of private consumption) is not supportive of their long-term economic growth.<sup>239</sup> Persistent current account surpluses also suggest a chronic undervaluation of the local currencies which, in turn, is consistent with policies of quasi-protection of semi-restructured and undercapitalized enterprises and the accumulation of official reserves. But the current situation is also partly a reflection of the revealed preference of Russian private capital holders to invest abroad.<sup>240</sup>

In contrast, running a current account deficit in a growing economy (which is consistent with a possible overvaluation of the currency) implies a closer and more direct exposure of the domestic enterprise sector to international competitive pressure, which can be an important influence on their restructuring. In turn, increased capital inflows and the growing competitiveness of enterprises are mutually reinforcing and influence the long-run trend appreciation of the real exchange rate. The working of these forces is conditional on the liberalization of the economy and, more importantly, on the formation of open competitive domestic markets and the enforcement of the rule of law. Even though these features may not be dominant in the policy environment in the CIS economies at present, at least some of them are moving in this direction.

Other characteristic features of the Russian current account are the chronic large deficits on the services account (with an expected net deficit on travel of over \$8 billion in 2003) and a large and growing deficit of factor incomes. The latter is subject to a widening gap between receivables and payables: the outstanding foreign debt of the (non-financial) enterprise sector requires a large and increasing amount of servicing (\$7.5 billion is the estimate for 2003), while the assets held abroad, including large stocks of FDI and portfolio holdings, are generating substantially smaller income flows (\$0.8 billion in 2003). A similar current account picture (where vast trade surpluses are largely offset by deficits in services and factor incomes) also holds in Kazakhstan, Turkmenistan, Uzbekistan, and to some extent in Azerbaijan. All of them are heavily dependent on exports of fuels and other primary commodities, while imports of services are vital for restructuring and development of the extraction industries. However, apart from a few exceptional years, the current account balance in

<sup>236</sup> At the end of 2003, the number of illegal foreign workers occupied in the economy was estimated at 3.5 million persons. Interview with the deputy Minister of Internal Affairs of the Russian Federation, Mr. A. Chekalin, 14 November 2003 [www.rbc.ru].

<sup>237</sup> In November 2003, the government decided to reduce by half (from 530,000 to 213,000) the official quota for foreign workers in the Russian economy in 2004, 6 November 2003 [www.rbc.ru].

<sup>238</sup> The common feature of these countries is their high dependence on exports of natural resources, especially energy. While this is less evident for Ukraine, more than half of its exports are highly energy intensive (such as metals) and it imports energy from Russia at preferential prices; Ukraine is also rich in other natural resources such as coal and iron ore.

<sup>239</sup> As indicated by the experience of the more advanced east European economies, under alternative domestic policies, export-driven growth can be compatible with a current account deficit (see section 3.5(i)).

<sup>240</sup> Capital outflow has been a systemic feature of Russian economic performance since the start of its economic transformation.

TABLE 4.5.1  
Current account balances of the CIS economies, 2001-2003  
(Million dollars, per cent)

	Million dollars				Per cent of GDP				Net FDI/current account <sup>a</sup> (per cent)		
	2001	2002	Jan.-Sep.		2001	2002	Jan.-Sep.		2002	Jan.-Sep.	
			2002	2003			2002	2003		2002	2003
<b>CIS<sup>b</sup></b> .....	32 829	30 812	22 651	30 708	8.0	6.6	6.7	7.4			
Armenia .....	-200	-148	-100	-146	-9.5	-6.3	-6.5	-8.1	75	58	71
Azerbaijan .....	-52	-768	-519	-1 290	-0.9	-12.3	-12.5	-27.9	139	144	120
Belarus .....	-435	-378	-50	-292	-3.5	-2.6	-0.5	-2.3	120	220	31
Georgia .....	-211	-231	-162	-263	-6.6	-6.8	-6.6	-9.2	70	65	83
Kazakhstan .....	-1 109	-696	-536	508	-5.0	-2.8	-3.0	2.3	310	262	-
Kyrgyzstan .....	-19	-35	-11	-60	-1.2	-2.2	-0.9	-4.4	14	15	27
Republic of Moldova .....	-81	-93	-51	-89	-5.5	-5.6	-4.2	-6.4	126	103	39
Russian Federation .....	33 795	29 520	21 549	28 711	11.0	8.5	8.5	9.2			
Tajikistan .....	-74	-15	-32	-60*	-7.0	-1.2	-3.4	-5.2*	238	68	25*
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..	..
Ukraine .....	1 402	3 173	2 207	2 489	3.7	7.7	7.5	7.1			
Uzbekistan .....	-113*	..	..	..	..	..	..	..	..	..	..
<i>Memorandum items:</i>											
<b>CIS without Russian</b>											
<b>Federation<sup>b</sup></b> .....	-967	1 292	1 102	1 997	-0.9	1.1	1.3	2.0	..	..	..
<b>Caucasian CIS</b> .....	-464	-1 147	-781	-1 699	-4.2	-9.6	-9.6	-18.3	117	117	110
<b>Central Asian CIS<sup>b</sup></b> .....	-1 389	-264	-223	1 588	-3.2	-0.5	-0.6	3.8	897	696	
<b>Three European CIS</b> .....	886	2 703	2 106	2 109	1.7	4.7	5.1	4.3	..	..	..

Source: UNECE secretariat calculations, based on national balance of payments statistics; IMF country studies (Washington, D.C.).

<sup>a</sup> This ratio is calculated only when net FDI is positive and the current account balance is negative.

<sup>b</sup> Totals include UNECE secretariat estimates for Tajikistan, Turkmenistan and Uzbekistan.

Kazakhstan has been traditionally in deficit, thus creating more scope for net imports of foreign capital services (table 4.5.4 and appendix table B.16). This policy has been followed to an even greater extent in Azerbaijan.

#### **Risk of a “Dutch Disease” for the commodity exporters**

Until recently, the economic performance of the resource-rich CIS economies has been marked not so much by booming fuel exports, as by the decline of the other sectors of the economy. However, heavy reliance on exports of abundant natural resources may become an impediment to economic restructuring and growth – a paradox, which is usually referred to as the “Dutch Disease”.<sup>241</sup> The risks and negative side effects associated with this can be reduced by pursuing policies that encourage the development of human capital, entrepreneurship in small- and medium-sized enterprises, prudential banking and the protection and enforcement of property rights.

The course of economic policy in Russia after the 1998 financial crisis, which included successful macroeconomic stabilization, fiscal consolidation and a notable acceleration of institutional and structural reforms, has addressed some of these risks. The large depreciation of the rouble, in the aftermath of the 1998 crisis, was also instrumental in boosting the competitiveness of domestic non-oil industries. Capital flight started to decline and official reserves were rapidly replenished (the latter amounted to some 19 per cent of GDP at the end of 2003).<sup>242</sup> By intervening on the foreign exchange market (in some years accompanied by sterilization), Russia’s central bank sought to strike a balance in countering the inflationary and appreciation pressures arising from the large current account surplus.<sup>243</sup> The recovery after 1998 in the chronically ailing manufacturing sector is an indication of the overall success of these policies. However, the sustainability of this recovery is conditional on a deepening and widening of the reform process, which now needs to focus on

<sup>241</sup> Exports of easily retrievable natural resources may lead to very high profits (based on natural rents), that no other sector can match. The real exchange rate tends to appreciate due to the emergence of a persistent current account surplus (which also feeds inflationary pressures). As a result, “traditional industries” tend to be crowded out, domestic savings tend to fall and public finance becomes excessively dependent on natural resource sectors. At the same time the high profits in such sectors often give rise to rent seeking and corruption. T. Gylfason, *Resources, Agriculture, and Economic Growth in Economies in Transition*, CERGE-EI, Charles University, Working Paper, No. 157 (Prague), July 2000 [www.cerge.cuni.cz/pdf/wp/wp157.pdf].

<sup>242</sup> The buildup in reserves has facilitated the creation of the Russian Stabilization Fund, which is due to start operation in 2004 (see section 4.1(i)).

<sup>243</sup> According to the Central Bank of the Russian Federation, in 2003 the rouble appreciated nominally vis-à-vis the dollar by 6.8 per cent year-on-year, while consumer prices increased by 12 per cent. At the same time, the real effective exchange rate of the rouble appreciated by 0.8 per cent in 2003. Inflation has been declining steadily since 1999 – the inflationary repercussions of the current account surplus were therefore mild – while the access to capital borrowing became easier.

microeconomic and institutional issues. Among the most essential elements of the future policy agenda are the need to attract FDI, to develop entrepreneurship in sectors and regions not associated with natural resources, to improve financial intermediation and to enforce property rights more effectively.

Ukraine's current account balance is also largely shaped by trade in commodities with a high content of natural resources. Thus base metals, fuels and minerals accounted for some 53 per cent of its exports in January-September 2003 and 44 per cent of imports. The surplus on current transfers (some \$1.5 billion in the first three quarters of the year) makes Ukraine the leading beneficiary of workers' remittances in the CIS region. It is a leading source of migrant labour to the EU but also to some east European countries.<sup>244</sup> The introduction of visas and stricter border controls in Hungary, Poland and Slovakia (required by their accession to the EU) and the adoption by the acceding countries of more restrictive employment laws (associated with the *acquis communautaire*) may curtail, at least temporarily, the growth of current transfers to Ukraine.

## (ii) International trade

### (a) Total trade of the CIS

#### Higher commodity prices boost export earnings

In the first nine months of 2003, the dollar value of total merchandise exports from the CIS countries increased by 25 per cent, year-on-year (table 4.5.2). This increase was largely due to strong commodity prices and followed two years of recovery from the period of very low commodity prices in 1999.<sup>245</sup> Virtually all the CIS countries (except Tajikistan where exports were roughly unchanged) increased the dollar value of their exports in the first three quarters of 2003. There was little variation across countries: 9 out of the 12 CIS countries recorded gains close to the regional average growth except Azerbaijan (5 per cent) and Armenia (41 per cent). Intra-CIS regional trade, about three times smaller than trade with the rest of the world in value, grew slightly faster than trade with non-CIS countries.

<sup>244</sup> There are no reliable estimations of the numbers of Ukrainians working abroad, at least temporarily. The figures vary widely from less than 0.3 million for long-term stays in the EU and from 1 million to 4 million for all stays outside of the CIS. Most Ukrainian workers are occupied in seasonal, often illegal, jobs. For example, the number of Ukrainians working officially in the Czech Republic in 2000 was 37,000 persons, and 50,000 Ukrainian citizens had permanent or long-term residence permits (Czech Statistical Office, *Demographic Statistics* (Prague), 2004). But anecdotal evidence suggests that a multiple of that number are working unofficially in construction and services, coming into the country with just a tourist visa. Russia, another destination for temporary employment, mainly attracts workers from western Ukraine.

<sup>245</sup> However, on a quarterly basis, the growth of the dollar value of CIS exports, slowed down gradually throughout 2003 from 37 per cent in the first quarter to 20 per cent in the third quarter.

TABLE 4.5.2

CIS countries' trade with CIS and non-CIS countries, 2001-2003  
(Value in million dollars, growth rates in per cent)

	Export growth		Import growth		Trade balances		
	2002	2003 <sup>a</sup>	2002	2003 <sup>a</sup>	2001	2002	2003 <sup>a</sup>
Armenia .....	48.4	40.6	13.0	38.6	-536	-484	-435
Non-CIS .....	61.8	43.0	4.0	43.2	-406	-276	-278
CIS .....	10.3	30.7	40.0	27.3	-129	-208	-157
Azerbaijan .....	-6.3	4.9	16.4	56.4	883	502	-193
Non-CIS .....	-8.0	2.2	2.9	77.5	1 106	909	179
CIS .....	9.4	27.7	46.1	25.3	-222	-407	-371
Belarus .....	8.7	24.2	9.8	27.7	-730	-882	-914
Non-CIS .....	23.0	24.8	11.8	23.0	485	872	944
CIS .....	-0.7	23.8	8.9	29.8	-1 215	-1 754	-1 858
Georgia .....	1.6	24.7	6.1	41.7	-359	-395	-437
Non-CIS .....	-5.1	24.9	3.1	57.8	-252	-274	-341
CIS .....	9.6	24.5	11.2	17.6	-107	-121	-96
Kazakhstan .....	12.3	37.6	2.0	20.4	2 285	3 219	3 603
Non-CIS .....	24.4	41.4	13.2	18.0	2 958	4 026	4 274
CIS .....	-15.5	25.0	-8.3	23.2	-673	-807	-670
Kyrgyzstan .....	2.5	7.5	25.6	16.9	9	-99	-113
Non-CIS .....	3.8	6.7	25.6	10.3	97	55	38
CIS .....	0.1	9.1	25.7	22.4	-88	-154	-151
Republic of Moldova .....	16.8	24.9	17.3	30.3	-327	-386	-383
Non-CIS .....	36.9	33.3	15.1	20.1	-333	-335	-284
CIS .....	3.9	18.5	20.7	47.0	6	-51	-99
Tajikistan .....	13.0	-1.0	4.4	11.5	-36	18	-73
Non-CIS .....	24.7	10.9	15.5	36.4	290	376	250
CIS .....	-11.4	-32.0	1.3	3.5	-326	-358	-323
Turkmenistan .....	5.6	20.4	-5.8	17.0	450	730	723
Non-CIS .....	5.4	37.1	-1.4	-10.2	-100	-10	401
CIS .....	5.7	6.1	-12.9	71.5	550	740	322
Ukraine .....	10.4	27.8	7.6	32.0	490	980	375
Non-CIS .....	17.2	24.9	15.3	38.2	4 646	5 571	4 282
CIS .....	-6.4	36.8	1.5	26.7	-4 157	-4 591	-3 906
Uzbekistan .....	-14.8	23.2	-18.9	0.3	90	200	510
Non-CIS .....	-4.9	24.6	-19.3	-2.4	130	400	621
CIS .....	-34.0	19.6	-18.2	5.0	-40	-200	-111
<b>Total above</b> .....	<b>7.7</b>	<b>26.8</b>	<b>5.2</b>	<b>27.0</b>	<b>2 220</b>	<b>3 403</b>	<b>2 665</b>
Non-CIS .....	<b>15.7</b>	<b>27.7</b>	<b>8.5</b>	<b>27.0</b>	<b>8 621</b>	<b>11 314</b>	<b>10 085</b>
CIS .....	<b>-6.4</b>	<b>24.7</b>	<b>2.4</b>	<b>27.0</b>	<b>-6 402</b>	<b>-7 910</b>	<b>-7 420</b>
Russian Federation .....	6.2	25.3	10.2	20.5	58 088	60 001	55 623
Non-CIS .....	6.1	24.3	17.1	18.4	54 672	54 625	50 483
CIS .....	6.8	31.3	-8.7	27.9	3 416	5 376	5 140
<b>CIS total</b> .....	<b>6.6</b>	<b>25.8</b>	<b>7.8</b>	<b>23.7</b>	<b>60 308</b>	<b>63 404</b>	<b>58 287</b>
Non-CIS .....	<b>8.4</b>	<b>25.2</b>	<b>13.8</b>	<b>21.6</b>	<b>63 294</b>	<b>65 939</b>	<b>60 568</b>
CIS .....	<b>-</b>	<b>28.1</b>	<b>-1.3</b>	<b>27.3</b>	<b>-2 986</b>	<b>-2 534</b>	<b>-2 280</b>

Source: CIS Statistical Committee data (Moscow) except for Turkmenistan and Uzbekistan: Dow Jones Reuters Business Interactive (Factiva) and UNECE secretariat estimates.

<sup>a</sup> January-September.

Many CIS countries rely on sales of primary commodities and so their export revenues are closely linked to world prices. As noted above, the prices of key natural resources were considerably higher in 2003 than in the first three quarters of 2002. Crude oil, natural gas, nickel, gold and cotton prices increased by 16-33 per cent, while other base metal prices increased by about 7 per cent.<sup>246</sup> In

<sup>246</sup> IMF, *Financial Statistics*, various issues.

addition to higher prices, many commodity exporters increased the volume of sales abroad. In the countries dependent on crude oil, such as Kazakhstan and Russia, the volumes of oil exports increased by 14-17 per cent in comparison with January-September 2002. Shipments of metals from Kazakhstan were mixed as exports of steel products increased, while those of base metals were slightly lower.<sup>247</sup> In Tajikistan, the volume of aluminium exported increased but shipments of cotton were flat. Exports from Turkmenistan and Ukraine rose by 20 and 23 per cent respectively in value based on natural gas and refined oil products in Turkmenistan and across-the-board increases in Ukraine. Uzbekistan's exports of cotton and probably gold supported the overall increase.

The value of total CIS merchandise imports also rose by about 25 per cent in the wake of strong economic growth and increased demand for consumer and investment goods.<sup>248</sup> Imports increased in virtually all the CIS countries ranging from 12 per cent in Tajikistan to 56 per cent in Azerbaijan where there was strong investment spending related to the oil and gas industries. Only in Uzbekistan imports were unchanged, a reflection of import restrictions and, perhaps, the buildup of foreign exchange reserves in anticipation of the unification of the multiple currency regime in the fourth quarter. In contrast to the deceleration of total exports, growth in the quarterly dollar value of merchandise imports increased steadily from 21 per cent in the first quarter to 26 per cent in the third.

In the first three quarters of 2003, the region's aggregate merchandise trade surplus was almost \$13 billion higher than a year earlier mainly because of larger surpluses in Kazakhstan and Russia. Other major primary commodity exporting countries such as Turkmenistan and Uzbekistan as well as Ukraine also had trade surpluses. In all the other CIS countries trade deficits were the rule and they worsened relative to the first nine months of 2002.

In the foreign exchange markets, the value of domestic currencies in most of the CIS increased in the first three quarters of 2003 by between 1 and 11 per cent in real terms against the dollar (year-on-year) – except in Armenia, Azerbaijan and Tajikistan where they depreciated by up to 2 per cent. In contrast, all the CIS currencies depreciated in real terms against the euro (in the range of 7-22 per cent). In general, fluctuations of CIS currencies against the dollar and the euro are more important for non-CIS exports and imports (respectively). All CIS currencies depreciated in real terms against the Russian rouble.

<sup>247</sup> Nevertheless, the large increases in the volume and price of crude oil provided an additional \$3.5 billion in export revenues for Kazakhstan.

<sup>248</sup> In the largest CIS economies, real exchange rate appreciation against the dollar encouraged increased imports from the non-CIS area, while depreciations against the euro worked in the opposite direction. For the real effective exchange rates see chart 4.1.2.

### (b) *Non-CIS trade*

In the first three quarters of 2003, the value of CIS exports to the rest of the world were 25 per cent higher than in the same period in 2002. In 10 countries the increases were in double digits ranging from 11 per cent (Tajikistan) to 43 per cent (Armenia). Because non-CIS countries are the most important destination for the region's primary commodity sales, those trade flows played a large role in the overall increase in revenues. In the first nine months of 2003, Russian exports to non-CIS markets increased in value by 24 per cent, while in volume the rise was over 8 per cent, year-on-year.<sup>249</sup> In Kazakhstan, a 25 per cent increase in the volume of crude oil (but a 60 per cent increase in value) was the main factor contributing to a 41 per cent increase in the value of its exports to non-CIS countries. In Ukraine, the substantial growth in the dollar value of exports reflected greater foreign demand for steel and oil products.<sup>250</sup> In Belarus the strong growth in the value of exports to the non-CIS area was partly due to a rise in the output of oil refineries. Tajik exports to non-CIS countries rose by 11 per cent in value – a moderate rise in comparison with other CIS countries – largely on the strength of a 7 per cent increase in shipments of aluminium as cotton exports were flat. Armenia, where exports of goods are dominated by sales of precious stones, also benefited from higher commodity prices. The increase in the value of Armenian exports to non-CIS countries – up by 41 per cent – was driven by jewellery sales to Belgium and Israel in the first three quarters of 2003. The Republic of Moldova increased exports of textiles to non-CIS countries and, to a lesser extent, agricultural products to EU markets. Textile products have become an increasingly important element of the Republic of Moldova's trade with CIS countries, reflecting its supply of skilled and competitively priced labour and its participation in outward processing by EU firms.

In January-September 2003, the dollar value of CIS merchandise imports from non-CIS countries rose by 22 per cent, year-on-year, a consequence of the continuing GDP growth in the CIS region. In general, the CIS countries buy machinery and equipment as well as foodstuffs from the non-CIS area. All the CIS countries, except Turkmenistan and Uzbekistan, registered strong growth in the value of non-CIS imports ranging from 10 to 78 per cent. Russian imports continued to be driven by buoyant domestic investment and consumption. In the first nine months of 2003, Russia's non-CIS imports of machinery and equipment rose by 23 per cent and capital

<sup>249</sup> The volume of exports of Russian crude oil and oil products to non-CIS markets rose by 18 and 3 per cent, respectively, in the January-September 2003 period, year-on-year. Natural gas exports increased by 6 per cent in volume.

<sup>250</sup> The increased exports of oil products not only reflected foreign demand, but also increased productive capacity due to considerable investment by Russian oil firms in Ukraine. The steel and fuel sectors account for over half of the country's total foreign earnings.

TABLE 4.5.3

**Russia's exports of manufactures, 1996-2001**  
(Million dollars, per cent)

	1996		1997		1998		1999		2000		2001	
	Millions	Per cent	Millions	Per cent	Millions	Per cent	Millions	Per cent	Millions	Per cent	Millions	Per cent
<b>CIS<sup>a</sup></b>												
Resource based .....	1 970	34	1 521	31	1 250	33	1 043	36	1 638	38	1 656	32
Low tech .....	857	15	811	17	673	18	346	12	534	12	621	12
Medium tech .....	2 324	40	1 946	40	1 385	36	1 190	41	1 668	38	2 191	43
High tech .....	630	11	594	12	500	13	338	12	512	12	641	13
Total .....	5 781	100	4 872	100	3 808	100	2 917	100	4 352	100	5 109	100
Total manufacturing exports as a per cent of total exports .....	..	48	..	41	..	42	..	42	..	53	..	48
<b>Non-CIS</b>												
Resource based .....	19 377	55	20 044	59	18 734	58	16 693	54	24 664	59	21 517	59
Low tech .....	4 062	12	3 777	11	3 134	10	4 001	13	4 630	11	3 549	10
Medium tech .....	9 995	29	8 416	25	8 307	26	8 229	26	10 706	26	8 955	25
High tech .....	1 596	5	1 772	5	1 935	6	2 193	7	1 907	5	2 456	7
Total .....	35 031	100	34 008	100	32 110	100	31 115	100	41 907	100	36 478	100
Total manufacturing exports as a per cent of total exports .....	..	46	..	46	..	49	..	46	..	44	..	41
<b>World<sup>a</sup></b>												
Resource based .....	21 347	52	21 565	55	19 984	56	17 736	52	26 303	57	23 173	56
Low tech .....	4 919	12	4 588	12	3 807	11	4 347	13	5 164	11	4 171	10
Medium tech .....	12 320	30	10 362	27	9 693	27	9 419	28	12 374	27	11 146	27
High tech .....	2 227	5	2 366	6	2 435	7	2 530	7	2 419	5	3 097	7
Total .....	40 812	100	38 880	100	35 918	100	34 032	100	46 259	100	41 587	100
Total manufacturing exports as a per cent of total exports .....	..	46	..	45	..	48	..	46	..	45	..	42

Source: Calculations based on COMTRADE, SITC, Rev.2.

<sup>a</sup> Excluding Belarus.

goods in general are expected to remain the most important component of Russian imports for some time to come. In the other CIS countries, the modernization of the capital stock and investment in new productive capacities have also contributed to increased imports. In Azerbaijan imports rose by almost 78 per cent due to increased expenditure, the pipeline infrastructure and further exploration and development of the country's oil and natural gas fields. Similarly, Georgia's large imports of pipe and other intermediate capital goods were related to the construction of a pipeline. In Kazakhstan, imports of capital goods increased by about 10 per cent, more than half of total imports consisting of machinery, equipment and transport equipment. The increased demand for non-CIS goods was also driven by the continuing strength of retail sales in most CIS countries. In Kazakhstan and Russia there were large increases in imports of passenger cars, food, alcoholic beverages, furniture and pharmaceuticals.

### (c) *Intra-CIS trade*

#### *Continued growth stimulates regional trade*

In the first nine months of 2003, the dollar value of intraregional trade increased by about 28 per cent, year-on-year, all the CIS countries except Tajikistan participating in the expansion. The continued growth of the Russian economy and the real appreciation of the

Russian rouble against other CIS currencies were behind a 28 per cent increase in the value of Russian imports from the rest of the CIS.<sup>251</sup> Russia's exports to CIS countries also increased considerably. The increases in the volume and value of Russia's regional trade went across-the-board with the exception of natural gas exports (which were redirected to the non-CIS markets). In particular, Russia shipped greater quantities of crude oil and refined products to the CIS and its exports of machinery and equipment to the area increased by 34 per cent (twice as fast as oil and oil products). Russia remains a major supplier of many manufactured goods to the CIS countries (box 4.5.1). In turn, the value of imports of machinery and equipment from the CIS – which accounts for the largest share of Russia's imports from the CIS – rose by 16 per cent. Most of Russia's imports of consumer products and foodstuffs from the CIS, such as grains, alcoholic beverages, furniture and clothes, also increased.

Intraregional exports and imports also grew substantially in the other CIS countries. Intraregional exports, for example, increased by 25 per cent in aggregate with individual increases ranging from 19 per cent in the

<sup>251</sup> Russia's trade with other CIS countries is a major determinant of total intraregional trade, Russia's imports being crucial for the export performance of many individual CIS countries.

## Box 4.5.1

## Russia's manufacturing exports, 1996-2001

Russia has never been a major exporter of manufactured goods (except for armaments). The country's export structure is relatively concentrated on natural resources. Crude oil, natural gas, base metals, steel (including steel products) and gold accounted for three quarters of total exports in 2002. Between 1996 and 2002 the share of machinery and transport equipment in total exports held steady at 9-10 per cent (of which about 80 per cent are exported to non-CIS markets).<sup>1</sup> In 2002, most of Russia's manufactured exports went to developing countries, such as India (5 per cent), former CMEA members (10 per cent) and China (10 per cent). Exports to the EU represented 8 per cent of the total machinery and equipment exports.

Changes in the structure of Russian exports since the breakup of the Soviet Union have been analysed in some detail in a number of studies.<sup>2</sup> In general, they show that Russia largely continues to export what it exported during the Soviet era. The changes that have occurred in the structure of Russian exports since the 1990s have reinforced the country's status as a raw material producer. Thus, between 1992 and 1995, the share in Russia's total exports of light manufacturing and consumer products fell. Similarly, between 1993 and 2000 the share of labour-intensive and science-based sectors in the total also fell, while that of exports of natural resources increased. The natural abundance of primary commodities, together with the legacies of central planning, delays in industrial restructuring, an unfavourable investment climate and the real appreciation of the rouble have all been cited as explanations for greater reliance on exports of natural resources. Sectoral studies of the Russian economy have supported these findings.<sup>3</sup>

Table 4.5.3 presents data on Russia's manufacturing exports grouped according to their degree of processing or their technology content.<sup>4</sup> They are defined as resource-based, low, medium and high technology. The corresponding shares of exports to the CIS countries (excluding Belarus), to non-CIS markets and of total manufacturing exports for 1996-2001 are presented.<sup>5</sup>

Between 1996 and 2001, Russia continued to be a major raw materials exporter to both non-CIS and CIS markets. The dollar value of Russia's total exports increased by 12 per cent, but virtually all of the increase is attributable to exports of unprocessed and processed natural resource-based products. The share of unprocessed commodities in total exports fluctuated slightly between 1996 and 2001, but it consistently accounted for over half of Russia's total exports. In each year from 1996 through 2001, about four fifths of the total were due to natural resources, whether unprocessed (e.g. crude oil) or processed (such as gasoline). The competitive advantage in these products arises from the local endowment of natural resources and it is related to skills and capital investment in exploration and development.

The remaining exports, about \$19 billion a year, can be classified as having been processed to varying degrees and which are largely unrelated to natural resource endowments. Exports of "low technology" manufactures (e.g. textiles, footwear or simple metal or plastic products) represent a steady 4-6 per cent of Russia's exports. Production processes in this class of products are not capital intensive and labour costs are a major share of production costs. In the 1990s many companies in high labour cost countries took advantage of the cheaper skilled labour available in eastern Europe through the outward processing trade arrangements (under which labour intensive goods are exported to a cheap labour country for partial processing and then re-exported to their country of origin). So far, Russia has not participated in this process to any significant extent.

Russian exports of "medium-tech" manufactures (mainly machinery, automobiles and industrial chemicals) accounted for a stable 12-13 per cent of total exports between 1996 and 2001. These products rely on complex, but not necessarily rapidly changing, capital-intensive technologies. This class of manufactures represents the largest share of Russian manufactured exports to the CIS, mainly to Kazakhstan and Ukraine, which account for 80 per cent of Russia's "medium-tech" exports to the CIS. This reflects, to some degree, the persistence of the intercountry links created under the Soviet pattern of specialization. Finally, exports of "high-technology" goods such as electronic products, precision instruments and pharmaceuticals account for only a small, albeit steady, 2-3 per cent of total exports.

<sup>1</sup> Machinery and transport equipment are defined here as HS sections 84-90, that is, nuclear reactors, electrical machinery, railway stock, vehicles, aircraft, ships and precision equipment.

<sup>2</sup> For example, P. Westin, "Comparative advantage and characteristics of Russia's trade with the European Union", *Review of Economies in Transition*, Vol. 2, BOFIT (Helsinki), 1998, and K. Soos, E. Ivleva and I. Levina, "Russian manufacturing industry in the mirror of its exports to the European Union", *Russian Economic Trends*, The European Commission, undated. Both studies rely on the EU's mirror statistics and thus limit the analysis to about one third of Russian exports.

<sup>3</sup> S. Boltramovich, G. Dudarev and V. Gorelov, *The Melting Iron Curtain, A Competitive Analysis of the Northwest Russian Metal Cluster*, B 198, ETLA, The Research Institute of the Finnish Economy (Helsinki), 2003 and G. Dudarev, S. Boltramovich and D. Efremov, *From Russian Forests to World Markets. A Competitive Analysis of the Northwest Russian Forest Cluster*, B 195, ETLA (Helsinki), 2002.

<sup>4</sup> There is no unique way of classifying exports into groups with specific technology characteristics. In this case, resource-based manufactures are mainly processed foods and tobacco, simple wood products, refined petroleum products, leather, precious stones and organic chemicals; low-tech manufactures are mainly textiles, footwear, toys, simple metal and plastic products, furniture and glassware; medium-tech manufactures are cars, industrial chemicals, machinery and electrical products; and high-tech manufactures are complex electrical and electronic products, aerospace, precision instruments, fine chemicals and pharmaceuticals. For detailed classification of exports based on SITC Rev.2, see UNIDO, *Industrial Development Report 2002/2003: Competing through Innovation and Learning* (Sales No. E.02.II.B.13), 2002, p. 145.

<sup>5</sup> The lags in statistical reporting mean that data are not available for more recent years.

TABLE 4.5.4  
Net financial flows into CIS economies, 2001-2003  
(Million dollars, per cent)

	Capital and financial account flows <sup>a</sup>						Changes in official reserves <sup>b</sup>		Changes in reserves/GDP <sup>b</sup>	
	Million dollars				Capital flows/GDP		(million dollars)		(per cent)	
	2001		2002		2002		2002		2002	
			Jan.-Sep.		Jan.-Sep.		Jan.-Sep.		Jan.-Sep.	
<b>CIS<sup>c</sup></b> .....	-22 062	-17 166	-11 049	-13 307	-3.7	-3.2	13 646	17 402	2.9	4.2
Armenia .....	220	230	110	164	9.7	9.1	82	18	3.5	1.0
Azerbaijan .....	317	965	683	1 416	15.5	30.7	197	126	3.2	2.7
Belarus .....	430	478	-55	286	3.3	2.3	101	-6	0.7	-
Georgia .....	258	269	184	261	7.9	9.2	39	-2	1.1	-0.1
Kazakhstan .....	1 494	1 231	1 149	1 044	5.0	4.8	535	1 553	2.2	7.2
Kyrgyzstan .....	35	78	38	94	4.9	7.0	44	34	2.7	2.5
Republic of Moldova .....	91	120	93	96	7.2	6.9	27	7	1.6	0.5
Russian Federation .....	-25 583	-18 145	-11 725	-15 693	-5.3	-5.0	11 375	13 018	3.3	4.2
Tajikistan .....	82	15	26	90*	1.2	7.8*	0	30*	0.0	2.6*
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..
Ukraine .....	204	-2 128	-1 398	-415	-5.1	-1.2	1 045	2 074	2.5	5.9
Uzbekistan .....	52*	..	..	..	..	..	..	..	..	..
<i>Memorandum items:</i>										
<b>CIS without Russian Federation</b> .....										
	3 521	979	676	2 386	0.8	2.4	2 271	4 384	1.9	1.4
<b>Caucasian CIS<sup>c</sup></b> .....	796	1 464	978	1 841	12.2	19.9	317	142	2.6	1.5
<b>Central Asian CIS<sup>c</sup></b> .....	2 000	1 045	1 058	579	2.1	1.4	782	2 167	1.6	5.1
<b>Three European CIS</b> .....	725	-1 530	-1 359	-34	-2.6	-0.1	1 173	2 075	2.0	4.2

Source: UNECE secretariat calculations, based on national balance of payments statistics and direct communications from national statistical offices or national banks; IMF country studies (Washington D.C.).

<sup>a</sup> Includes errors and omissions; excludes changes in official reserves.

<sup>b</sup> A negative sign indicates a decrease in reserves.

<sup>c</sup> Totals include secretariat estimates for Tajikistan, Turkmenistan and Uzbekistan.

Republic of Moldova to over one third in Ukraine. Exports from Kyrgyzstan and Turkmenistan were rather less dynamic (increases of 6-9 per cent in value), while those from Tajikistan declined by a third in value despite large increases in shipments of its two main commodities, cotton and electricity. Other CIS commodity producers also increased the volume of their exports to regional trade partners. Small increases (of about 5 per cent) in the volume of sales of oil products together with higher prices helped to boost the value of Azerbaijan's exports by 28 per cent (oil products account for almost a half of Azerbaijan's regional exports). Kazakhstan's exports to the CIS increased by 25 per cent reflecting a variety of price and volume changes – grain exports increased by a half in volume and almost doubled in value, while the value of crude oil was roughly flat on much lower volumes. Kyrgyzstan, a supplier of electricity to central Asia, provided roughly the same amount of energy to its neighbours as in 2002, but shipments of cotton rose by a third. In other CIS countries, the increased dollar value of imports largely reflected higher prices for crude oil and natural gas.

### (iii) External financing and FDI

#### *Rising capital inflows*

In 2002-2003 there was a marked difference between Russia and the other CIS countries in the

direction and composition of their international financial flows. While Russia strengthened its position as an important net exporter of capital, the other countries increased their dependence on capital imports. The ongoing economic recovery and the progress in macroeconomic stabilization seem to have made the CIS economies (and especially the resource-rich ones) more attractive to foreign investors than was the case some years ago (tables 4.5.4 and 4.5.5). Thus, in 2003 there was a substantial increase in the flow of capital into Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan and Turkmenistan, as well as other CIS countries. In some cases this consisted of inward FDI (mostly going to natural resource sectors), while elsewhere the funds were channelled into the official foreign exchange reserves.

In Russia, despite its real effective appreciation by some 50 per cent between 1999 and 2003, the rouble is still probably undervalued compared with its equilibrium level.<sup>252</sup> The gap between the current market rate and the potential equilibrium exchange rate is mainly a reflection of the strong demand for foreign exchange on the financial

<sup>252</sup> According to one estimate, in the absence of central bank intervention the rouble would strengthen from the present 29 roubles per dollar to approximately 25 roubles per dollar. An updated estimate of E. Gurvich of The Economic Expert Group associated with the Ministry of Finance, as a follow-up to the report in *Izvestia*, 9 December 2003.



TABLE 4.5.5  
Net financial flows by type of capital into CIS economies, 2000-2003  
(Billion dollars)

	Russian Federation				Belarus, Republic of Moldova and Ukraine				Caucasian and central Asian CIS <sup>a</sup>			
	2000	2001	2002	Jan.-Sep.	2000	2001	2002	Jan.-Sep.	2000	2001	2002	Jan.-Sep.
				2003				2003				
Capital and financial account <sup>b</sup> .....	-21.7	-16.2	-11.7	-9.0	-0.6	0.9	-0.6	-0.1	1.2	3.6	2.7	3.3
Capital and financial account <sup>c</sup> .....	-30.8	-25.6	-18.1	-15.7	-0.5	0.7	-1.5	-	0.3	2.8	2.5	2.4
of which:												
FDI .....	-0.5	0.2	-	-0.5	0.8	1.0	1.3	1.0	1.9	3.5	3.7	3.6
Portfolio investment .....	-10.3	-0.7	2.5	-7.8	-	-0.9	-1.8	-0.5	-	-1.3	-1.3	-1.0
Medium-, long-term funds .....	-13.9	-7.6	-0.1	-9.6	-1.5	0.4	0.6	-0.2	-0.6	1.0	0.8	2.0
Short-term funds .....	-7.9	1.1	-1.7	9.6	0.1	0.3	-0.8	-0.4	0.3	0.7	-0.4	-1.3
Errors and omissions .....	-9.2	-9.3	-6.5	-6.7	0.1	-0.2	-0.9	-	-0.8	-0.8	-0.2	-0.9
Capital account .....	11.0	-9.4	-12.4	-0.6	-	-	-	-	-0.3	-0.2	-0.1	-
Short-term investment <sup>d</sup> .....	-27.4	-8.9	-5.7	-5.0	0.1	-0.8	-3.5	-0.9	-0.6	-1.4	-1.9	-3.2

Source: UNECE secretariat estimates, based on national balance of payments statistics.

<sup>a</sup> Includes Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. Aggregates include UNECE secretariat estimates for Tajikistan, Turkmenistan and Uzbekistan.

<sup>b</sup> Excluding errors and omissions and the change in official reserves.

<sup>c</sup> Including errors and omissions, but excluding the change in official reserves.

<sup>d</sup> Includes portfolio investments, short-term funds and errors and omissions.

TABLE 4.5.6  
Selected external financial indicators for the CIS economies, 2001 and 2003  
(Million dollars, per cent)

	Gross debt, national data (million dollars)		Gross debt/exports (per cent) <sup>a</sup>		Gross debt/GDP (per cent)		Official reserves				Net debt relative to gross debt (per cent)	
	2001	2003 <sup>b</sup>	2001	2003 <sup>b</sup>	2001	2003 <sup>b</sup>	Million dollars		Months of imports <sup>a</sup>		2001	2003 <sup>b</sup>
							2001	2003 <sup>b</sup>	2001	2003 <sup>b</sup>		
CIS <sup>c</sup> .....	195 760	220 091	113	94	47	38	43 110	75 772	3.6	4.7	78	66
Armenia <sup>d</sup> .....	906	1 032	141	93	43	38	321	452	3.8	3.3	65	56
Azerbaijan <sup>d</sup> .....	1 267	1 430*	53	38*	22	21*	897	754	4.2	1.6	29	47*
Belarus .....	2 447	3 131	29	26	20	18	391	638	0.5	0.6	84	80
Georgia <sup>e</sup> .....	1 712	1 930	189	152	53	50	159	194	1.4	1.3	91	90
Kazakhstan <sup>f</sup> .....	15 158	21 438	145	136	68	71	1 997	4 270	2.0	3.4	87	80
Kyrgyzstan .....	1 678	1 840	293	285	110	101	264	341	4.9	4.9	84	81
Republic of Moldova <sup>f</sup> .....	1 543	1 695	159	118	104	93	229	284	2.3	1.9	85	83
Russian Federation .....	150 800	165 400	126	103	49	38	32 542	58 330	4.6	5.9	78	65
Tajikistan .....	1 017	1 030*	145	128*	96	69*	93	111	1.2	1.3	91	89*
Turkmenistan .....	..	..	..	..	..	..	..	..	..	..	..	..
Ukraine <sup>e</sup> .....	12 149	14 065	57	48	32	29	2 955	6 499	1.7	2.9	76	54
Uzbekistan <sup>d</sup> .....	4 684	..	143	..	41	..	1 208	1 300*	4.2	5.0	74	..
Memorandum items:												
CIS without Russian Federation <sup>c</sup> .....	44 960	54 691	86	74	43	39	10 568	17 442	2.3	2.8	76	68
Caucasian CIS .....	3 885	4 392	98	71	35	32	1 377	1 400	3.4	1.9	65	68
Central Asian CIS <sup>c</sup> .....	24 937	31 408	140	125	58	54	5 616	8 622	3.4	4.5	77	73
Three European CIS .....	16 139	18 891	53	44	31	27	3 575	7 421	1.4	2.1	78	61

Source: National statistics; IMF, *International Financial Statistics* (Washington, D.C.) and IMF country studies; UNECE secretariat estimates.

<sup>a</sup> Exports of merchandise and services, and factor income receipts. Total imports of merchandise and services, and factor income payments, respectively.

<sup>b</sup> Gross debt at end September 2003.

<sup>c</sup> Totals include UNECE secretariat estimates for Azerbaijan, Tajikistan, Turkmenistan and Uzbekistan.

<sup>d</sup> Government guaranteed debt only.

<sup>e</sup> Gross debt excludes cross-border inter-enterprise arrears.

<sup>f</sup> Gross debt includes cross-border inter-enterprise arrears.

account. In 2003, this segment of the market was affected by a reversal of some types of financial flows, such as portfolio investments, medium- and long-term financial

investments and FDI, of which the net inflows to Russia turned negative (table 4.5.5). The most important investor in foreign exchange in 2003 was the Russian central

TABLE 4.5.7

**Inflows and stocks of foreign direct investment in the CIS economies, 2002-2003**  
(Million dollars, dollars, per cent)

	Inflows				Cumulative net inflows (stocks) <sup>a</sup>			
	Million dollars			Per cent/GDP <sup>b</sup>	Million dollars	Per cent/GDP <sup>b</sup>	Dollars per capita <sup>b</sup>	Per cent of CIS
	2002	Jan.-Sep. 2002	Jan.-Sep. 2003	Jan.-Sep. 2003	Sep. 2003	Sep. 2003	Sep. 2003	average per capita
<b>CIS<sup>c</sup></b> .....	8 957	6 128	7 439	1.8	66 615	16.1	237	100
Armenia .....	111	58	103	5.7	834	46.2	220	92
Azerbaijan .....	1 392	859	2 108	45.7	7 554	163.6	924	389
Belarus .....	247	111	92	0.7	1 706	13.5	172	72
Georgia .....	165	109	222	7.8	1 273	44.7	278	117
Kazakhstan .....	2 583	1 822	1 489	6.9	15 198	70.0	1 023	431
Kyrgyzstan .....	5	2	16	1.2	451	33.3	90	38
Republic of Moldova .....	117	53	35	2.5	786	57.0	217	91
Russian Federation .....	3 442	2 574	2 324	0.7	30 263	9.7	209	88
Tajikistan .....	36	22	15*	1.3*	216*	18.6*	34*	14*
Turkmenistan .....	..	..	..	..	..	..	..	..
Ukraine .....	693	395	935	2.7	6 192	17.7	129	54
Uzbekistan .....	..	..	..	..	..	..	..	..
<i>Memorandum items:</i>								
<b>CIS without Russian</b>								
<b>Federation<sup>c</sup></b> .....	5 515	3 554	5 115	5.1	36 352	36.2	268	113
<b>Caucasian CIS</b> .....	1 668	1 027	2 433	26.2	9 661	104.2	583	246
<b>Central Asian CIS<sup>c</sup></b> .....	2 789	1 969	1 620	3.8	18 007	42.8	314	132
<b>Three European CIS</b> .....	1 057	559	1 061	2.2	8 684	17.7	141	59

*Source:* National balance of payments statistics; IMF, *Balance of Payments Statistics* (Washington, D.C.) and IMF country studies; UNECE secretariat estimates.

<sup>a</sup> Net of residents' investments abroad.

<sup>b</sup> National forecasts of the GDP for the third quarter of 2003 and the population for 2003 are used in the denominator.

<sup>c</sup> Totals include UNECE secretariat estimates for Tajikistan, Turkmenistan and Uzbekistan.

bank, whose reserves increased by \$26.2 billion in the course of the year.<sup>253</sup> Approximately two thirds of the current account surplus was thus absorbed into reserves. The excess private demand for foreign exchange on the financial account was absorbed by an increased supply of foreign short-term funds. Reliance on such funds, however, carries certain risks, as these flows tend to be volatile. In turn, the viability of the manufacturing sector is contingent on fairly rapid progress in raising its productive efficiency.

Official reserves grew in most CIS countries in 2003 (tables 4.5.4 and 4.5.6). While Russian reserves in absolute terms reached a record \$76.9 billion, as a proportion of GDP, reserves were even higher in Kazakhstan and Ukraine. In Ukraine, moderate but declining net private capital exports were complemented in 2003 by a \$2 billion increase in reserves during January-September, thus largely eliminating the pressures for an appreciation of the hryvnia.

Throughout the region, the net outflow of portfolio investment continued in 2003 (table 4.5.5). Except for a few securities in the Russian natural resource sector, local capital markets are still considered too risky by foreign investors. In addition, this reflects the fact that governments of most CIS countries still have no access to international financial markets. The importance of short-term borrowing from abroad has generally been declining, with the exception of Russia. As shown by the indicators of debt and reserves (table 4.5.6), the overall external financial position of the CIS strengthened during 2002-2003, reflecting the achievement of macroeconomic stabilization in most countries.<sup>254</sup> In 2003 there was a reduction of gross debt relative to GDP in most CIS countries and in all of them the debt fell as a proportion of annual exports. As suggested by the experience of the more advanced east European economies, it can be expected that the role of external finance (particularly of FDI) for the economic transformation and restructuring of the CIS economies will grow substantially in the coming years.

#### **FDI absorption is still low**

During the first three quarters of 2003, the intensity of FDI flows to the CIS region remained practically unchanged from the previous two years, at some 1.8 per

<sup>253</sup> While it is clear that in the absence of central bank intervention the rouble would have appreciated even more, there are wildly diverging views as to how much. Theoretically, a sharp appreciation of the exchange rate would have occurred only if both the supply and demand for foreign currency were very inelastic in response to exchange rate changes. This might be the case for Russian exports due to their high content of natural resources (with over 78 per cent of total exports); most of the commodity exports would probably be shipped irrespective of the appreciation. However, demand is usually much more sensitive to changes in the exchange rate and is also rather volatile. Nevertheless, even a mild appreciation of the rouble could be detrimental to the recovery of Russian manufacturing.

<sup>254</sup> Although some of the CIS countries are still heavily indebted and 9 out of 12 countries have ratings for creditworthiness below the median of 150 evaluated countries, there has been a marked improvement in their debt positions since 1999.

TABLE 4.5.8

Outflows of foreign direct investment from CIS economies,  
1990-2003<sup>a</sup>  
(Million dollars)

	Cumulative 1990-2000 <sup>b</sup>	2001	2002	Jan-Sep. 2003	Cumulative 1990-2003 <sup>b</sup>
<b>CIS</b> .....	-14 075	-2 536	-4 036	-3 241	-23 888
Russian Federation .....	-13 955	-2 533	-3 490	-2 787	-22 765
<b>CIS without Russian Federation</b> .....	-118	-4	-545	-454	-1 121
<b>Caucasian CIS</b> .....	-1	0	-330	-557	-887
<b>Central Asian CIS</b> .....	-52	20	-426	116	-343
<b>Three European CIS</b> .....	-66	-23	211	-14	107

**Source:** National balance of payments statistics; IMF, *Balance of Payments Statistics* (Washington, D.C.) and IMF country studies; UNECE secretariat estimates.

<sup>a</sup> Outflows of FDI from the reporting countries. A negative sign indicates a net outflow of capital by national economic residents. A positive sign indicates a net repatriation of such capital.

<sup>b</sup> Assumes no outflow of FDI from the CIS countries other than the Russian Federation during 1990-1992. Totals include UNECE secretariat estimates for Tajikistan, Turkmenistan and Uzbekistan.

cent of the region's aggregate GDP (table 4.5.7). However, the differences in FDI absorption widened further. While all three Caucasian countries improved their position and Azerbaijan attracted FDI amounting to 46 per cent of its GDP, flows to countries such as Belarus, the Republic of Moldova and Turkmenistan, among others, fell both absolutely and as a proportion of GDP. Ukraine received a record FDI inflow in 2003 (appendix table B.17), but in relative terms the inflows remained small and are unlikely to have a significant effect on its economy.

FDI in Russia took an unexpected turn in 2003. Russia's remarkable economic growth in the last five years and expectations of a sustained long-term recovery had aroused hopes for an increase of FDI. However, after reaching \$3.2 billion in the first six months of 2003 expectations of a record inflow did not materialize; in fact the inward FDI flow actually reversed in the second half of the year and for the year as a whole there was an estimated net outflow of \$200 million.<sup>255</sup> This is in addition to Russian direct investments abroad (table 4.5.8), which are expected to exceed \$3.4 billion for the year as a whole.<sup>256</sup> But a more general issue concerns the small FDI stock that the Russian Federation has been able to attract since the start of economic transformation. As a proportion to GDP (less than 9 per cent in 2003), the total FDI stock in Russia is the lowest of all the CIS and east European economies. Various factors appear to have

contributed to this outcome. In general, throughout most of the 1990s, investment in Russia was falling and domestic savings actually exceeded the demand for investment (since the start of transition, Russia has been a net exporter of financial resources). In addition, the Russian authorities have pursued a prudent policy regarding access to the country's natural resources by foreign investors (the main attraction for FDI in other CIS countries). Another possible explanation could be inadequate FDI statistics due to loopholes in the regulations concerning equity registration.<sup>257</sup>

In general, the relatively lower levels of FDI in the majority of CIS countries, especially if compared with the economies of eastern Europe or China, reflect their slower progress in economic reforms. Besides, the distribution of these inflows has been rather uneven, with the overwhelming share going to the natural resource sectors of the economy. Although countries with rich endowments of natural resources may have different development strategies from those without such endowments, the former will not be able to develop a modern economy without active participation in the international division of labour and in isolation from the international markets for a wide range of goods, services, capital and labour. Thus, all the CIS economies need to aim at further economic diversification (for example, into manufacturing industry and services), and the attraction of FDI to sectors other than the natural resource industries could be an important element of their development strategies.

<sup>255</sup> These disinvestments can be mainly attributed to the repayment of existing intra-company loans from abroad, which are among the most volatile components of FDI.

<sup>256</sup> As reported in the balance of payments of the Russian Federation, published in January 2004.

<sup>257</sup> For example, the \$6.75 billion acquisition in 2003 of TNK, Russia's third largest oil producer, by British Petroleum (which was a case of a strategic sale to a direct investor from abroad), has not been registered by the central bank as an inflow of FDI because the actual payment for the equity sale was made to a Cypriot, not a Russian entity. *The MoscowTimes.com*, 12 January 2004 [www.themoscowtimes.com].