

# Russian Economic Report\* – June 2004

## Introduction

Russia is continuing on a path of brisk economic growth, and the best news is that this is not news anymore, as growth rates in excess of 7 percent acquire an air of normality. Estimated first quarter growth in 2004 was 7.4 percent, close to the 7.5 percent observed last year.

However, seven out of eleven of Russia's CIS neighbors are growing at an even brisker pace, and it should also be noted that the price for Russian oil, the country's mainstay export, increased by 20 percent from January through May over the same period last year, averaging USD 28 per barrel. As a simple rule of thumb, growth above 5 percent in Russia has always come with an increase in oil prices; and this association seems to have held in the first quarter this year.

High dependence of Russia's growth on prices for export commodities is undesirable in any case, but even more so in light of the ambitious goals of doubling GDP by 2012 and cutting poverty in half by 2007. Success in achieving these goals would depend on scope and speed of diversification, both away from oil and gas, and deeper into Russia's regions. As this report indicates, high crude oil prices have triggered a multiplier leading to an increased production in other industries, with manufacturing growth outpacing resource industries for the first time since 2001, but there is still insufficient diversification to cushion growth against oil price volatility.

This issue of the Russia Economic Report relates to three types of concern about Russia's current development. The first is, the role played by higher export prices for oil and gas in economic performance, i.e. the extent to which economic activity broadens into sectors outside the key resource export industries, enabling the country to sustain economic development at a rapid pace while becoming less dependent on prices for export commodities, which are determined outside the country. Second, while there is widespread agreement on the reforms necessary to enable sustainable high growth in the future – from financial sector reform and completion of the privatization of land to health, education, and housing reform, re-organization of the state monopolies and public administration reform – much remains to be done for these reforms to be actually im-

plemented. Some observers see emergence of a "reform gap" as implementation lags behind the reform statements. And finally, there are well known issues of governance – not only corporate governance in the narrow sense of how commercial entities are created and run, but governance in the broader sense of drawing clear demarcation lines between the public and private sector, and setting rules for all parties on how to live within them.

The report, as usual, is structured in three parts. The first part, as we have done in the past provides an overview of recent economic developments. Short-run developments look impressive indeed and, more important for the long term, economic activity continues to branch out from the natural resource sectors. In particular investment and manufacturing have broadened substantially, although this appears still driven by spillovers from the resource sector rather than being entirely self-sustained.

The second part addresses the recent restructuring of the Government, which needs to be understood as part of a broader public administration and public service reform. The restructuring in itself is laudable, and the seriousness with which it was undertaken sent the right signal to a bureaucracy with a long history of obstructing change. But implementation risks for reforms on this scale are high, particularly the risk that key components will stall or not yield the expected results. This part of the report points out further steps that are needed to improve the chances of success.

The last section of this report introduces new data on ownership concentration that has become available since the draft Country Economic Memorandum for Russia was presented in April 2004. It is now possible to include data on sales and employment for 2002, enabling us to recalculate some of the performance measures of this study for an additional year (closer to the summer of 2003 to which the ownership data refers), and showing that productivity of large private owners grew faster than that of smaller owners in 2001-2002. The last section introduces these results and discusses related questions.

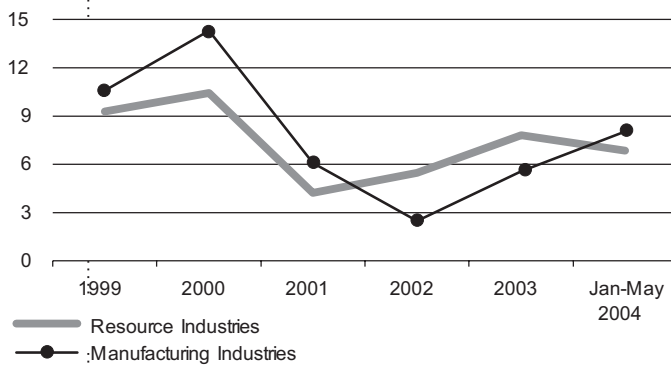
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## I. Recent Economic Developments

The strong output growth of recent years continued into 2004, with first estimates of the Federal Statistical Agency (formerly Goskomstat) suggesting real GDP growth of 7.4 percent in the first quarter, compared to 7.5 percent in the same period of 2003. The price for Russian oil averaged USD 28 per barrel from January through May, almost 20 percent above its level during the same period of 2003. However, growth is clearly spreading beyond the oil & gas sectors, and beyond services. In particular, fixed capital investment continued its strong expansion, growing 12.8 percent from January through May 2004 (compared with 11.9 percent in the same period of 2003).

Macroeconomic policy was well managed, with the CBR keeping effective control over inflation, and the Ministry of Finance again reporting higher-than-expected fiscal surpluses. Higher prices for Russia's main export commodities during the first quarter have also helped to sustain a surplus on the current account (7.2 percent of GDP) although it was lower than in the same period of 2003 (12.7 percent). Improved investor sentiment about Russia and relatively low interest rates abroad resulted in a further reduction of net capital outflows which, in turn, helped to ensure overall sustainability of the balance of payments, and allowed the CBR to continue accumulating foreign exchange reserves. The picture is marred by the ongoing uncertainty over the fate of Yukos, leaving the first visible imprints on financial markets and short term capital flows.

Fig. 1. Growth Rates in Manufacturing and Resource Industries



Source: Goskomstat, WB calculations.

Table 1. Growth Rates in Resource and Manufacturing Industries

	1999	2000	2001	2002	2003	5M-2004
Non-ferrous metals	10.0	15.0	4.9	6.0	6.2	4.2
Ferrous metals	17.0	16.0	-0.2	3.0	8.9	5.9
Fuel and energy	2.4	5.0	6.1	7.0	9.3	8.3
Wood and processing	18.0	13.0	2.6	2.4	1.5	7.0
<b>Weighted average</b>	<b>9.3</b>	<b>10.4</b>	<b>4.2</b>	<b>5.5</b>	<b>7.8</b>	<b>6.8</b>
Electricity	-1.0	1.8	1.6	-0.7	1.0	0.4
Chemical	24.0	15.0	5.0	1.6	4.4	10.0
Machine building	17.0	20.0	7.2	2.0	9.4	14.2
Construction materials	10.0	13.0	5.5	3.0	6.4	9.8
Light industry	12.1	21.0	5.8	-3.4	-2.3	-2.3
Food	4.0	14.0	8.4	6.5	5.1	7.5
<b>Weighted average</b>	<b>10.6</b>	<b>14.3</b>	<b>6.3</b>	<b>2.5</b>	<b>5.6</b>	<b>8.0</b>

Source: Goskomstat, WB staff estimates

### Industrial Production

Strong growth continued in the industrial sector, and it broadened outside the resource sectors. According to latest official data, industrial production grew by 7 percent from January through May 2004, compared to the same period last year. The composition of growth within industrial production was also quite encouraging: if one divides the sub-sectors of industrial production appropriately, aggregate growth in manufacturing exceeded growth in the resource-based industries for the first time since 2001 (Figure 1). The manufacturing sub-sectors grew by 8 percent from January through May 2004 on average, and the resource-based industries reported 6.8 percent growth. Overall, the fastest growing sub-sector of manufacturing was machine building (14.2 percent), followed by chemicals (10 percent growth), and construction materials (9.8 percent). Fuel and energy, which over the last two years had reported the highest growth rates of all sub-sectors of industrial production, now takes fourth place, with 8.3 percent growth (Table 1). Fuel and energy includes oil extraction, which reported 10.4 percent growth over the same period. While this is a sign of a welcome broadening of production outside the core resources industries, coming amidst exceptional world market prices for oil & gas, this shift also indicates that it will become more difficult to sustain high growth in the extractive industries as putting new production on stream becomes more costly. Performance of the extractive industries is also negatively affected by continued weakness in the gas industry where the monopolist, Gazprom, reported growth in gas production of only 3.1 percent (January through May), following 3.2 percent in 2002 and 5.2 percent in 2003, according to the Federal Statistical Agency (FSA, former Goskomstat).

Decomposing growth in manufacturing, machine building (which contributes 19 percent to industrial production) was the fastest growing sub-sector, as in 2003, and was the main contributor to high growth in manufacturing during the first five months of 2004.

In addition, there has been a broadening of growth within machine building. Growth in that sub-sector early last year was uneven and driven by three sub-industries (railways, instrument-making and communications), while some of the others reported negative growth rates. In the first five months of this year all of the 11 published major sub-industries in machine building made advances (Table 2). In this context, it is important to note that the average growth rates reported for machine building appear low compared to the published components because this average includes military production, which is not reported in detail by sector.

Yet this process, by which industrial production recorded the highest growth rates since 2000, seemingly on the back of broadening growth in manufacturing, also should serve as a good reminder of just how important the role of higher crude oil export prices has been in triggering the multiplier, which eventually leads to increased production in other industries. For example, the massive increase in production of railway cars (by more than fifty percent y-o-y in January-May this year and almost that much during the same period last year) is largely the consequence of pressure to circumvent bottlenecks in the state-run pipeline system by using rail facilities on a huge scale to transport oil and gas products.

With seven out of eleven of Russia's neighbors in the CIS growing faster than Russia itself (average growth in the CIS exceeded Russia's growth in each of the last three years), export demand emerged as a second main factor, along with natural resource prices, driving the rapid rise of manufacturing. Export volumes in machine building jumped by almost 27 percent in the first quarter, up from negative growth in 2003, when output growth in that sector was also much lower (Table 3). Exports by the chemical industry (the third largest component of manufacturing with 5.5 percent) also increased significantly. For example, fertilizer exports (the biggest sub-industry in chemicals) grew by 15.9 percent, compared with 8.1 percent growth in 2003 and negative growth in 2002. As in machine building, growth rates in the chemical industry correlate strongly with rates of growth of exports. Most of these exports go to neighboring CIS countries, which continue to grow faster than Rus-

sia, a picture that has not changed since 2001. Further integration of trade within the CIS would therefore appear to be a winning strategy for harnessing overall growth in the region, and seems certain to continue to benefit Russia's manufacturing industries.

Table 2. Growth in Machine Building by Sub-sectors

	Jan-May 2003	Jan-May 2004
Metallurgy	10.6	2.3
Construction Machinery	-6.1	16.3
Railways	47.4	50.7
Electro-technical	7.9	3.0
Chemical and oil machines	-10.3	12.9
Machine tool construction	-14.8	29.3
Instrument-making	10.8	24.7
Car industry	-3.9	14.4
Agricultural machinery	-30.6	15.7
Light and food industry	15.1	31.5
Communications	47.2	56.8

Source: Goskomstat

Table 3. Growth in Major Manufacturing Industries (percent)

	2002	2003	Q1-2004
<b>Machine building</b>			
export growth	-4.0	18.5	26.9
output growth	2.0	9.4	17.5
<b>Chemical</b>			
export growth (fertilizers)	-2.5	8.1	15.9
output growth	1.6	4.4	10.7

Source: Goskomstat

Table 4. Investment and Capacity Utilization, % rates of change

	2000	2001	2002	2003	Q1-2004
Rate of increase of fixed capital investment, %	17.4	8.7	2.6	12.5	13.1
Rate of change of capacity utilization, % (CEA)	7.4	8.8	0.9	4.6	6.9
Rate of change of capacity utilization, % (REB)	7.8	3.8	0.5	4.4	N/A

Source: Goskomstat, Center for Economic Analysis, Russian Economic Barometer

### Investment and Capacity Utilization

Goskomstat's preliminary estimates for investment during the first five months of 2004 offer more good news. Investment grew more impressively than output, with fixed capital formation increasing by 12.8 percent y-o-y in January-May 2004 (compared to 12.5 percent y-o-y in the whole of 2003 and 11.9 percent in January-May 2003; cf. Figure 3). Investment is still driven by the fuel and energy sectors, which attracted about 30 percent of fixed capital investment (18 percent went to oil extraction) in the first quarter of 2004 – the biggest share in the economy by far. However, this share did not increase compared with the last two years.

There is still room for improvement as regards investment levels. Russia's investment share in GDP is about 20 percent, higher than the US (18 percent) or the slow growing European economies, but below the average for middle-income and low-income countries (23 percent in 2002 in both cases), and not outstanding within the CIS (Ukraine has an investment share of 19 percent, Kazakhstan has 27 percent).

The most recent data on capacity utilization together with the recorded rise in investment changed the relationship between investment and capacity utilization over the last two years. Whereas in 2002-2003 investment growth was almost 3 times higher than growth of capacity utilization, this gap narrowed considerably during the first quarter of 2004. Estimated growth in capacity utilization increased to 6.9 percent from 4.6 percent in 2003 and only 0.9 percent in 2002 (Table 4). There is a fruitful interdependence here: higher investment indicates that companies are writing off more worn and outdated equipment, and installing new machinery, which, in turn, has a positive impact on the effective rate of capacity utilization.

### Private Sector Credit

Overall, the financial sector continued to deepen, with M2 growing by 8.4 percent in nominal and 3.5 percent in real terms from January through April 2004. Recent Central Bank (CBR) data confirm that last year witnessed the fastest ever growth of credit to the private sector, the stock of which reached 2.910 billion rubles (USD 99 billion) by the end of 2003. This translates into a 43 percent nominal, and 28 percent real increase compared to end 2002. The maturity structure of credits also improved in 2003: the share of long- and medium-term credits (maturity longer than one year) increased to 30 percent from 25.3 percent at the

end of 2002. The share of long- and medium-term credits denominated in foreign exchange was equal to the share of ruble credits in the total stock of long- and medium-term credit at the end of 2003.

Credit to the private sector continued to grow rapidly in 2004, increasing by 8.4 percent in real and 4.6 percent in nominal terms by the end of March relative to the end of 2003. The share of credits denominated in foreign currency continued to decline, from 36.7 percent of total credits outstanding at the end of 2002 to 33.8 percent at the end of 2003, and further to 32.6 percent at the end of March this year. This decline is partly related to appreciation of the ruble against the US dollar and euro, which increased the relative value of outstanding ruble credits.

Coming from a low base, the increase in consumer credit is even more impressive. During 2003, consumer credit outstanding reached almost 300 billion rubles (USD 10.2 billion), increasing by 90 percent in real terms relative to the end of 2002. This increase brought the share of consumer credit in total credit to 10 percent from 7 percent at the end of 2002 (Figure 2), and there had been further advance to 11.1 percent by the end of March.

### Enterprise Finances

In spite of rapid economic growth in 2003, annual financial data on enterprise performance show much less impressive improvements and continue to convey a rather mixed picture. On the positive side, profitability (ratio of net profit to sales revenues) picked up and averaged 20.7 percent in 2003 after it had dropped to 17.4 percent in 2002, down from 25.6 percent the previous year. However, the share of loss-making enterprises decreased only slightly (to 41.3 percent from 43.4 percent in 2002), and thus remains at a very high level. The data available for the beginning of 2004 continues to paint this seemingly contradictory picture, as average profitability continued to increase while the number of loss-making companies went up as well (to 42.9 percent by the end of March). This growing differentiation within the (measured) old enterprise sector likely indicates ongoing restructuring efforts, as some enterprises increase profitability in the course of restructuring (improving the average) and others fall behind, report losses and evidently stay in business only because of soft budget constraints (mainly public sector support, since inter-enterprise arrears – the other way of staying afloat – have significantly diminished, as discussed below). Improved profitability of the enterprise sector since 2003 is con-



firmed by an improvement in other, more indirect, indicators of financial health. For example, the share of non-cash settlements in total sales shrank to an average of 14.2 percent in 2003, compared to 18 percent in 2002, and 22 percent in 2001 (Fig.4). Continued monetization of the economy during the first quarter of 2004 positively influenced the extent of non-cash transactions, which dropped to 11 percent. Improved liquidity also helped to deal with inter-enterprise arrears. Their stock fell by 127 billion rubles in 2003, and by another 100 billion in just two months of 2004 (Fig. 5).

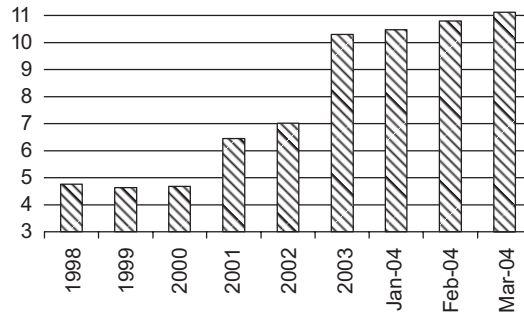
## Financial Markets Development

Financial markets are experiencing volatility in the wake of shifts in international interest rate expectations and due to the uncertainty, which hangs over Yukos. The increase of private sector debt in Russia was partly due to low international interest rates and to Russian funds flowing back into the country. In addition, many Russian blue chips tried to raise as much money as possible on the Eurobond market, taking advantage of last year's temporary reallocation of global financial resources toward emerging markets and declining short-term risks due to exceptionally high prices for Russia's major export commodities. This resulted in the biggest placement of new Eurobonds issues ever recorded in one year – about USD 9 billion, bringing the stock of outstanding Eurobond issues to more than USD 12.5 billion by the end of 2003 (an increase of 132 percent over 2002).

Other markets also benefited from capital repatriation, high commodity prices, and low opportunity costs internationally: (1) the domestic bond market registered even higher growth than the Eurobond market, with the stock of outstanding corporate bonds increasing by almost 170 percent in 2003 to about USD 5 billion by year-end; (2) the stock market (RTS index) rose by 60 percent in 2003 (although its most recent developments have underlined the risks of capital markets that are shallow and highly concentrated at the same time); (3) the real estate market, especially in big cities, was booming in 2003. According to unofficial estimates, real estate prices in Moscow increased by over 40 percent. Judging by visible inflows from off-shore centers, soaring demand for both financial and real estate assets in 2003 continues to receive substantial support from Russian capital coming home.

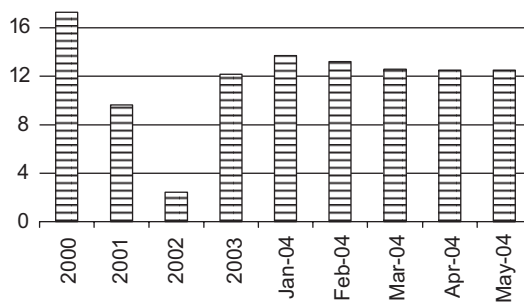
However, developments in the first six months of this year also demonstrated the inherent fragility

Fig. 2. Share of Consumer Credits, %



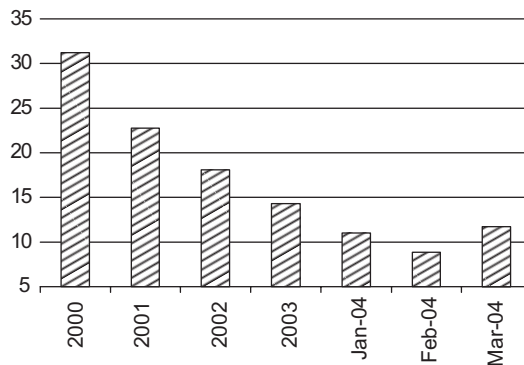
Source: CBR.

Fig. 3. Capital investments, % to previous



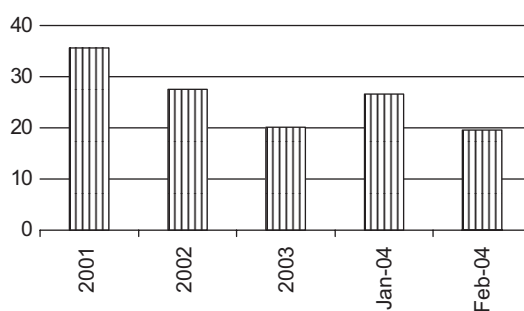
Source: Goskomstat.

Fig. 4. Non-cash Settlement as % of Total Sales



Source: Goskomstat.

Fig. 5. Stock of Overdue Payable, % of Annual Sales



Source: Goskomstat.

of Russia's financial markets in the course of a bungled CBR operation to withdraw the license of a medium-sized bank (although it is laudable that the CBR moved decisively, for the first time since installation of a new management team, against an institution accused of violating the rules), the ongoing uncertainty over the fate of Yukos, and the more cautious international interest rate environment. Nevertheless, given continuous support from long-term commodity price trends, such incidents appear minor and resolvable by improved economic management.

### Monetary Policy, Inflation and Exchange Rates

So far, monetary policy has kept consumer prices in line with the target of 10 percent set for 2004. In January-May consumer prices rose by 5.4 percent. This implies that, for the inflation target to be met, consumer prices should not increase by more than 4.3 percent in the remainder of the year. Although the Government and CBR are confident that they will be able to keep inflation within the target range, many market participants are not.

A recent shift in priorities of the Central Bank has special significance for monetary policy. In the past, the CBR was mainly dedicated to an inflation target, but today it increasingly refers to the real effective exchange rate as another policy target, and has set a 7 percent ceiling for appreciation of the real effective exchange rate in 2004. Given the CBR's extremely limited set of instruments to conduct monetary policy (for the most part it is still confined to forex trades), future exchange rate management is likely to remain trapped between the desire to limit money supply growth to keep inflation under control and huge foreign currency inflows which could result in an inability to hold back ruble growth against the dollar at a time of very high export prices.

Short-term expectations on the domestic forex market were affected by the CBR declaration in April of a new policy, by which it will no longer focus on the bilateral exchange rate between the ruble and the US dollar but an *exchange rate index* based on the two bilateral exchange rates between the ruble and the US dollar and the ruble and the euro. The dollar appreciated by 1.8 percent against the ruble from April through May, which helped to limit the ruble's real appreciation against the dollar to 5.5 percent from January through May 2004. Russia, however, is a "price taker" for the dollar/euro exchange rate, which increases vulnerability of its exchange rate targets to external factors. Thus, from January through

May of this year, the ruble appreciated 4 percent against the euro in nominal terms and 8.3 percent in real terms, leading to appreciation of the real effective ruble exchange rate by more than 6 percent during the first five months of the year. If the US dollar had continued to depreciate against the euro – an expectation widely held in the market (and perhaps not only there) – the Central Bank's goal of keeping real appreciation below 7 percent would have been easy to achieve.

On balance, it appears questionable whether the 10 percent inflation target and the 7 percent appreciation target can be met simultaneously, without a substantial overhaul of policy instruments and reforms designed to deepen the financial sector and to improve its institutions, to enable more effective fine tuning.

### External Debt

High oil prices and prudent macroeconomic management, on one hand, and low international interest rates, on the other, have had a noticeable impact on the dynamics of Russia's external debt. According to CBR estimates, the stock of Russia's total debt to non-residents increased considerably from USD 153 billion at the end of 2002 to over USD 182 billion at the end of 2003. Almost all of this increase occurred, however, in the private sector with banks increasing their debt by USD 10.6 billion and non-financial enterprises by USD 16.5 billion. By contrast, external debt of the Russian government (including the monetary authorities) increased by only USD 1.8 billion, and this was mostly due to revaluation of the debt stock to reflect appreciation of the euro against the US dollar.

### Trade and Balance of Payments

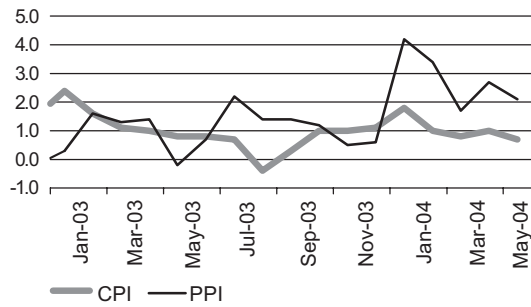
In 2004, Russia's Balance of Payments continued to be driven by higher prices for its main export commodities. According to preliminary estimates for the first quarter, the current account totaled USD 11 billion, compared to USD 11.6 billion for the same period last year. Exports and imports continued to grow rapidly in 2004, following rises of 25 and 23 percent, respectively, in 2003. Imports have grown faster so far this year, unlike last year. Average monthly imports increased to USD 6.4 billion (or by 21.3 percent) in the first quarter, and average monthly exports rose to USD 12.4 billion (or by 19.9 percent). The trade surplus continued to be a function of international prices for hydrocarbons, with export dynamics mirroring oil and gas price development (Figure 8).

At USD 0.2 billion, recorded net capital outflows remained at a very low level during the first quarter (by previous Russian standards). The resulting excess supply of US dollars was partially sterilized by a high fiscal surplus and the rapidly swelling stabilization fund (which had grown to USD 6.9 billion by mid-May), but still led to nominal ruble appreciation of 1.5 percent against the dollar from January through May and accelerated accumulation of foreign exchange reserves. Reserves reached a record level of USD 86.3 billion by the end of February (up from USD 77 billion at the end of 2003), and stood at USD 85.6 billion at the end of May.

Although perception of reduced risk, together with improvements in the overall investment climate, have helped to reduce net capital outflows, and thus to sustain the short-run viability of the Balance of Payments, the medium- and especially the long-term vulnerability of Russia's Balance of Payment still gives cause for concern. This holds true to the extent that the current reduction in net capital outflows is driven primarily by external factors, such as hydrocarbon prices and record lows for interest rates in developed economies, rather than by changes in Russia's fundamentals. In addition, the medium- and long-term risks of investing in Russia's real sector continue to be perceived as relatively high, as reflected in the still modest inflows of foreign direct investment. According to preliminary estimates of the Federal Statistical Agency, FDI was USD 1.5 billion in the first quarter of 2004, an increase of 43 percent compared to 2003. Although this increase is substantial, total FDI inflows for the year would still only be around USD 9 or 10 billion, if the growth continues at the same rate. That is equivalent to about USD 65 per year per capita, compared, for example, to USD 200 per capita in Hungary. However, FDI is likely to be underestimated because many offshore transactions cannot be properly recorded (e.g. the BP-TNK deal did not show up in the 2003 FDI statistics for this reason).

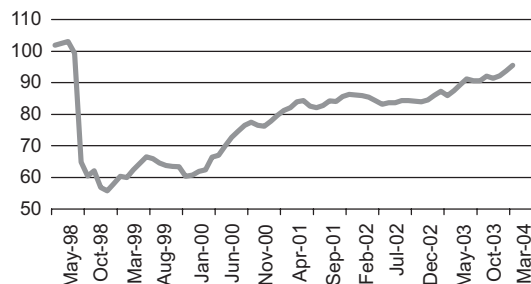
Another indication of enduring long-term risk is "capital flight" or illegal capital outflows, most of which represent non-repatriated export proceeds and uncovered import advances, recorded by the CBR in the Balance of Payment statistics as a separate account. Unlike capital flows, capital flight is likely to reflect judgment on the longer term investment climate, and risk perception. In our estimate, based on CBR Balance of Payment statistics (Table 5), capital flight, unlike net capital outflows, has remained at a relatively high level - in the range of USD 3.5 to 5 billion in the first

Fig. 6. CPI and PPI monthly inflation, %



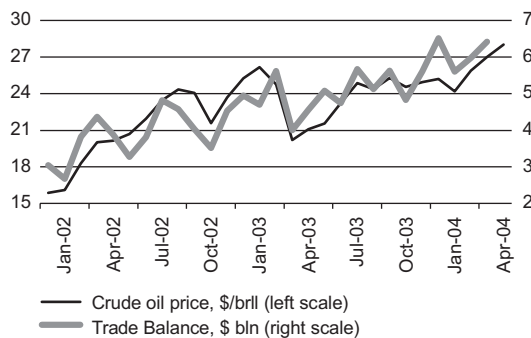
Source: Goskomstat.

Fig. 7. Real Effective Exchange Rate, 1997 = 100



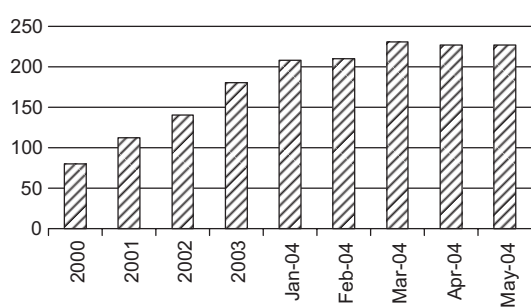
Source: IMF.

Fig. 8. Oil Prices and Trade Balance



Source: Goskomstat.

Fig. 9. Average wage, USD per month



Source: Goskomstat, WB estimates.

quarter of each year since 1999 – and there is no clear indication that it has diminished in 2004.

The situation is further complicated by liberalization of foreign currency regulations, effective June 18, 2004. According to new regulations, the upper ceiling for obligatory sales of export proceeds cannot exceed 30 percent and the CBR already decided on a 25 percent requirement, to be effective in June.

At the same time, however, the law allows the Central Bank to introduce special reserve requirements, according to which economic agents involved in certain foreign currency transactions will have to deposit a specified amount of foreign currency with the CBR. The CBR hopes that these reserves, which would then be surrendered on a “temporary” basis (up to two years), will reduce the vulnerability of the capital account and hence of the Balance of Payments. While the first measure facilitates liberalization of the forex regime, the second would, at least potentially, impose considerable restrictions.

#### Fiscal policy and the budget

Exceptionally high world oil prices once again resulted in higher-than-planned revenues to the Federal Budget. Preliminary estimates suggest that the Federal Budget in Q1-2004 was executed with a sizeable surplus of 127 billion rubles, or 3.6 percent of GDP (compared to a deficit of 43 billion rubles written into the budget law for the first quarter of 2004). The revenue-to-GDP ratio substantially exceeded the target, reaching 19.8 percent in Q1-2004 compared with 17.9 percent stipulated in the budget law. A part of the surplus was due to relatively slow utilization of allocated expenditures by recipients – 562 billion rubles compared to 682 billion assumed for the first quarter in the 2004 budget law.

The higher-than-expected oil exports, which boosted budget revenues, allowed the govern-

ment to rapidly accumulate resources in the newly established stabilization fund. The fund expanded from 106.3 billion rubles at the end of 2003 to 199 billion rubles by mid-May. The MoF expects that it will grow further to 280 billion rubles by the end of 2004 and will reach 500 billion rubles by mid-2005. According to the Budget Code, when the fund reaches that ceiling the government (with parliamentary approval) will be allowed to use any extra resources for expenditure financing. In fact, the MoF has already announced that it will spend 81 billion rubles from the stabilization fund in 2005 for transfers to the Pension Fund, which will be running a deficit next year, and that it may use some of the excess funds for debt retirement.

The stabilization fund has started to smooth budget expenditures over time, and it can play a major macroeconomic role by sterilizing foreign currency inflows. It therefore remains important to continue and even extend the policy of channeling oil windfalls to this fund, in order to prevent growth of non-interest expenditures as a share of GDP.

#### Income, Labor Market Indicators and Poverty

Dollar wages continued to grow rapidly, averaging USD 220 a month in January-May 2004 (Figure 9), which is USD 62 (or 39 percent) higher than in the same period of 2003 (with real ruble appreciation against the dollar accounting for 20 percentage points). Unemployment (ILO definition) has not changed much since the end of 2003, averaging 8.1 percent in January-May 2004, which is roughly the same as the level reported for Q4-2003.

Although poverty statistics for the beginning of 2004 are not yet available, the dynamics of real wages and disposable income, which grew respectively by 14.4 and 9.9 percent y-o-y in January-May, suggest further reduction in the level of income-related poverty in Russia. The reduction has so far been primarily driven by positive trends in earnings. In general, recovery since 1999 has been particularly favorable for the poor, because the increase in consumption has been greatest for the poorest groups of society. However, non-income aspects of poverty, particularly relative deprivation of quality healthcare and education, are becoming more acute. The World Bank is close to completing a Poverty Assessment for Russia, which addresses three broad areas: the nature of poverty in Russia, linkages between growth and poverty, and improving sectoral policies for greater poverty reduction. A section in the next issue of the RER will present the findings of this report in more detail.

Table 5. Net Capital Outflows vs. Capital Flight

	Q1-2000	Q1-2001	Q1-2002	Q1-2003	Q1-2004
Net capital outflows, USD bln.	6.3	7.0	3.2	0.4	0.2
<b>% of current account</b>	<b>54.3</b>	<b>59.8</b>	<b>50.0</b>	<b>3.4</b>	<b>1.8</b>
Capital flight, USD bln.*	3.3	4.1	3.6	5.0	3.5
<b>% of current account</b>	<b>28.4</b>	<b>35.0</b>	<b>56.6</b>	<b>43.1</b>	<b>31.8</b>

\* Defined as non repatriated export proceeds and uncovered import advances + E&O\*.

Source: CBR, WB staff calculations



## II. Government Restructuring and Public Administration Reform<sup>1</sup>

*One proposition on which everyone can agree is that Russia needs a much more effective public administration, and that public administration reform is essential for generating a rapidly growing private sector and enabling Russia to compete globally. The unstructured civil service has become one of the major obstacles to the implementation of an increasingly ambitious structural reform agenda. The World Bank, like so many others, has long emphasized the urgency of accelerating administrative and civil service reforms. The need for such reform is evident from benchmarking Russia's civil service not only against civil services in G7 countries. Finally, in March 2004, the authorities announced – and immediately moved to implement – a blueprint for restructuring the Federal Government, which was far more radical than commentators or most public officials had been expecting. Unsurprisingly, given the scale of change, large parts of the Government effectively ceased to operate during the first weeks of implementation. Most observers were of two minds concerning these opening steps, unsure whether the new structure will ever operate more efficiently than the old one, and also whether restructuring the Government meant that the harder and more significant task of reforming the entire underlying civil service has been put off to an indefinite date. The following discusses these questions and in particular what remains to be done to put in place a modern public administration, which can support instead of hindering Russia's ambitious agenda for accelerating growth and reducing poverty.*

To start with a straight proposition, we believe that, overall, the current restructuring of the Federal Government is a major step in the right direction. All earlier reform efforts (over the last 12 years) have been comprehensively blocked by the bureaucracy they were meant to reform. Hence the radical nature of the recent restructuring, which is a positive development on balance because it sends the right signal to public servants, warning that serious reforms are now inevitable. However, the restructuring now under way carries certain risks. There appear to be a number of different and sometimes contradictory views on the objectives of restructuring the Federal Government. Some take a more "traditionalist" view, seeing the objectives as a strong and effective state, with strengthened top-down control and restored internal discipline, arguing that key structural and social reforms cannot be implemented without this. Others in the Federal Government,

from a more "reformist" angle, share the objective of getting reforms implemented, but believe that effectiveness, responsibility, and accountability of Ministers is best enhanced by an incentive-based approach. This group also emphasizes the need to reduce opportunities for corruption through eliminating conflicts of interest embedded in the old Government structure. In order for administrative reform to be implemented effectively, the latter view needs to prevail.

### How is it supposed to work?

The number of different types of government bodies has been reduced from 6 to 3: Ministries, Services, and Agencies. The number of Ministries has been reduced from 23 to 15 (of which 5 report to the President and 10 to the Prime Minister). The number of Deputy Prime Ministers has been reduced from 6 to 1; and the size of the Cabinet of Ministers has been reduced from 31 to 18 members (closer to the prevailing 12-15 members in OECD countries). However, the overall number of Government bodies has increased, from 57 to 72. Apart from a number of key regulatory bodies, such as the Federal Financial Markets Supervision Service and the Federal Antimonopoly Service, which report to the Prime Minister, all Services and Agencies are subordinated to a specific Ministry.

How this works in practice will only become clear once detailed mandates for the new bodies have been approved. But the intention motivating the differentiation of roles between Ministries, Services and Agencies is as follows:

1. Ministries are responsible for delivery of Government Program objectives, which fall within their competence. The job of Ministries is to "set the rules", undertaking policy analysis, development, monitoring and evaluation, as well as legislative drafting. Ministries are now to be the prime (if not the only) source of legislative initiatives.
2. Services are responsible for "enforcing the rules" through supervision and regulatory activities. The prime client for Services is the state, and their funding should come primarily from the state budget.
3. Agencies are responsible for "implementing the rules" through service delivery, and management of state property. The clients for Agencies include the private sector and citizens, and their

<sup>1</sup> Further information on the subject of public administration reform is available at [www.worldbank.org.ru](http://www.worldbank.org.ru).

funding could come both from the state budget and from user fees and charges.

Each year the relevant Minister (or the Prime Minister) is supposed to agree with the heads of Services and Agencies under his supervision on their goals and on performance indicators for the coming year, as well as on their budget bid. The Ministry will then submit a budget bid for itself and all subordinated bodies for approval by the Ministry of Finance. In the course of the year thereafter, a Minister should not challenge or over-rule decisions taken by heads of Services or Agencies, unless they violate legislation.

To strengthen performance orientation and internal accountability within Ministries (which all report to the Prime Minister), the number of Deputy Minister positions in each Ministry has been reduced from 16-18 to 2. In the 10 Ministries concerned, this has meant an overall reduction in the number of Deputy Ministers from around 240 to 20. Simultaneously, Moscow-based staff of these Ministries have been reduced by 20 percent. This made it possible to finance pay increases on an increasing scale, with up to 500 percent for Ministers, Heads of Department, Deputy Ministers, and other government employees. The "apparat" (organizational staff) of the Government has also been restructured, with the aim of gradually turning it into the Government's secretariat, instead of its current role as a parallel government. The Administration of the President has been restructured along similar lines, with some areas of duplication of functions with the Government eliminated.

**What is the main risk to the reforms ?**

This new structure is indeed in line with international practice. But it also is a very radical and risky reform, which will be extremely difficult to operate, particularly since it was launched with no advance consultation or communication. Even inside the system, most participants do not fully understand how it is all supposed to work in the future. Shifting boxes in structure charts – no matter how radically – does not by itself change the behavior of individual civil servants and institutions. There have to be new incentive and accountability systems, and procedures for translating government restructuring into real administrative reform in order to achieve real improvement in performance of the civil service.

The major elements of the new performance management system are presented in Chart 1 below, and the most important required reform actions are discussed in the following section.

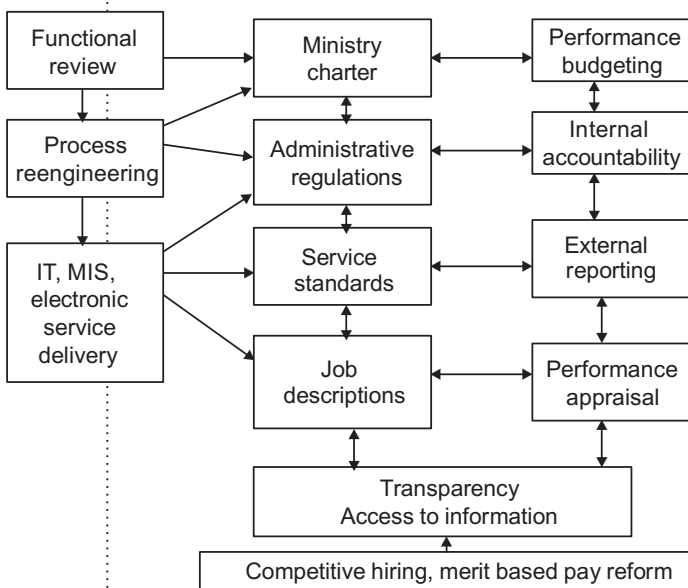
**What needs to be done to make it work?**

First, the process of **aligning structures and functions of the Government with its key policy objectives and priorities needs to be completed**. This will involve implementing a program of functional reviews at the level of Ministries, Services and Agencies. These reviews will help to identify functions and services that can be: **(i)** set up as state-owned enterprises; **(ii)** privatized; **(iii)** decentralized to regions or municipalities; **(iv)** transferred to self-regulating bodies; **(v)** identified for outsourcing or for market testing through external tendering; **(vi)** set up as non-profit organizations, or as public/private partnerships; or **(vii)** simply eliminated.

Second, **restructuring of the Government's "apparat" needs to be completed** to strengthen capacity for policy management. This includes elimination of all branch and sectoral departments, and conversion of the "Apparat" into the Secretariat of the Government, to which individual Ministries would be accountable for their performance in delivering the Government's work program and policy objectives.

Third, **incentives, ethics and values of public servants require further attention**. Stronger incentives for good performance should be put in place through a mixture of continuing radical pay reform (particularly for government experts and deputy heads of department), providing performance-based pay incentives, focusing attention

**Chart 1. The heart of the reform: Developing systems and procedures for managing Government performance**



on new ethics codes with appropriate sanctions, and enforcing strict control over potential conflicts of interest.

Fourth, **these measures need to be complemented by strengthening transparency, external accountability, and external participation.** Freedom of information needs to be established with robust processes for providing access to information. Once service standards have been developed, external accountability can be further strengthened through monitoring of actual performance against the standards, and the publication and dissemination to stakeholders of performance reports. Opportunities need to be identified for giving service users and stakeholders greater participation in decisions on services affecting them directly.

Last, but certainly not least, **adequate budget resources need to be allocated to support the effective implementation and functioning of the new structures and systems.** If this reform is under-funded, its success will be seriously jeopardized. The Government needs to consider creating a three- to five-year federal program to cover the costs of implementing administrative and civil service reforms, the permanent costs of which might be as high as one percent of GDP per year to fund the required pay increases and retraining. In addition, each Ministry, Service or Agency will need funding for one-off, IT-related modernization, training, development of e-government, building mechanisms of external consultation and control, and other required upgrades. This might require investment of around USD 750 million for Federal Government alone, plus investment of around USD 900 million by the 89 subjects (administrative regions) of the Russian Federation, and initial investment of around USD 250 million by the Federal center for development of the new system of municipal self-governance, bringing the total investment need for reform to somewhere around USD 2 billion. Such levels of investment may sound high, but under-financing greatly increases risk that the reform effort will fail.

### III. Ownership Concentration, Once Again

*Although it is recognized as an important characteristic of Russia's economy, and therefore as an issue worth serious discussion, relatively little is known of the actual extent of ownership concentration in Russia, and much less of its economic consequences. Furthermore, the topic has*

*become so politicized that economic arguments risk becoming tainted and embroiled in a debate that is not motivated by economic questions. Unsurprisingly therefore, when the World Bank in April published a draft study on the structure of Russia's economy that contained one chapter on ownership concentration and its role for Russia's economic development, it triggered a set of heterogeneous comments. Most were positive and many offered good, constructive criticism, concentrating on the methodology, or on technical aspects. A few, however, suggested that a discussion of ownership concentration is not appropriate in today's political climate, and some went further by suggesting that the publication itself was part of a political agenda, i.e. of the desire to restrict the power of "the oligarchs".<sup>2</sup>*

*By now, the draft report has been amended to incorporate new data that has become available since it first became public. There are two types of new data. The new version incorporates additional information on the extent of control over Russian firms by the group of big owners identified in the first report, which was generously provided to the World Bank by the team of scholars of the Foundation for Perspective Research and Initiatives. On the other hand, the coverage of the assembled data set has been widened, because it is now possible to add newly available sales, employment and investment figures for 2002 to the previously used figures for 2001, making the analysis more consistent with ownership data referring to summer of 2003. Thus we can extend (and replicate) the analysis by one year. Further extensions will be carried out when the data for 2003 becomes available.*

*The following provides a summary of the new findings and briefly discusses their significance. It goes without saying that we continue to believe that the debate sparked by making the draft report available in public is an important one for economic development in Russia. It is too important, in fact, to be left to those pursuing their own political agenda, or to the ideologues on either side of the issue. We hope to help to "normalize" the discussion, allowing it to be held as a debate of figures and economics, and not one of myths and politics. To curtail this discussion would in fact not only mean to delay such normalization. It also cannot be in the interest of anyone who wants to find the best path for economic reform and development in Russia.*

<sup>2</sup> Chapter 5 of the draft Country Economic Memorandum for the Russian Federation "Transition Meets Development" at [www.worldbank.org.ru](http://www.worldbank.org.ru). The final report discussed above is to be published at the same website.

## Recap

The earlier draft report collected data from the largest enterprises across all major sectors of Russia's economy, and tried to trace the pyramidal structures that establish who ultimately controls them. The background was an economy in which much consolidation across firms still remains to be done: Russia's firms are fragmented by international standards, despite the fact that many more employees in Russia work at large industrial plants than in other countries. This is primarily a legacy of the method employed in mass privatization: since individual enterprises (industrial plants, retail outlets, etc. – what we referred to in the report as “establishments”) were commonly privatized to insiders, each one of them tended to be converted into a single firm (i.e. one legal entity). Secondary markets for trading ownership rights across firms were slow to develop and could therefore not facilitate mergers, acquisitions, and sundry forms of takeover to the extent required to correct this initial fragmentation. Under these circumstances, further consolidation appears beneficial to the acceleration of restructuring of the (often oversized) inherited enterprises. Large owners commanding major investment resources are one obvious source of consolidation.

Economic theory would agree that concentration of ownership *on the firm level* (i.e. a dominant owner in each firm) tends to be beneficial for overall economic efficiency. By unifying control and cash flow rights, it enables efficient decisions in running complex organizations. However, economic theory also suggests that – highly relevant for Russia – there are technological and market reasons why ownership concentration in some sectors should be higher than in others. If there are economies to scale that make production in a few large units more efficient than in many smaller ones, or if there are huge markets with high fixed and/or transaction costs that make competition by large units more effective than by smaller ones, the respective sectors will, everything else equal (in particular equal concentration within the firm), be dominated by fewer units and will therefore show higher ownership concentration. The car industry or oil and gas production are cases in point: it makes no sense to assemble cars in somebody's backyard, and so the market for cars is likely to be dominated by a few large players. Similar arguments apply in the case of export-oriented companies that have to compete on global markets.

But then there is the question whether other reasons for high concentration exist, i.e. reasons that have nothing to do with technology, market size, or economic efficiency. Ownership in many countries is so concentrated that a few parties hold ownership rights that are significant on a *national level*. Typically, this characterizes economies known for underdeveloped market institutions and weak legal systems. Under these circumstances, owners may reap benefits from size that have nothing to do with economies of scale, technology or high fixed costs. A few owners receive preferential treatment because their size and power enables them to collude, perhaps with each other, but certainly with state officials who are empowered to make decisions that affect the operating environment of a large company.

Although there is a shortage of reliable and easily accessible information on ownership concentration across the Russian economy, few doubt the existence of a group of large owners with national significance in Russia. Some argue that they are “good” because they restructure their respective industries and some argue that they are “bad” because they use politics to further their business and milk the state for preferential treatment, living from ill-gotten gains at the expense of their competitors and therefore, ultimately, at the expense of the consumer and to the detriment of an efficient economic system.

## First results

The data set publicized by the World Bank helped to shed at least some light on these issues. Concretely, it was used to ask three particular questions. First, is there a group of nationally significant private owners? Second, if yes, what can be said about the economic performance of their firms, relative to those of other categories of owners? And third, what degree of preferential treatment, if any, do they receive, and what are the consequences for their competitors and the rest of the economy?

The draft report provided answers that were relatively straightforward. First, using reasonable criteria, it identified a group of large owners with national significance. The holdings of these large owners are highly sector specific, being concentrated in natural resources and manufacturing sectors that are comprised of large companies. Within these sectors, large owners control firms of above average size. Second, the report claimed that the data (a) reveals no evidence supporting



the claim that, if adjusted for size and sector, the firms of large owners were more productive than those of other private owners, although **(b)** firms of all private owners – large, small, domestic and foreign – outperformed state-owned companies in any of the measured dimensions, i.e. by sales growth, productivity levels, and by productivity growth, and **(c)** firms of large private owners (and those with foreign owners) had much higher rates of investment, but as soon as energy was taken out of the sample, these investment rates became similar to those of other private owners. And third, if measured by preferential treatment as reflected in regional legislative acts over the last few years, large and smaller private owners both received less preferential treatment than either foreigners or state-owned (regional or federal) firms, but, when preferential treatment was granted to large private owners, the data strongly indicated that these owners were better at taking advantage of such preferences than other owner categories, and did so at the expense of regional competitors, and hence to the detriment of local markets.

As has been mentioned, there were a few technical, and unavoidable, problems with the data set. One point, which has been ill-understood in the public debate, is that our sample was not designed to collect all consolidated holdings of the group of largest owners. Instead, it proceeded from the “bottom up”, tracing control over the largest production units in the economy. As a result, it missed, for example, some of the trading companies that were used by many larger groups as profit centers to minimize tax payments (by means of transfer pricing). This is of course particularly relevant in the oil and gas industry. We had an opportunity to check on these aspects of our sample by cooperating with the Foundation for Perspective Studies and Initiatives, which published a compendium of corporate statistics for the biggest Russian business groups earlier this year.<sup>3</sup> The detailed outcomes will be reported in the final version of the CEM, but the bottom-line is that these adjustments in the data set changed a few rankings but did not result in major changes in the composition of the group. Similarly, data published by Expert magazine, Forbes, etc., mainly coincide with the information in the draft report, though it was assembled using different criteria.

Validity of the ownership data therefore seems to be in little doubt, and they are also fairly up to date, referring to Summer 2003. However, the available data for sales, investment and employment were

from 2001. Performance measures therefore had to rely on sales and employment data from that year, and to assume that changes in control between 2001 and 2003 had been minor. A major advance has been possible in this respect: the 2002 data are now available, so the same key questions can be addressed on the basis of more recent data.<sup>4</sup>

### An update

What changed? Recalculation of the performance criteria, and the new sales data, do not affect the overall conclusion as to the existence of a group of nationally significant owners who control 42 percent of employment and 39 percent of sales in our sample (and a minimum of 11.3 percent of employment and 30.8 percent of sales in all of industry). Large owners are still most prevalent in sectors dominated by large companies, including natural resources.

However, the new data show that total factor productivity grew fastest between 2001 and 2002 in firms controlled by foreigners and in firms controlled by the group of largest private owners, which both outperformed other private owners, as well as government-owned firms. Although productivity growth in the firms of other private owners continues to outperform government-owned firms (whether owned by regional or federal Government), this result ceased to be statistically significant. There is still no statistically significant difference in productivity levels between the different private Russian owners.

There is no reason to expect the new data to imply changes with regard to the third question raised above, i.e. preferential treatment and its consequences. In fact, data points from two years are insufficient to judge what caused the improvement in productivity growth of large private owners, and in particular whether it was due to effective restructuring, previous high investment rates, or to the acquisition of firms with the highest growth potential (e.g. firms benefiting from the surge in raw material prices during the period under consideration). But even these improvements had not made companies controlled by large owners more productive than those controlled by other private owners (with due correction for size and sector) by 2002.

<sup>3</sup> Krupnyj Rossiskij Bizness-2003. Foundation for Perspective Studies and Initiatives, 2003.

<sup>4</sup> These data were used for re-running the regressions in chapter 5 of the draft CEM and will be discussed in the update. The results discussed here also draw on a CEM background paper by S. Guriev and A. Rachinsky, “Oligarchs: the past or the future of Russian capitalism?” (mimeo, New Economic School, Moscow).

The fact that relatively fast productivity growth has still not made large owners more productive than smaller owners is indirect evidence that large owners were indeed worse (and not only “not better”, as the draft report cautiously stated) off, at least in terms of productivity measurement in 2001. The main pending question then becomes whether large owners have continued to outperform other owners in terms of productivity growth after 2002, which would bring their productivity to levels closer and eventually above those of other private owners. This will require further study using data of subsequent years.

The recalculations also confirm some basic findings about ownership concentration in Russia's economy. First, international comparison (so far as it is possible) confirms that Russia is one of the most concentrated economies in the world, if not the most concentrated.<sup>5</sup>

Second, ownership concentration in Russia remains highly sector specific. This holds not only for the largest owners that are in control of large industrial and raw material sectors, but also for government (energy transport, a few non-privatized resources such as gas, jewelry, or rubber), where federal and regional ownership seems to coincide in a few sectors, and for foreigners, who tend to control production of final consumption goods (soft drinks, tobacco), i.e. sectors where relatively small capital and technology transfers can generate huge quality improvements and where brand names are important. Overall, ownership in Russia's economy has not yet gone through the sort of “remixing”, which would have eliminated the most obvious traces of the transition from state to private ownership.

ship concentration in small firms may help to explain their productivity, in which case it seems churlish to argue that such concentration is against the original aims of mass privatization. The data indicate that, although effective secondary markets (or other mechanisms) for broad-based trading of ownership rights between firms have not yet developed, ownership *within* firms has been consolidated quite effectively. One way or another, a few owners acquired large stakes from others within firms by amassing the vouchers, which were distributed to managers and workers in the so-called “mass privatization” of the early 1990s. This may also go a long way towards explaining the disdain for privatization, which so many polls have reported among the Russian general public.

Where does this leave us? The data seem to indicate that high concentration of ownership rights is just as much of a double-edged sword in Russia as it is in other countries. There is evidence that large as well as small private owners have higher levels of productivity than state-owned firms, and that large owners find it easier to increase productivity further because they have better access to investment resources and, presumably, because they populate sectors with high growth potential, e.g. those that benefited most from the recent surge in natural resource prices. While Russia's industry remains in need of consolidation, markets on which ownership rights can be traded (and the financial sector in general) remain underdeveloped. A class of smaller owners has come into existence, but the broad distribution of property rights envisaged early on in the privatization process has been subverted. The most important source for broadening private ownership will therefore be creation of new firms, rather than redistribution of old ones.

Contrary to some misinterpretations of the draft report findings, the straightforward implications of this analysis are as follows:

Nothing in the data provides an argument for renationalization in any shape or form, no matter how the current ownership rights were established. There also appears no reason for the arbitrary splitting up or bankrupting of commercial companies. Instead, the potential “dark side” of large owners, i.e. their ability to obtain unfair advantages by co-opting state authorities or by colluding with each other, needs to be addressed in Russia, like anywhere else in the world, by establishing clear rules for competition policies designed

This supports the suspicion that secondary markets for ownership rights are not yet efficient enough to drive further consolidation.

The data indicate very strong ownership concentration within firms, across all categories of private owners: large owners in our sample control 79 percent of their firms, while other private owners control 74 percent. The high owner-

<sup>5</sup> One way of drawing such comparisons is to focus on available comparisons of the share of the national stock market controlled by the 10 largest owners or their families. Given Russia's particular history, even such a limited comparison is difficult to make, but if one does, Russia (June 2003) emerges as more concentrated than any comparator country, with 60 percent of its stock market controlled by ten owners, followed by pre-1997 crisis Indonesia (58 percent) and then economies such as Korea (37 percent), Singapore (27), or Taiwan (18) (continental Europe is in the 10-25% range), followed by high-income countries such as the US (2.8, for the richest 15 families), or Japan (2.4). A slightly less scientific but instructive way of comparing Russia with other countries is to look at its listing of 26 billionaires (according to Forbes magazine): only Germany and the US have more, but the total wealth of all 275 billionaires in the US is less than 7 percent of GDP (the top 26 are 4 percent), whereas the 26 Russian billionaires are said to control wealth equivalent to approximately 19 percent of GDP.

to protect market competition. And in Russia, as everywhere, the task of effective antitrust legislation is to protect market competition, but not to restrict ex-ante the size or any market based actions of certain companies, be they large or small.

Further, these rules, and the policies guiding competition, have to be binding for all players, private as well as state-owned. The need for secondary markets and institutions that could support faster consolidation on the firm level confirms the need for a clear set of rules of engagement, the development of an independent court system, and support for competition from abroad in order to guarantee efficient competition on domestic markets. The conclusion that a rule-based system is necessary to safeguard competition at all levels of

the economy (among new entrants as well as large concerns) is the opposite of advocating the arbitrary "guerilla warfare" against "big" business that in the perception of many has taken hold in Russia. In order for rules and institutions to protect markets, they must apply to all players alike, be they public bodies or private owners.

Against this background, any review and potential revisions of previous privatization are inadvisable. It is unclear who would be the judge under present circumstances, and it appears all too clear that re-privatization, if intended, could not be organized any more fairly a second time around. No potential gain from re-nationalization could even remotely offset the damage to the security of property rights, which such a maneuver would entail. □