ICEG EUROPEAN CENTER

NEWS OF THE MONTH

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Budapest, Hungary, Phone: +36 1 248 1160, +36 1 319 0628 Fax: +36 1 248 1161
E-mail: office@icegec.hu Website: www.icegec.org

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TOURISM – TREASURY OF SLOVENIAN ECONOMY

After years of steady growth, the tourism industry slowed down in Slovenia. In the first 8 months of 2006 tourist arrivals increased by 1% compared to the same period of the previous year, while overnight stays stagnated. Foreign tourists maintain the achievement of the tourism industry as the growth from January till August reached 2% concerning tourist arrivals and 1% concerning overnight stays, compared to the stagnation of the number of domestic tourists and a 1% decrease of overnight stays.

TOURISM, AS A LEADING SECTOR

Slovenia is a country of contrasts and diversity with its Adriatic beaches, the Alpines and thermal springs. Slovenia exploited these favourable conditions, thus tourism became one of the best performing and most important industries of the Slovenian economy.

According to the World Travel & Tourism Council (WTTC) the total demand in tourism in Slovenia will reach USD 6746.3 million in 2006 and it will grow to USD 13027.4 million by 2016. The real demand growth in 2006 was estimated to 7.4% which will continue in the following 10 years at an average of 4.4% growth per annum. The contribution of the tourism sector to the Slovenian GDP is estimated to 3.4% in 2006. According to the estimation of WTTC, this share will remain constant until 2016. However, including other branches supplying the tourism sector, the total (direct and indirect) economic effect reaches 14.6% in 2006 and will grow by 0.9 percentage points by 2016. The share of employees working in the tourism industry will reach 5% in 2006 in the country, but complementing it with the employees of the supplier sectors, the total share of employment will amount to 16.9% in 2006, which is a record since 1990, when the share of employment was only 11%. The growth trend will continue in the coming 10 years, and the contribution to employment will reach 17.6% by 2016.

UPS AND DOWNS

The Slovenian tourism sector experienced a throw-back after the middle of the eighties concerning both the number of tourist arrivals and overnight stays. Between 1985 and 1995 the number of tourist arrivals decreased by 42.7% parallel to a 33.4% decrease in the number of overnight stays. Interestingly, domestic tourism was boosted in this period, as the number of domestic tourist increased by 12.7% while the number of overnight stays grew by 29.6%. The reasons for the negative trend are twofold. Firstly the Balkan war and the following huge political instability of the region frightened foreign tourists. Secondly, the stabilization of the Slovenian economy (appreciation of the Slovenian Tolar) and the process of privatization and denationalization hindered the development of tourist facilities and services. The trend turned in 1995 and the industry increased year by year, however, the number of tourist arrivals and overnight stay is still under the level of 1985. The growth originated from the increase of foreign tourism as domestic demand decreased by 5% both in case of tourist arrivals and overnight stays between 1995 and 2005.

Since domestic tourists spend longer holidays in their home country the average length of stay reached its maximum in 1995, when tourists had on average 0.7 days longer holidays compared to the average of 3 days in 1975. Foreign tourists had 0.8 days shorter holidays than their Slovenian counterparts in 2003. As the length of domestic holidays is increasing (from 3.81 to 3.9 days between 2003 and 2006) while the length of foreign holidays is decreasing

(to 2.87 days), the gap increased in the last four years and reached 1.03 days in the first 8 months of 2006.

Table 1. Changes in the Number of Tourist Arrivals and Overnight Stays 2003-2006

	2003	2004	2005	2006*
Tourist arrivals	4%	4%	2%	1%
domestic	2%	-3%	0%	0%
foreign	5%	9%	4%	2%
Overnight stays	2%	1%	0%	0%
domestic	1%	-3%	-2%	-1%
foreign	4%	4%	1%	1%

**the first 8 months of the year*
Source: Slovenian Tourist Board

The most attractive tourist destinations concerning tourist arrivals were mountain resorts (having a share of 25.5%), followed by health and seaside resorts (23.4% and 21.7%) in 2005. However comparing the different types of resorts the capital Ljubljana showed the most dynamic growth between 1998 and 2005, as the number of tourist arrivals grew by 102%. In case of overnight stays health resorts (32.3%) are at the first place, followed by seaside and mountain areas (25.7% and 24.1%). As a result of increased tourist inflow, Ljubljana achieved the highest growth (79%) in the number of overnight stays in the last seven years.

The longest holidays were spent in health resorts (4.6 days) in the first eight months of this year, followed by seaside and mountain resorts (3.8 and 3 days). Health and seaside resorts have experienced a decrease in the average length of stay since 1980, while the capital and mountain resorts only since the beginning of the nineties. The most serious throw-back effected health resorts, where the average length of holidays decreased by 3.5 days between 1980 and 2004. Despite this negative trend health resorts had the best occupancy rate in 2005 (47%) and only seaside resorts (33%) and Ljubljana (31%) could achieve around the country average of 32%.

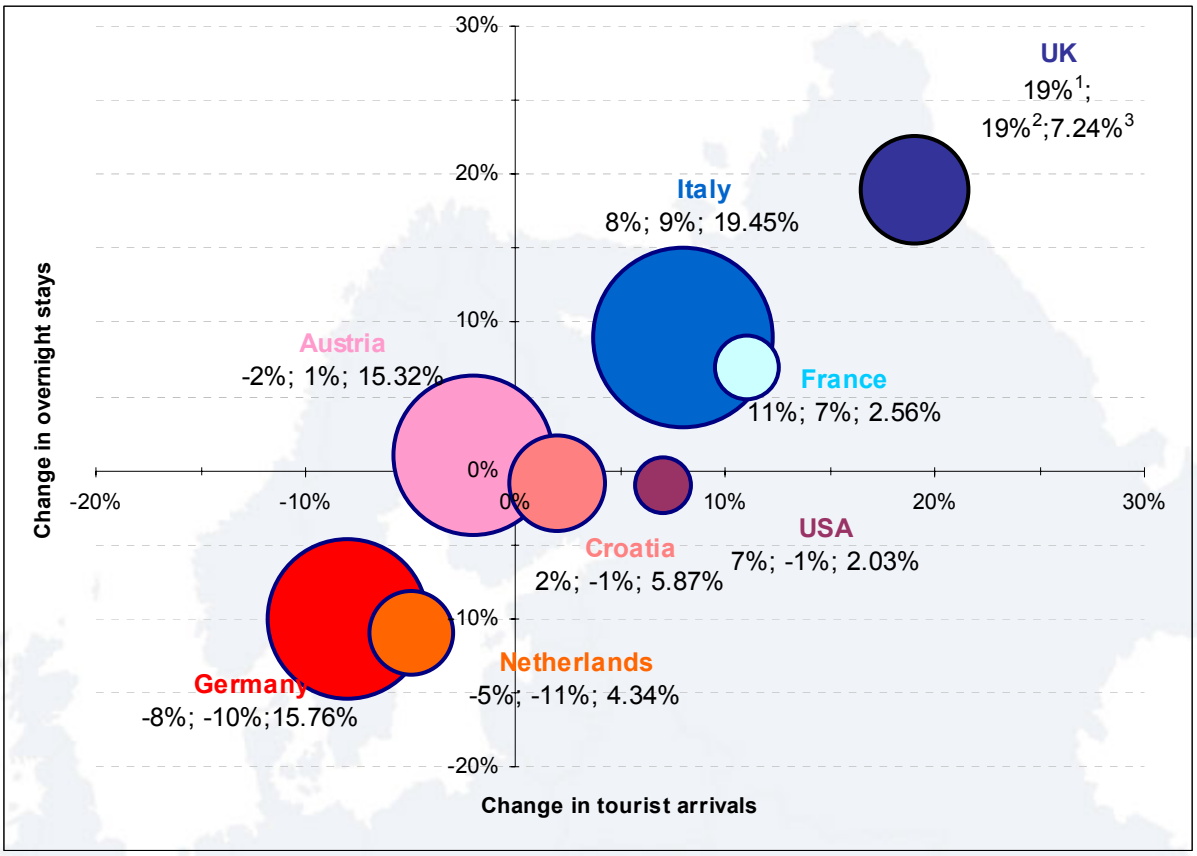
The most common accommodation used by tourists are hotels (over 60% of overnight stays), followed by camping sites, apartments and private accommodation concerning both tourist arrivals and overnight stays. However, the most dynamically growing accommodation types were apartments between 1998 and 2005. While hotels had an occupancy rate of 47% in 2005, only apartments exceeded the country average by 3 percentage points.

The share of foreign tourism is significant concerning both tourist arrivals and overnight stays. The proportion of foreign tourist arrivals grew by 4 percentage points between 2003 and 2006 to 65.35%. The domination of foreign tourists was not always so explicit, as during the war period their share in tourist arrivals dropped to 47% in 1995. The recovery is rather slow as foreign tourist arrivals have not reached the peak of 73% of 1985 yet. The same trend is observable in case of overnight stays, however, the share of nights spent by foreign tourists is a bit lower (58.1% in 2006) compared to their share in tourist arrivals. The record share of 70% in 1985 could be reached in case the negative trend of domestic tourism will continue.

Most foreign tourists come from the neighbouring countries such as Italy, Austria and Croatia. 40% of foreign tourist arrived from these three countries in 2005. Germany and the United Kingdom are two other important consumers of Slovenian tourist services concerning both tourist arrivals and overnight stays. However, the significance of German tourists is

decreasing, while the United Kingdom seems to be the future market for Slovenian tourist packages, as it almost doubled its share of foreign tourists in Slovenia between 2003 and 2006.

Chart 1. Development of Foreign Tourism between 2004 and 2005 in Slovenia*



**The figures shown in the chart represent the change in the number of tourist arrivals[1] and overnight stays[2] of some foreign countries in the period and their market share[3] in relation to the number of foreign overnight stays*
Source: Statistical Office of the Republic of Slovenia

Despite their low share in tourist arrivals, Russian guests spend the longest holidays in Slovenia: the average length of stay was 6.51 days in the first 8 months of 2006. Except for Italy and Croatia the average length of holidays dropped by 0.2 to 0.6 in the countries presented in *Chart*, and only Dutch tourists reach more than half of the length of Russian holidays (3.54 days).

EXPECTATIONS

The Slovenian Ministry of Economy formulated a strategy of Slovenian tourism for the period between 2002 and 2006. The most important objectives set in the strategy were remodelling Slovenia as a transit state to a country with predominantly stationary tourism; reaching the dual value of the annual economic growth of Slovenia; increasing the number of overnight stays by 7% yearly until 2006 and increasing the occupation rate of hotels to at least 50% by 2006. However, none of these objectives were accomplished as the average length of (foreign) holidays was decreasing during these four years, which means, that foreign tourist still recognize Slovenia as a transit country. The maximum growth rate was reached in the number of tourist arrivals (4% in 2003 and 2004), which is not double as high as GDP growth, as even the smallest yearly real growth rate of GDP amounted to 2.7% between 2002 and 2006. The

yearly growth rate of overnight stays was mainly stagnating in this period and the occupancy rate of hotels was still 3% below the target in 2005.

As a new strategic period is approaching, the Slovenian government should rethink its measures in order to improve the achievement of the tourist sector. Based on the strengths of Slovenian tourism, such as the country's traffic and geographic position, the variety, attractiveness and accessibility of natural environment and the disperse and relative smallness of tourist centres instead of mass tourism, the number of tourists (not only from neighbour countries), the length of average holidays (especially in case of foreign and health tourism), and the occupancy rate could be improved in the coming years. In order to reach these objectives, tourist offers should be better connected, the quality and quantity of accommodations should be increased, especially in case of mountain cottages, youth hostels and camp sites, traffic infrastructure should be developed also in regions far from Trans-European transport corridors, winter tourism facilities needed to be improved and last but not least the tourist informational system should become more integrated. As Slovenia is a relative undiscovered and untraditional tourist destination in Europe and the economy of the European Union is expected to be dynamic in the coming years, it is not an unrealistic goal to reach the achievement of the seventies and eighties until the end of this decade.

TRANSFER PRICING IN HUNGARY

One of the latest important issues regarding taxation is the question of transfer pricing in the New Member States (NMS) and in Community of Independent States (CIS) region as well. In the US and developed countries in West Europe, transfer pricing is taken seriously for a long time. NMS and CIS tax authorities seem to realize that appropriate rules and regulations may result in higher tax receipts, so they take transfer pricing documentations more serious than before.

The phenomena of transfer pricing is in connection with corporate taxation, as it influences the tax base of corporate tax. If transfer prices are below normal market prices, the corporate tax base can be reduced with the difference of the charged prices and arm's length prices. If they are higher, the tax authority increases the tax base with the difference.

The main purpose of a transfer pricing report is to prove that transactions of a company are in compliance with the arm's length principle. According to OECD Guidelines, arm's length principle means: conditions made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. Then any profits that would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

THEORY

As a definition, one can state, transfer pricing rules are about transaction between related parties. Especially in the case of international transactions, a company group has the opportunity to optimize its tax burden with influencing the prices charged for raw materials, goods, services etc. The two entities operate in two different countries with two different levels of corporate taxes. The parent company's country – where the corporate tax is higher – opens an affiliate in another country – where corporate taxes are significantly lower. As they are related parties, the parent company has the opportunity to sell and buy raw materials, goods, services, intellectual properties etc. at such a price, that the highest tax base would appear in the country where tax rates are lower. This process is shown below in Chart.

Chart 2. Transfer Pricing in Theory

Note: CT = Corporate Tax
Source: Own Chart

An example shows how the companies can affect profit allocation in order to minimize their tax burden. (*See Table below*)

3 cases show how an international company can allocate its profit between two countries in order to increase profit after taxes with the overall gross profit not changing.

Affiliate in country B purchase raw materials from its parent company in country A at a certain price of 300. Than affiliate sells the goods back to the parent company, who sells it the final consumers for 1000. The overall profit is the same in the 3 cases, but depending on the transfer prices, allocation of the profit differs. The more profit can be allocated to the country with lower taxes, the more the overall taxed profit will be.

Table 2. Transfer Pricing Example

		Country A (CT = 45%)			Country B (CT = 12%)			Overall Profit
		Buy	*Sell*	*Profit*	*Purchase*	*Sell*	*Profit*	
Case 1	Turnover	500	1000	500	300	500	200	700
	Taxed Profit			**275**			**176**	**451**
Case 2	Turnover	750	1000	250	300	750	450	700
	Taxed Profit			**137,5**			**396**	**533,5**
Case 3	Turnover	900	1000	100	300	900	600	700
	Taxed Profit			**55**			**528**	**583**

Source: own calculations

From this point of view, transfer pricing can be seen as the lowest level of international tax planning. Because of it, tax authorities and especially OECD turned their attention towards these transactions already in the 1960s. Nowadays, in most of the developed countries, every company that deals with related party transactions must have a documentation with the company can prove that the prices charged for related transactions are arm's length – in case of a tax investigation.

BACKGROUND – LAW IN HUNGARY

Some countries – especially developed ones, where tax burdens are usually higher – could lost huge amount of tax incomes, so authorities started to regularise transfer prices in the form of guidelines, international treaties (both bilateral and multilateral), decrees and acts. Hungary also has laws related to the phenomenon. In Hungary, the following should be taken seriously, when preparing a transfer pricing documentation.

Corporate and Dividend Tax Act

1996. LXXXI. Act about corporate tax and dividend tax was the first act mentioning the fact that transfer pricing documentation must be obligatory, when it was amended in the year 2002.

As the 1§ of section 18 of the corporate and dividend tax act says: „if in the business contracts between affiliated companies a higher or lower consideration is applied….than the consideration enforced….via independent parties under comparable circumstances, the taxpayer…..takes the difference between the customary market price and the consideration applied and deducts it from the pre-tax profit, provided the consideration applied renders the pre-tax profit greater than it would have been had the customary market price been applied, and adds it to the pre-tax profit….if the consideration applied renders the pre-tax profit lower than it would have been had the customary market price been applied"

OECD Transfer Pricing Guidelines

The first version of the OECD Guidelines was published in 1979, „the principle article". Two major amendments were made (1984, 1987) in order to get the guidelines more sophisticated and more accurate. Every OECD country uses this as a basic for a transfer pricing report. It includes the different types of methods how to calculate an arm's length price for different types of transactions. Two basic methods can be mentioned:

- Traditional Transactional Methods
  1. Comparable Uncontrolled Price method (CUP)
  2. Resale Price method (RP)
  3. Cost Plus method (CP)
- Transactional Profit Methods
  4. Profit Split method
  5. Transactional Net Margin Method (TNMM)

According to the guidelines, traditional methods are prior to profit methods. The first three methods are more appropriate than the other, because they are based on gross margin data, and thus, indirect costs can be also measured more accurately. Companies operating in Hungary usually do not have gross margin data, as Hungarian accounting legislation do not prescribe it as compulsory. Therefore, in Hungary, TNMM method is the most commonly used method. The essential parts of documentation must be the followings:

- Functional analysis – functions undertaken by the company
- Industrial analysis – main characteristics of the market where the company conducts its business
- Company analysis – structure of the organisation, history of company, ownerships
- Benchmarking – finding the appropriate method, finding comparable companies and setting up an arm's length range

Decree of Ministry of Finance

The 18/2003 Decree of Ministry of Finance contains the rules of transfer pricing in Hungary, and the obligations for a transfer pricing documentation. According to Article 4 in the decree, the followings should be included:

- The company's name, address, tax identification number etc.
- The contents of the agreement
- Assets, business activity, risks of the company
- Description of the market concerned and its characteristics
- The method used to determine the arm's length price
- Circumstances that influences the prices charged by the company

Companies operating with a turnover less than HUF 50 million should only have a simplified documentation.

ACTUALITY IN HUNGARY

From 1 January 2007 Advanced Pricing Arrangement (APA) will come into force, which means that companies can ask tax authority to determine the arm's length price for the future regarding transactions of the company. That means, if the Hungarian Tax Authority (APEH)

can bargain for higher transfer prices with other tax authorities regarding APA, millions of tax amounts would stay in the country.

TAX ADMINISTRATION

Transfer pricing documentations are of high attention in the last couple of years and will be in the future more serious. Tax Authority investigations will be more and more accurate and detailed and the absence or incompleteness of the reports will imply heavy penalties. The fine can reach up to HUF 2 million in such circumstances.

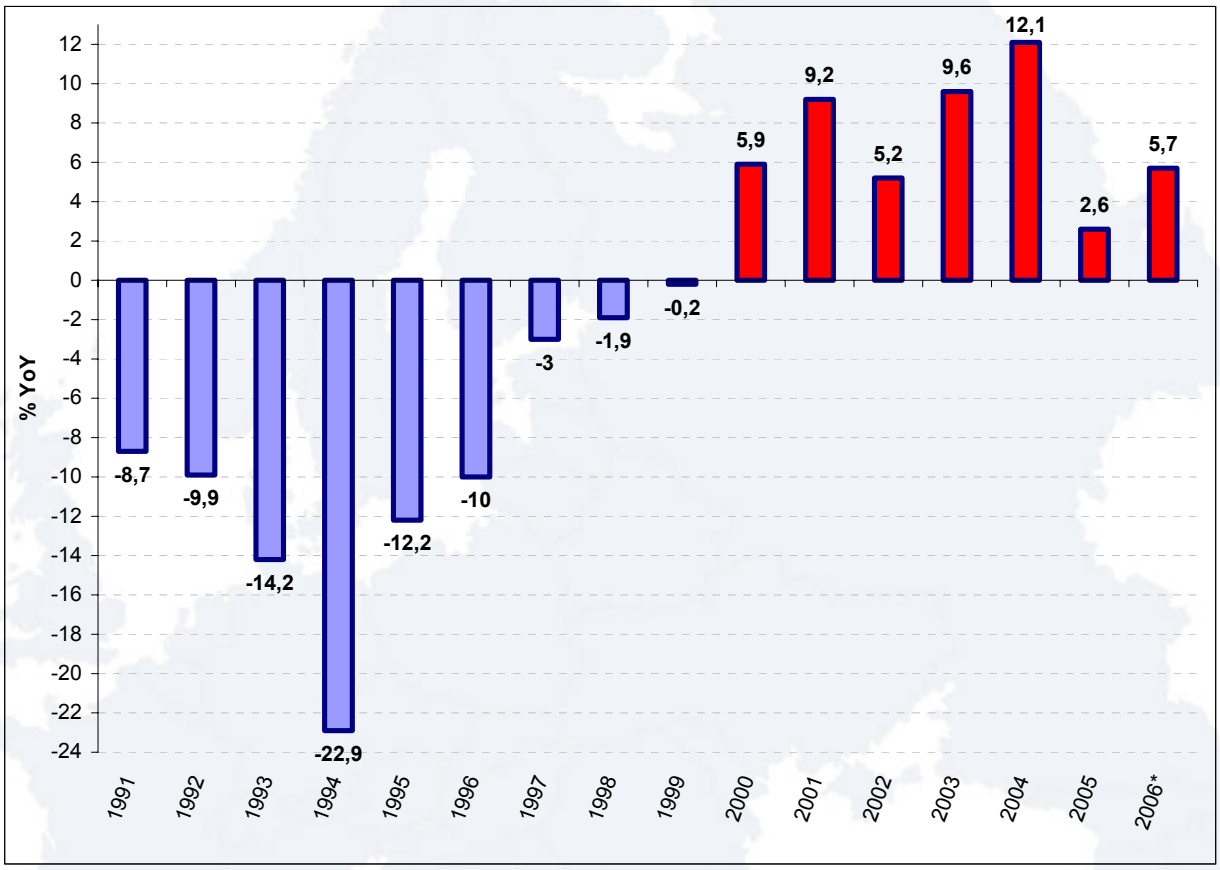
Hungarian Tax Authority has some fallback concerning transfer pricing issues, but as it is a hot issue in taxation, the authority deals with it ever harder. Future expectations are that companies will have to have more sophisticated and well structured documentations, which fulfil the requirements of the OECD Guidelines and comply with Hungarian legislation perspective.

REGENERATING UKRAINIAN ECONOMIC GROWTH

After record high real GDP growth of 12.1% in 2005 and after a considerably lower 2.6% in 2005, Ukrainian growth seems to recover. In May, June and July the monthly year on year growth rates were 8.5%, 9.3% and 7.7% respectively. In January-August 2006 the real GDP growth was 5.7% as compared to the same period of the previous year.

After almost a decade of uninterrupted decline of GDP, Ukraine experienced first year of output growth in 2000, real GDP increased by 5.9% year-on-year.

Chart 3. The Ukrainian real GDP growth 1990-2006



**by expectation*
Source: State Statistics Committee of Ukraine

Consecutive growth rates show high volatility and vulnerable economic background as it is remarkably influenced by different shocks. The structure of economy is not balanced and diversified adequately and technically obsolete. Influences of political changes on the economic cycle in the country are still too significant compared with democracies on the west.

COMPOSITION OF GROWTH RECOVERY

As concerns the nature of supply side of the GDP, with exception of agriculture, education, healthcare and social assistance, almost every important branches of economy were able to increase its output in real terms. However the main pulling factors were mining and quarrying (6.2%), electricity, gas and water supply (7.4%), construction (7.1%), wholesale and retail trade (13.2%) and transport (8.9%). The biggest branches, like manufacturing brought a

stable, closed to average peace of growth. Agriculture experienced in the current year 2.6% fall in the first eight months, due to lower harvest of grain.

Table 3. Development of GDP by Main Activities in January-August, 2004-2006

Activities	Jan-Aug 2006	Jan-Aug 2005	Jan-Aug 2004
Agriculture, hunting, forestry	97,4	102,5	131,6
Mining and quarrying	106,2	103,1	106,7
Manufacturing	105,2	103,5	116,6
Electricity, gas and water supply	107,4	102,9	98,3
Construction	107,1	92,3	124,6
Wholesale and retail trade; trade in transport vehicles; repair services	113,2	95,7	121,3
Transport	108,9	106,1	110,3
Education	103,2	105,2	106,4
Health care and social assistance	102,3	104,7	105,2
Other sectors of economic activity	105,3	107,4	105,4
Gross domestic product	**105,7**	**103,7**	**113,5**

Source: State Statistics Committee of Ukraine

Industrial output in the first seven months of 2006 rose by 5.5% as compared to the same period of previous year with the contributions of extraction of non-energy resources (9%), manufacturing in food industry and processing of agricultural products (7.1%) and especially with recovery of external demand on metallurgy and metal processing (8.6%) and machine building (11.9%) that experienced sharp fall in recent overall slow growth period.

In the demand side a favourable structure of growth is observable. In the first six months of 2006, investments in fixed capital increased by 12.2% year on year. Investments prove the base of sustainable growth through rebuilding capacities of further economic development. Especially favourable the investment growth in manufacturing by more than 11%, as this industry attracts almost 40% of all investments. Another 20% of all investments flew to transactions with real estate, letting and services to legal persons with a 23.5% y-o-y increase in the first half. Capital invested in agriculture increased by 65%.

Private consumption remains main contributor to growth not only with its weight on the consumption side of GDP, but also in its peace of growth. Household expenditures increased by 32.7% in first seven months of 2006 as compared to same period of 2005, mainly due to increasing household income related to social and wage policy expansion and to developing financial market services ensuring wide range of crediting. Average monthly wages increased by 22% in the first eight months. This consumption mainly directed on higher demand on non-food products.

Regarding to external demand's contribution on the use side of GDP, slight recovery is observed after double digit export fall in 2005. In January-August 2006, total exports increased by 7.9% while total imports by 21.2% as compared to the same period of 2005. Exports into the CIS region increased by above the average 10.3% and to America by 36%, while imports from outside the CIS increased by 25.5% (mainly from Europe and from Asia). As of commodity structure, exports were pushed by export of base metals and preparations (43% of total exports), it rose by 9.1%. Exports of machines and equipments (weight in total exports 8.1%) and of products of chemical and allied industries (weight in total 9.1%)

increased by 8.9% and 15.5% respectively. Imports, however, henceforward depend on inflow of mineral products (31.5% of total imports), within this group especially on import of mineral fuel, petroleum, crude oil and natural gas. Import of natural gas increased by 17% mainly because of increasing price of gas. Import of ground, air and water transport facilities increased by 68% (weight of 11.3%), machines and equipment by 18% (weight of 10.9%). External demand contributed to growth pretty well.

SPECIAL CIRCUMSTANCES OF UKRAINIAN ECONOMY

The gas misery of Ukrainian economy has several dimensions as it has affected its growth components considerably. The import rise and the widening of current account deficit are mainly originated from change in agreed gas price. The main contributor to export performance in Ukraine is the metallurgy and the heavy industry, and also the chemical industry that is adversely affected by gas price increases. However the price boom encourages of economy to shift into a more healthy structure and to increase technical level and efficiency of gas depending branches, ensuring growing productivity.

Politics and political uncertainty means sluggish economic performance, as it is seen through investigation of last one and half year. Ambiguity concerning political intentions coming from different sides, like privatization revision, uncertainties around property rights, threats around breaking the country. However the Ukrainian political situation seem to be in dwell, as the two antagonistic sides of Ukrainian parliamentary powers signed a Unity Pact in August, that determines the major basics of internal and external policy.

SUSPICION OF DUTCH DISEASE IN RUSSIA

Since the 1998 crisis, Russia ended 2005 with its seventh straight year of economic progress with an average annual GDP growth rate of 6.4%. Recently, the country's external balances have improved considerably too, together with a significant increase in foreign reserves. A huge budget surplus even made it possible for Russia to start repaying significant part of its external debt. However, it is obvious that much of these results can be attributed to a single sector: fuel production and the production of oil in particular. The present favourable macroeconomic situation of Russia is quite unsteady as it depends heavily on the performance of its oil industry.

Nevertheless, from other side the above mentioned structural uniqueness of Russian economy threatens analysts of arising of so called Dutch Disease.

NOTION OF DUTCH DISEASE

Dutch disease is an economic concept that intends to explain a relationship between the exploitation of natural resources and a decline in the manufacturing sector. The theory is that an increase in revenues from natural resources will de-industrialize a nation's economy by raising the exchange rate, which makes the manufacturing sector less competitive. However, it is difficult to say that Dutch disease is the cause of the decreasing manufacturing sector, since there are many other factors at play in the economy.

This was the case in the Netherlands after having discovered enormous gas deposits in the North Sea in the 1960s. The Dutch guilder experienced a vast appreciation pressure due to income inflow that made stronger currency and thus the ratio of exchange changed. This influenced badly competitiveness of non-oil-gas exports. Among others (factor redistribution among booming and lagging sectors) it caused serious problems for Dutch economy as a whole.

While the phenomena of Dutch disease most often refers to natural resource discovery, it can also explored in connection with large inflow of foreign currency, including a sharp surge in natural resource prices, foreign assistance and foreign direct investment.

The channels of such phenomena are the resource movement channel and the spending channel. The first refers to that case when the resource boom increases the demand for other factors (like labour), which causes production shift from non-oil-gas tradable to oil-gas tradable sector. The second is related to that case when as a result of extra receipts its increases the demand for labour in the non-tradable sector, attracting labour from the non-oil-gas tradable sector. As an outcome of increased demand for non-tradable sector goods its prices increase, while prices of tradable sector are determined internationally. In result the real exchange rate appreciates. (*Corden W.M., Neary J.P. (1982). "Booming Sector and De-industrialisation in a Small Open Economy." The Economic Journal 92 (December): 829-831.*)

CASE OF RUSSIA – OIL AND GAS DOMINATED ECONOMY

As concerns of the role of oil in the economy, the Russian Federation responsible for more than 12% of world's total oil production that makes Russia ranked second worldwide after Saudi Arabia (13.5%), while in natural gas production Russia posses the first place with its

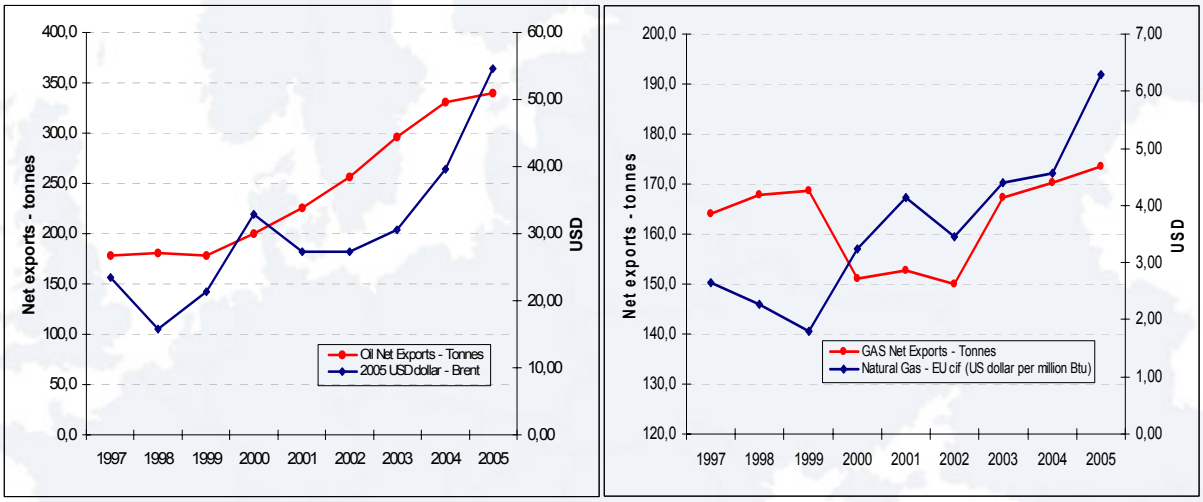
21.6% share in total. In the same time Russia disposes of 6.5% of oil proved reserves, and 26.6% of natural gas proved reserves. (*Data source: BP 2006*)

The gap defined by difference between the production and consumption increased during the period of 1998-2005, as parallel with the annual average 7% increase of production the consumption have been stagnated, thus the net exports increased in average annually by more than 10%. This means that from 1997 to 2005, Russia managed to double its net exports of oil. The production and consumption of gas is more hectic.

However the oil net export increase is in line with price developments that made efficient to extract Russian type oil reserves. In case of natural gas difficult to identify such trivial connection, but this is in line with nature of gas consumption.

Approximately 80% of all Russian exports were natural resources, while 55% were from oil and gas sector in 2003. Thus Russian GDP growth - facilitated mainly by the export performance that heavily depends on natural resources (especially on oil and gas industries) – is in clear connection primarily with oil and in lesser extent with natural gas price developments.

Chart 4. Prices and Russian Net Exports of Oil and Natural Gas 1997-2005



Note: Oil net exports and price development on the left side, natural gas net exports and price on the right side
Source: BP Statistical Review of World Energy 2006

According to World Bank estimation, oil and gas sector accounts for up to 25% of the GDP in 2003, while employing less than 1% of the total population. Another IMF study came out with the finger rule: USD 1 per barrel Ural blend oil price increase for a year is estimated to raise federal budget revenues by 0.35% of the GDP, consolidated budget revenues by 0.45% (*Source: IMF Working Paper Wp/05/241*)

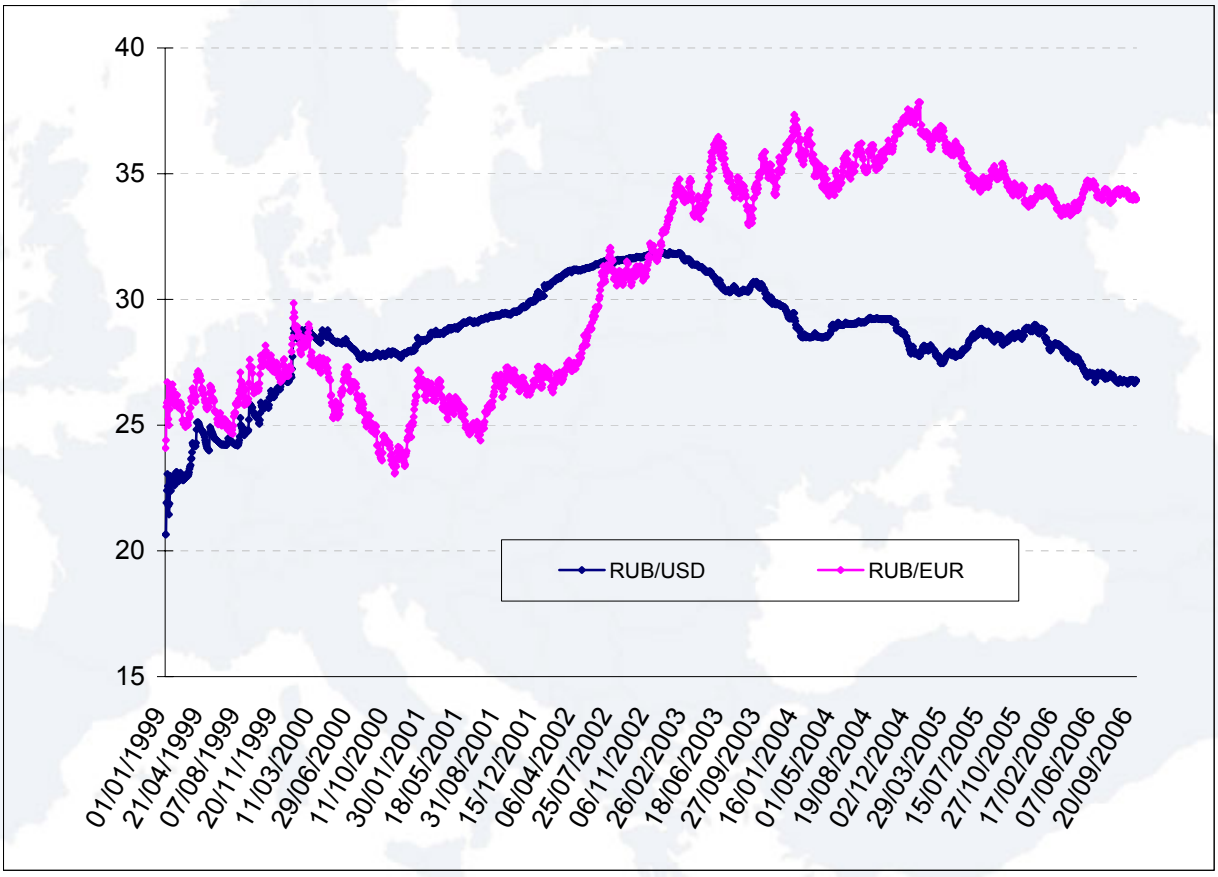
SYMPTOMS OF THE DISEASE

It is difficult to recognize the Dutch disease as the reasons behind exchange rate appreciation, decline of manufacturing sector, changes in real exchange rates and the relationship between all of mentioned are difficult to prove. However it is possible to determine whether is there a room for suspicion of having the phenomena called Dutch disease.

The share of mineral products in export increased from 57.8% in 2004 to 64.6% in 2005. By Goskomstat (Statistical Office of Russian Federation), more than 50% of total exports were oil and gas products in the first 8 months of 2006. In January – August of the current year the crude oil exports increased by 35.7% as compared to the same period of the previous year. The same data for the natural gas exports is 44.2%. Both of oil and gas exports increased above the average of export rise.

Accelerating receipts on oil and gas foreign trade likely put high pressure on the Russian currency that has been appreciated against the US dollar mainly as a result of oil price rise. By an estimation, the pressure becomes effective above the price per barrel of 30 USD. When the RUB/USD exchange rate trend changed and the rouble started to appreciate in the beginning of 2003, the Ural type oil price fluctuated around 25-27 USD per barrel and this time was the starting point for the oil price of fast increase. The RUB/EUR exchange rate is more volatile as it is not directly targeted by Bank of Russia, it stepped into a trend of appreciation in the beginning of 2005, mainly as a result of oil export denomination, that eased the pressure on the RUB/EUR exchange rate. This means that the rouble appreciation and its possible negative effects on economy are mainly the problem of last 3-4 years.

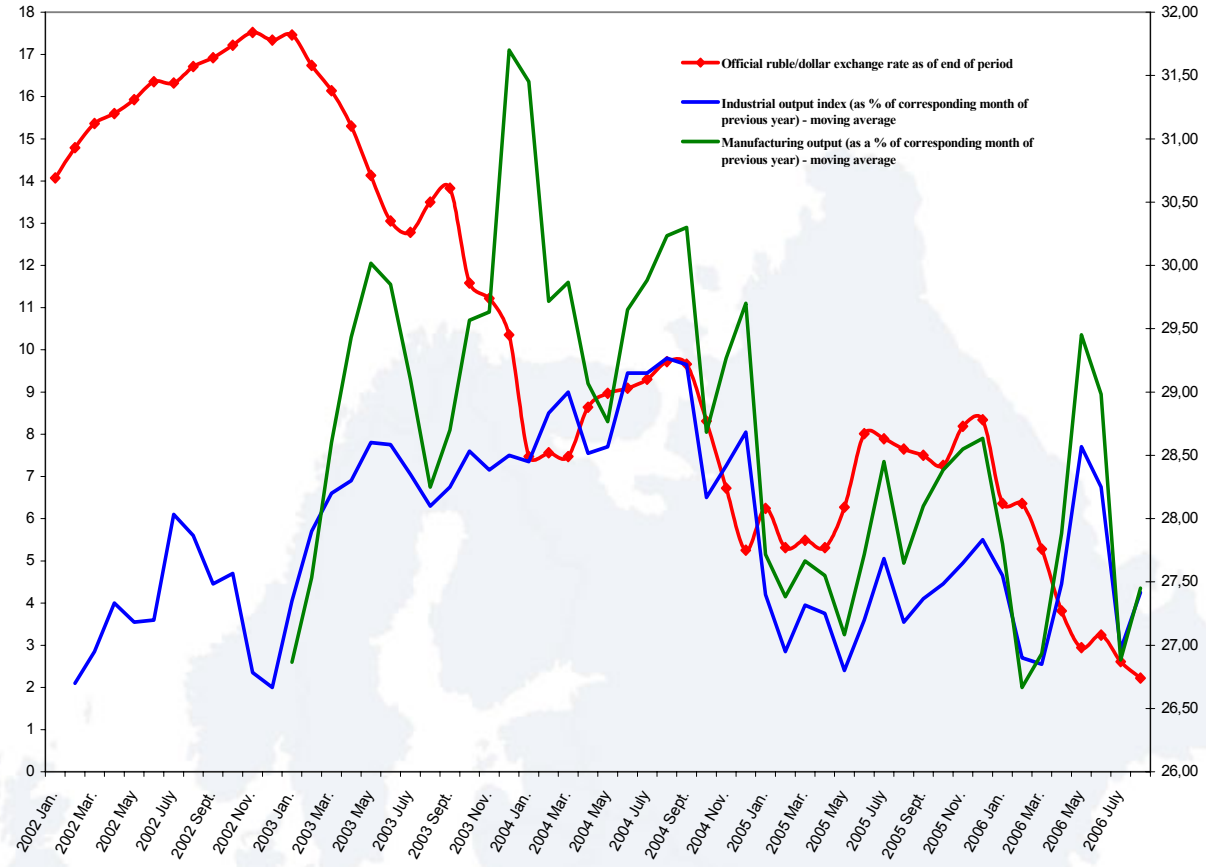
Chart 5. Exchange Rate Developments 1999-2006 (daily official exchange rate)



Source: Bank of Russia

As concerns the industrial and especially manufacturing sector performance that is obviously affected by developments of the ratio of exchange in international economic relations, development of industrial production index and manufacturing output make likely some correlation with the exchange rate developments.

Chart 6. Development of Exchange Rate, Industrial and Manufacturing Output Index



Note: Data on Manufacturing Output is 2003-2006
Source: Bank of Russia, own calculations

By investigation of related data, one can state that we have the symptoms of phenomena called Dutch disease. It seems that through the trade channel - because of the high oil prices - exchange rate appreciation (and also the real exchange rate appreciation) is in process that worsens the positions of national manufacturing sector through two channels, but mainly through increasing competitiveness of imports that crowd out local production.

Additional factor that underpins our suspicion of having the disease is the predominant share of fixed capital investments generated in the oil and gas related sectors.

PROBLEMS AND SOLUTIONS

The oil and gas generated growth is unsustainable. In case of running out from extracting or transporting capacities it is not possible immediately to shift growth from the oil and gas sector to the manufacturing sector. As investments and other production factors are moving to the booming sector, capacities and technological level of lagging (usually manufacturing) sector stabilizes on unsatisfactory.

As it is clear from definitions, two solutions are possible to counteract the negative effects of Dutch disease: to keep stable the exchange rate or to increase competitiveness of manufacturing sector.

The stable exchange rate can be achieved by strong continuous intervention on the forex. It is also a question whether it is possible to sterilize the oil and gas export revenues. Bank of Russia was not able or intended to keep the exchange rates stable however by heavy interventions it caused excess liquidity and this way inflation.

The other possible solution is in hands of fiscal policy. The oil and gas sector proves extra revenues for the general government as well that can give possibility for fiscal policy to counteract the negative shocks affecting particularly manufacturing, but also other important sectors. The Russian Federations attempt to solve this problem came into force in 2004, when an automatic saving mechanism has directed unexpected fiscal oil windfalls into the so-called Oil Stabilization Fund (OSF).

These extra fiscal revenues has to prove room for decreasing tax wedge of local industries, to prove investment resources for manufacturing industries to increase technological level, to improve infrastructural availability, to invest into education, and to back the structural reforms still needed. Nevertheless the risk of government failure arises.